Seeking Meaningful Nonprofit Reform in a Post Sarbanes-Oxley World

Danné L. Johnson
Oklahoma City University School of Law, djohnson@okcu.edu

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SEEKING MEANINGFUL NONPROFIT REFORM IN A POST SARBANES-OXLEY WORLD

DANNÉ L. JOHNSON*

PRELUDE

John’s Morning¹

I don’t like her. I am smart and I do not forget. I do remember. At 8 o’clock I eat my first meal today that was fruit loops with sugar and milk. No bananas, where are the bananas. I make it myself.

I was at the table in my room and Nathan, my friend, came to share. We eat and laugh. At 9 o’clock I brush my teeth. 1. Water, 2. toothpaste, 3. spit, 4. drink, and I can watch TV. But my TV don’t work. I go to the big room downstairs for TV. I am first. I see my show and I sit in the big chair. It is not too quiet. I want quiet. Lots of talking. My show is funny. I laugh. No one makes me quiet. They can’t see me.

I want an apple. No apple. Where is the apple? I get a tuna fish on bread. Lunchtime. Not so good. Miss Lisa make me eat and I make a happy plate. I want more. Miss Lisa say I will get a snack if I go and get dress. I want my apple.


I wait. Count 1, 2, 3, 4. Miss Lisa walk away. I tell Miss Tina my apple. She mad at me. She say I not smart. She mean. I remember my apple. I don’t get nothing.

* * * * *

* Associate Professor of Law, Oklahoma City University School of Law; former Chairperson of the Board of Directors of one of the largest nonprofit organizations in New York. The author wishes to thank friends and colleagues whom she met while working as a nonprofit board chairperson including John Courtney, Co-Founder, Partnership for Family Supports and Justice at the Fund for Social Change, and Bonda Lee-Cunningham, Director, Members Services, Federation of Protestant Welfare Agencies. She would also like to thank Anahaita N. Kotval, Managing Director and General Counsel, RBS Global Banking and Markets Americas, former Oklahoma City University School of Law students, Siobhan Barbee Acker, and Amy Buehrle, for research assistance, and Oklahoma City University for its support during the writing process.

¹ John is a fictional character.
This is just a short part of John’s narrative about his life as a mentally retarded adult living in an independent living facility. John is ignored and left to his own devices from the time that he awakes until one in the afternoon. John’s experiences are typical, but they should not be. He is vulnerable to the facility’s other residents, staff, and third party providers. People do not properly attend to John’s needs, and his interaction and activity levels are low.

In New York, the Office of Mental Retardation and Developmental Disabilities (“OMRDD”) states its mission to be:

[T]o develop programs to further the prevention and early detection of mental retardation and developmental disabilities; to develop a comprehensive, integrated system of services which has as its primary purposes the promotion and attainment of independence, inclusion, individuality and productivity for persons with mental retardation and developmental disabilities; to serve the full range of needs of persons with mental retardation and developmental disabilities by expanding the number and types of community-based services and developing new methods of service delivery; and to improve the equity, effectiveness and efficiency of services for persons with mental retardation and developmental disabilities by serving persons in the community as well as those in developmental centers, by improving the conditions in developmental centers, and by establishing accountability for carrying out the policies of the State with regard to such persons.2

* * *

Jeffery’s Afternoon3

I’m going to run right out to Starbucks for a venti caramel latte with no foam. It’s three in the afternoon and I just need to hang in here for a few more hours then I’m off to my board meeting. It’s funny how I got hooked up with the board in the first place. I’m thirty and looking for meaning in my life; I wanted to work in the community and to use my education for good. I’m a do-gooder.

After I took a course on how to be a board member, I was placed on the board of a nonprofit agency that focuses on child development and other things. There are numerous programs and sites. I have been on the board for two years, and I still don’t know all of the stuff that we do. The board meets three times each year, and we have a killer holiday party. We always get a band, and the food is always great. Sometimes we invite donors.

I respect and totally trust the CEO. Matt founded this agency fifteen years ago, and he has a tremendous vision of growth and opportunity. The people in the agency seem like they know what’s going on. They have been able to get

3. Jeffery is a fictional character.
all sorts of state and federal contracts so that we can accommodate these programs.

As might be expected, we have an auditor who keeps track of the money, and we have several bank accounts. I am on the fundraising committee, and the other board members are really nice. They have been around much longer than me. When we meet, we spend time catching up with one another. Everyone always wants to know what cases I’m working on. I ask them about their children and their jobs. Matt’s a great leader; I guess he just needed a lawyer from Wall Street to make the agency look good. So, here I am: smart, good-looking, single, a scratch golfer, and an attorney to boot.

* * *

Jeffery and the other board members are ultimately responsible for guiding Matt’s agency and ensuring that John receives quality services. Jeffery does not know John and seems to have limited knowledge about the agency. Jeffery is young and enthusiastic about service. He is certainly smart, but is failing at his responsibility as a board member.

Jeffery might be surprised to know that the agency manages a budget of thirty-three million dollars per year. These funds are restricted funds from city, state, and federal sources. Each funding dollar is allocated. Matt’s best friend is the accountant and he has been with the agency since it was founded, fifteen years ago. The agency operates ten day cares and several residential facilities for people in the community with mental disabilities.

Jeffery would also be surprised to know that recently the agency has come under fire from the Office of Mental Retardation and Developmental Disabilities (“OMRDD”). A tour of the facility where John lives revealed that there was a lack of security, frequent inappropriate visitation among the residents, misappropriation of resident funds, and no lock on the medicine cabinet. Matt entered into a corrective action plan with OMRDD to cure these deficiencies and others in an effort to retain this lucrative government contract to provide services, without which the agency might not be able to meet its payroll.

How could Jeffery know these things; should he; and how can he and the other board members respond to this situation? Can the gap between John, service client, and Jeffery, a board member, be closed?

INTRODUCTION

Corporate scandals have unfolded before our eyes. The loss of pensions, corporate collapse, and subsequent prosecutions followed as the fallout of these transgressions. The ethical and accountability crisis in the corporate sector is not isolated. The personalities, ethical challenges, profiteering, and
general lack of accountability and moral leadership found in the corporate setting plague all of society.

Cross-pollination among corporations, charities, and small business, through savvy board members and executives, spreads corporate ethical norms and practices, both good and bad. As a result of a number of highly publicized nonprofit scandals in recent years, many commentators are suggesting that the Sarbanes-Oxley Act of 2002 (“Sarbanes-Oxley”), a body of legislation adopted to stem the tide of corporate scandal, could be a possible solution to the nonprofit woes.

In this Article, I suggest that strong, ethical, and transparent nonprofit board governance, influenced by Sarbanes-Oxley, can strengthen nonprofits. But at the same time, some of the law’s rigorous reforms are not appropriate for all nonprofits. Part I examines the role and strength of nonprofits in American society and the duties of nonprofit boards. Part II discusses the environment that gave rise to Sarbanes-Oxley and reflects on the criticism and impact of Sarbanes-Oxley. Part III explores nonprofit scandals and their similarity to past corporate scandals in terms of impact and the regulatory response that followed. Part IV provides guidance to nonprofits considered in light of Sarbanes-Oxley requirements.

I. NONPROFITS IN THE AMERICAN ECONOMY

A. Nonprofits in the American Economy

Nonprofit agencies play a significant role in the United States. There are legal distinctions between the different types of nonprofit organizations, such as charitable and noncharitable, as well as different reporting requirements for each. These organizations primarily pursue social welfare missions, providing care for those members of society who cannot provide for their own well-being. These charitable sentiments, and possibly also the birth of the modern nonprofit sector, date back to eighteenth century Europe as a religious and social method to address the impact of the Industrial Revolution.


5. Other nonprofits care for animals, encourage conservation, provide legal services, and host other good deeds. I.R.C. § 501(c) (2006).

6. The YMCA was founded in 1844 in London to channel young men away from unhealthily pastimes and toward educational, religious, social, or physical pursuits. YMCA, History of the YMCA Movement, http://www.ymca.net/about_the_ymca/history_of_the_ymca.html (last visited Jan. 11, 2010). In 1863, the Red Cross was founded. ICRC, Discover the ICRC, 3–6 (2005), http://www.icrc.org/Web/Eng/siteeng0.nsf/html/p0790. The International Red Cross is a highly-respected humanitarian assistance organization that delivers rapid relief to societies affected by natural or man-made disasters. Id. at 3. The first nonprofit organization in the United States predates these social services organizations noted above. In the 1600s, the
founding of the United States, early North American settlers formed churches, orphanages, schools, and other voluntary associations to address social ills. In 1831, Alexis de Tocqueville lauded this American impulse to establish such organizations throughout the land.

While nonprofits have a long history in the United States, currently, nonprofit entities are divided broadly into two types: (1) charitable or public-service and (2) noncharitable or member-servicing organizations. As established by the Internal Revenue Code Section 501(c)(3) organizations are divided into two smaller categories: public charities and private foundations. A study by the Public Agenda, however, found that most donors define the nonprofit sector work almost exclusively as the work of charitable, human-service organizations. The IRS defines certain organizations as “charitable” because they serve broad public purposes, including educational, health, charitable, religious, scientific, and literary activities, as well as the relief of poverty and other public benefit actions. This status permits donations to charities to be tax-deductible for the donor.

clergy and the Massachusetts corporation struggled to govern the Harvard. JOSIAH QUINCY, THE HISTORY OF HARVARD UNIVERSITY 1, 4 (1840). These struggles set the tone for the roles of directors and board governance and were instrumental in establishing the duties of boards.


9. Charitable nonprofits are most often characterized as “public service” organizations, and are recognized under I.R.C. § 501(c)(3) (2006). See also Arnsberger et al., supra note 7, at 105. Contributions to these organizations are tax deductible. I.R.C. § 501(c)(3).

10. Noncharitable nonprofits have also been described as “mutual benefit” organizations, and include, but are not limited to, labor unions, social clubs, chambers of commerce, and other organizations that could be characterized as promoting the interests of their members. Arnsberger et al., supra note 7, at 106. These organizations are recognized for tax purposes under I.R.C. §§ 501(c)(4)–(23) (2006). Donations to these organizations, with few exceptions, are not tax deductible. See id. § 501(a).

11. Private Foundations are divided into operating private foundations (spending resources on charitable purposes) and nonoperating private foundations (engaged in grant making). Arnsberger et al., supra note 7, at 110.

12. Ana Maria Arumi et al., Summary of Findings, in THE CHARITABLE IMPULSE 5 (Public Agenda, New York, N.Y. 2005). Donors seemed indifferent to foundations and surprised or resentful that hospitals and other large organizations that charged fees and made profits could be categorized as nonprofits. Id.


late 1990s, the number of nonprofit organizations in America grew dramatically.\textsuperscript{15}

**Nonprofit Statistics in the United States\textsuperscript{16}**

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<td>228,848</td>
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The modern nonprofit sector is viewed very favorably overwhelmingly by Americans. The nonprofit sector operates on the principles of voluntary service and community support through time and money. Volunteerism is not uniquely American, but the diversity of services offered and the extent of

\textsuperscript{15} There are at least three factors that help explain nonprofit sector growth over this time period: (1) Increasing American affluence, (2) federal subsidies associated with Lyndon Johnson’s Great Society programs, and (3) the Civil Rights Movement. David C. Hammack, *Introduction: Growth, Transformation, and Quiet Revolution in the Nonprofit Sector Over Two Centuries*, *30 Nonprofit & Voluntary Sector Q.* 157, 165 (2001).

\textsuperscript{16} These totals may not be exact due to rounding. This chart was created by a table-generating website. See generally Nat’l Center For Charitable Stat., *NCCS All Registered Nonprofits Table Wizard*, http://nccsdataweb.urban.org/tablewiz/tw_bmf.php (last visited Jan. 11, 2010) (providing documentation of statistics regarding growth in nonprofit organizations).
public support is impressive.\textsuperscript{17} Approximately 90\% of American families contribute to charity, and donated an average of $1,620 each in 2001.\textsuperscript{18} In 2006, individuals, corporations, and foundations gave $295 billion in charitable contributions to nonprofits.\textsuperscript{19} Donors generally do not expect to receive benefits from their donations, but they do anticipate that their funds will be used to support the mission of the organization.\textsuperscript{20} Not only do Americans support nonprofits financially, over forty-four million, or nearly 22\% of adults, give their support by volunteering.\textsuperscript{21}

In 2005, the IRS recognized roughly 1.4 million nonprofit organizations, public charities, and private foundations—and that is not counting nearly half of the church congregations (approximately 175,000) that choose not to register with the IRS.\textsuperscript{22} Most nonprofit organizations registered with the IRS are public charitable organizations and exempt from taxes under Section 501(c)(3) of the Internal Revenue Code.\textsuperscript{23} Approximately one-third of these registered organizations, however, must report their financial data to the IRS.\textsuperscript{24} Religious organizations and entities with less than $25,000 in gross receipts are not required to report data to the IRS.\textsuperscript{25}

\begin{thebibliography}{9}
\bibitem{cvote} According to the Johns Hopkins Comparative Nonprofit Sector Project, the value of volunteer work in the U.S. is $109 million, leading both Germany and France with $48.4 million and $41.9 million respectively. The John Hopkins Comparative Nonprofit Sector Project, tbl.2 (2004), http://www.ccss.jhu.edu/pdfs/CNP/CNP_table201.pdf. Additionally, the U.S. ranks fourth for people volunteering with 44.5 million, or 22\% of all adults. \textit{Id.} Norway (52\%), United Kingdom (30\%), Sweden (28\%), and Uganda (23\%) lead the U.S. for percentage of adult population volunteerism. \textit{Id.}
\bibitem{giving} \textsc{Independent Sector, Giving \\& Volunteering in the United States: Key Findings} 1, 3 (2001), available at http://www.independentsector.org/PDFs/GV01keyfind.pdf.
\bibitem{arumi} Arumi, \textit{supra} note 12, at 10. Many donors anticipate that they will receive a tax benefit from their donation in addition to the personal gratification from doing good. \textsc{Wing et al., supra note 19, at 1.}
\bibitem{salamon} \textsc{Lester M. Salamon et al., Global Civil Society} 297 tbl.A.2 (2004).
\bibitem{wing2} \textsc{Wing et al., supra note 19, at 139.}
\bibitem{taxexempt} \textit{See id.} at 139–40 tbl.5.1; \textsc{26 U.S.C. § 501(c)(3)} (2006). Other types of tax-exempt organizations include social welfare organizations, labor and agricultural associations, business leagues, and fraternal beneficiary societies. \textit{See 26 U.S.C. §§ 501(c)(4)–(6), 501(c)(8).}
\bibitem{wing3} \textsc{Wing et al., supra note 19, at 140.}
\bibitem{volunteer2} \textit{Id.} at 140 tbl.5.1.
\end{thebibliography}
The financial impact of the nonprofit sector is significant. In 2005, all reporting nonprofits had assets in excess of $3.4 trillion and spent approximately $1.4 trillion. Contributions from individuals and major corporations support these nonprofits. Each year several studies are conducted to determine their economic impact. A 2005 study of the nonprofit arts and culture industry suggests that this sector spends $63.1 billion dollars per year and generates more than $103 billion in additional economic activity.

In 2005, public charities reported nearly $1.1 trillion in total revenues, $2 trillion in total assets, and $1.1 trillion in total expenses. Of the nearly $1.1 trillion in total revenues, 21.3% came from contributions, gifts, and government grants, and 70.3% came from fees for goods and services, which consist of tuition payment and hospital patient revenues, including Medicare and Medicaid. Nonprofits accounted for over 8% of all wages and salaries paid in the United States in 2005. In 2004, nonprofits paid $321.6 billion in wages, compared to $355.8 billion in wages paid by the finance and insurance sectors combined. In 2005 and 2006, nonprofits accounted for 5% of gross domestic product.

26. In 2007, the largest public charity was the President and Fellows of Harvard College, with approximately $57.9 billion in total assets. National Center for Charitable Statistics, NCCS - Display Largest Public Charities, http://nccsdataweb.urban.org/PubApps/showTopOrgs.php (follow “All Orgs.” under “Total Assets”) (last visited Jan. 11, 2010). The top ten largest public charities in 2007 had approximately $237.9 billion in total assets. Id.


28. AMERICANS FOR THE ARTS, ARTS & ECONOMIC PROSPERITY 6, 9 (2008), available at http://www.artsusa.org/pdf/information_services/research/services/economic_impact/aepiii/national_report.pdf. “Nationally, the nonprofit arts and culture industry generates $166.2 billion in economic activity every year—$63.1 billion in spending by organizations and an additional $103.1 billion in event-related spending by their audiences.” Id. at 3.

29. Id. at 3.

30. In 2004, public charities reported nearly $1.1 trillion in total revenues and $981 billion in total expenses. THE URBAN INST., supra note 19, at 3 tbl.2.

31. Id. at 20.


33. Id. at 20.
In the United States, the nonprofit sector is a major employer, employing more people than utility, wholesale trade, and construction industries combined. This workforce segment is comprised of 9.4 million paid and 4.7 million unpaid volunteers, equaling 10.5% of the total U.S. workforce. In addition, the nonprofit sector plays a leading role in the fields of health and hospital care, social assistance, and higher education.

In Florida, nonprofits are the fourth largest employment sector, providing 630,000 jobs as of the second quarter of 2005. In Miami-Dade County, Florida, nonprofits are the third-largest employment sector, providing 76,741 jobs. In Iowa, charitable nonprofit employment is the fifth-largest employment sector, providing approximately 129,000 jobs in 2005. Between 2002 and 2004, while employment overall was down by 0.2%, employment in the nonprofit sector increased by 5.3% for paid and volunteer workers. The annual budget of the entities that compose the nonprofit sector in the United States, such as the private sector, public sector, and nonprofit organizations, surpasses the national budgets of nearly every other country in the world. In 2005, all reporting nonprofits declared combined revenue of $1.6 trillion.

Nonprofits are an integral part of American society. These organizations provide services, employ many people, and contribute to the national economy. Considering the impact that nonprofits have on the economy, it is surprising that the majority are managed by volunteer boards of directors working with nonprofit staff.

A. Directors and Their Role in Nonprofits

State law divides corporations into profit, or “for-profit” corporations, and nonprofit, or “not-for-profit” corporations. A for-profit corporation, generally, is a legal entity incorporated in the state where part of the income or profit is

35. Salamon & S. Sokolowski, supra note 33, at 3.
36. Id.
37. Id. at 10.
38. Id. at 33.
41. Salamon & S. Sokolowski, supra note 33, at 6.
43. Wing et al., supra note 19, at 140 tbl.5.1.
distributable to its members, directors, or officers. In other words, the primary goal of a for-profit corporation is to make a profit. A profit is a tangible or pecuniary benefit such as dividends, interest, capital accounts, or salaries—or it may be a saving of expense which one would otherwise incur. A not-for-profit corporation is a legal entity incorporated in the state, where no part of the income or profit is distributable to its members, directors, or officers. Unlike the revenue driven goal of for-profit organizations, nonprofit organizations exist for reasons other than monetary gain.

Both for-profit and not-for-profit corporations require a board of directors. Directors are “person[s] appointed or elected to sit on a board that manages the affairs or a corporation.” The board of directors is a governing body that should reflect a spectrum of public interests and be responsible for management and operation of the corporation. There are three ways to select directors. First, the members of the organization can elect directors from a list of candidates. Second, directors may be selected through the use of a self-perpetuating process. Under this system, the existing board members can elect or re-elect directors. Third, and finally, directors may serve “ex officio by virtue of holding another position, such as chief executive of the corporation, or officer of an affiliate organization or constituency group.” Directors, once on the board, can be assigned roles and advance in terms of board leadership based on their status, seniority, or affiliation. At the meetings, the board can take action in two ways. One, it may hold a meeting with a quorum, meaning a meeting with a minimum number of the members present and voting. Two, it may act with written consent of the voting directors.

Generally, boards are engaged in monitoring management, approving major transactions, and giving direction to the organization. Both types of

44. See BLACK’S LAW DICTIONARY 367 (8th ed. 2004).
47. COMM. ON NONPROFIT CORPS, GUIDEBOOK FOR DIRECTORS OF NONPROFIT CORPORATIONS 4 (George W. Overton & Jeannie Carmelle Frey eds., 2d ed. 2002).
48. Id.
49. Id.
50. Id.
51. Id.
52. See COMM. ON NONPROFIT CORPS, supra note 47, at 5–6.
54. Id.
55. Bylaws of organization can provide alternative calculations for a quorum. David M. Bardsley, Committees, in NONPROFIT GOVERNANCE AND MANAGEMENT 127 (Victor Futter et al. eds., 2002).
56. RUNQUIST, supra note 53, at 81.
boards, for-profit and nonprofit, are guided by similar legal principles, involving the fiduciary duties of loyalty and care. Courts presume that directors have specialized skill and knowledge to manage the affairs of organizations, and would rather not substitute their judgment for that of their boards when legal disputes arise. The Business Judgment Rule protects individual directors from personal liability when making board decisions in good faith and with due care. The rule presumes that, in the absence of self-interest, directors act in good faith and with due care, and courts need not perform a “substantive review of the merits of a business decision made by directors acting without self-dealing and in good faith and with due care.”

While the Business Judgment Rule is a safe harbor from director liability, it is not absolute. In cases of self-dealing, a failure to act, or where action or inaction is shown to be a gross abuse of discretion, directors cannot rely on the protection of the Business Judgment Rule. All boards have two legal duties to the corporation: the duty of care and the duty of loyalty. Nonprofit boards have a third additional legal duty to the corporation: a duty of

57. COMM. ON NONPROFIT CORPS., supra note 47, at 19.
60. BRODSKY & ADAMSKI, supra note 59, § 2:10.
61. Id. at n.22 (citing Grobow v. Perot, 539 A.2d 180, 187 (Del. 1988)), overruled on other grounds by Brehm v. Eisner, 746 A.2d 244 (Del. 2000); Matter of Munford, 98 F.3d 604 (11th Cir. 1996), cert. denied, 522 U.S. 1068 (1998) (applying Georgia law) (“The business judgment rule protects directors and officers from liability when they make good faith business decisions in an informed and deliberate manner.”).
62. See BRODSKY & ADAMSKI, supra note 59, § 2:10.
63. Id. at n.22 (citing Aronson v. Lewis, 473 A.2d 805, 813 (Del. 1984), overruled on other grounds by Brehm v. Eisner, 746 A.2d 244 (Del. 2000)).
64. Wisconsin, 2000 WL 238026, at *9 n.27 (citing Grobow v. Perot, 539 A.2d 180, 189 (Del. 1988), overruled on other grounds by Brehm v. Eisner, 746 A.2d 244 (Del. 2000)).
These common law fiduciary responsibilities ensure that boards act in a manner consistent with the organization’s mission and purpose.

1. The Duty of Care

The board has a duty to make rational decisions, in good faith, with reasonable care. Reasonable care means that an ordinary prudent person in the same situation would reasonably believe that the decision made is appropriate. The duty of care first requires that a director be informed; second, a director must discharge his duties in good faith. The directors are held to a standard that demands “the most scrupulous observance of [their] duty” and “to refrain from doing anything that would work injury to the corporation.” Also, directors should efficiently allocate time to making board decisions.

To ensure the duty of care is met, the corporation should observe corporate formalities. The board should hold regular meetings. Before meetings, the board should, within budget and staff resources limitations, distribute the meeting agenda, the rules of meeting procedure, and other information needed to make decisions. The board should keep good records of the meeting minutes and committee reports and distribute them after the meetings are held.

2. The Duty of Loyalty

Directors of a corporation owe a duty of loyalty to the corporation. This is a fiduciary duty to act for the best interest of the nonprofit corporation and

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68. David B. Rigney, Duties and Potential Liabilities of Officers and Directors of Nonprofit Organizations, in NONPROFIT GOVERNANCE AND MANAGEMENT 83 (Victor Futter et al. eds., 2002).
69. COMM. ON NONPROFIT CORPS., supra note 47, at 19.
70. Id.
72. COMM. ON NONPROFIT CORPS., supra note 47, at 19.
73. See id.
74. See id.
75. See RUNQUIST, supra note 53, at 80.
76. Id. at 26.
77. Id. at 27. Nonprofit boards are discouraged from using Robert’s Rules of Order. See ANDY ROBINSON, GREAT BOARDS FOR SMALL GROUPS 53–56 (2006); Pamela McAllister, Should You Use Robert’s Rules of Order?, 20 NONPROFIT WORLD 4, 6 (2001). Also, the procedure may be best distributed in a manual for meetings.
78. Id. at 19.
stands in opposition to acting with self-interest or in the interest of another.\textsuperscript{79} It prohibits directors from engaging in fraud, bad faith, or self-dealing, and from usurping an opportunity that belongs to the corporation.\textsuperscript{80}

If there is a possibility of a conflict of interest, the director must disclose all relevant facts about the potential conflict, including the director’s personal interest in the transaction.\textsuperscript{81} A conflict occurs when a director or an officer is in a position where there is a duty to act in the best interest of the corporation and a duty or the ability to act in the interest of another, possibly his or her own.\textsuperscript{82} The director with the possible conflict has a duty not to vote—thus only disinterested directors may vote.\textsuperscript{83} In order for a transaction to occur in favor of the individual director over the organization, the individual director must demonstrate, and the rest of the board must agree, that the transaction is fair in terms of price and process.\textsuperscript{84} Otherwise the interested director must abstain from the transaction.\textsuperscript{85}

To ensure that directors comply with the duty of loyalty, the corporation should adopt policies concerning potential conflicts of interest. Directors should be required to disclose business relationships and transactions with other individuals and organizations that might pose a conflict. Corporations should also require that directors adhere to policies regarding gifts and other activities that might lead to the appearance of impropriety.

3. The Duty of Obedience\textsuperscript{86}

Third, the nonprofit board members have a duty of obedience. This is a duty to advance the mission and goals of the nonprofit corporation.\textsuperscript{87} It differs

\textsuperscript{79} Id. at 29.
\textsuperscript{81} COMM. ON NONPROFIT CORPS., supra note 47, at 30–31, 33; RUNQUIST, supra note 53, at 73.
\textsuperscript{82} COMM. ON NONPROFIT CORPS., supra note 47, at 30.
\textsuperscript{83} Id. at 33.
\textsuperscript{86} The phrase “duty of obedience” has also been used to discuss the duty of the organization to comply with use restrictions that donors place on gifts to the organization. Jeremy Benjamin, Reinigorating Nonprofit Directors’ Duty of Obedience, 30 CARDOZO L. REV. 1677, 1680 (2009). “Duty of obedience,” however, is inapplicable here.
from the duty of care in that the duty of care addresses the level of competency with which directors must act. 88 It also differs from the duty of loyalty in that the duty of loyalty requires directors to put the interests of the organization ahead of their personal interests. 89 Litigation regarding the duty of obedience occurs as much as litigation on the duty of care and duty of loyalty. 90 The overriding duty in the nonprofit context is that “[t]he purpose of every act and decision of a director should be to advance the nonprofit’s purpose.” 91

Charities provide benefits to the public. These organizations achieve this goal by creating a mission to guide their efforts. 92 Directors must adhere to the mission in the way it was written and designed. 93 To ensure that the duty of obedience is met by directors, corporations should conduct mission-based governance training for board members and should adopt mission-based policies. Staff and directors must be able to affirm that their actions are performed in an effort to further the corporation’s mission.

B. Given Similar Legal Duties and Responsibilities, Are Nonprofit and For-Profit Boards Different?

Both for-profit and nonprofit boards are charged with managing and monitoring their organizations. 94 Management of a complex organization creates challenges for even the most dedicated board member. The manner in which these responsibilities are communicated to and understood by board members and supported by the organization has an impact on board activities, engagement, and efficiency. A comparison of these two types of boards in terms of experience, compensation, and resources, is a study in contrast.

1. For-Profit Board Members Receive Services

For-profit board members are a somewhat incestuous group. Many directors serve on several prominent boards and refer themselves and their friends to sit on other boards with vacancies. 95 The benefits from this process are numerous. For example, for-profit board members have an opportunity to learn from past experiences, have access to mentoring, and practice being a good board member through experience. 96 These board members can also form peer groups for discussion and educational purposes. In some instances,

87. Rigney, supra note 68, at 87.
88. Id. at 84–85.
89. Id. at 86.
91. RUNQUIST, supra note 53, at 18.
92. KURTZ, supra note 90, at 85.
93. Id.
94. See supra notes 69–77 and accompanying text.
95. See infra note 115–19 and accompanying text.
96. See infra note 115–19 and accompanying text.
prior board service is a proxy for formal board training. Such nonprofit board experience, however, is not necessary, because for-profits can pay for board member training courses for new, inexperienced board members.97  

On average, publicly-traded companies compensate their full board of directors just over $1 million per year.98 Compensation plans for board members vary by company and nature of service.99 Compensation can include stipends, attendance fees, stock options, and equity awards.100 Additional compensation may be available for certain committee services and positions held on certain committees.101 In some instances, the compensation level can signal a member about the quality and quantity of time that should be devoted to board activities. In 2004, an average compensation for the for-profit board chairperson that meets quarterly and serves as an audit committee member was

97. Directors’ Consortium is a board member training course offered by the University of Chicago Booth School of Business, Stanford Graduate School of Business, Stanford Law School, and the Tuck School of Business at Dartmouth. Stanford Graduate School of Business, Director’s Consortium (2008), http://www.gsb.stanford.edu/exed/directors/ (last visited Jan. 11, 2010). This program teaches board members the importance of knowing their duties, in light of regulatory changes. Id. The program reaches both new and experienced directors, showing them how to make informed, complex decisions, and the comprehensive actions that must be taken in reaching these decisions. Id. Stanford offers a three-day course for $7500 or a four-day combination course for $8700. Id.. Harvard Business School offers a course in Making Corporate Boards More Effective. Harvard Business School, Making Corporate Boards More Effective (2008), http://www.exed.hbs.edu/programs/mcb/ (last visited Jan. 11, 2010). This program offers directors of public companies the opportunity to learn strategies and techniques on how to strengthen board effectiveness by learning how to maximize the knowledge and time of each of its own board members. See id. In 2009, the program was anticipated to cost $7750, and in 2010, another $8000. Id. Previous companies such as Adobe Systems, Liberty Mutual Insurance Company, and Motorola have participated in this program. Id. at http://www.exed.hbs.edu/ programs/mcb/print.html (last visited Jan. 11, 2010).


99. See Scott, supra note 98.

100. See id.; RUEL & HODGSON, supra note 98, at 3, 10.

$55,000 per year, excluding stock options and reimbursement for expenses. A recent study of 3,096 publicly-traded corporations’ proxy statements indicated that “about one quarter of the companies studied paid less than $500,000 in total compensation to its full board.” The top-ten most highly compensated boards for 2007 range from a high of almost $16.5 million at Valero Energy Corporation to just over $8 million for the board of News Corporation. In 2007, the study showed that Valero Energy spent more than $16 million on its board, with $15 million going to a single director, William E. Greehey, and “that six companies offered their full board a cash bonus based on company performance.” The study also noted that the practice of establishing stock ownership guidelines for directors is growing, and that such awards are generally correlated with a company’s size and expensed earnings. The amount of total board compensation varied based on company size. While these payments to for-profit boards may not be unreasonable, these payments are certainly out of line with the compensation available to directors of nonprofits.

For-profit boards are often aware of accountability pressures exerted from shareholders. In addition to compensation and the pressure of accountability, for-profit boards are routinely provided with legal counsel. Directors affiliated with the corporation normally rely on corporate counsel, while unaffiliated directors are provided with independent counsel. In each instance, board members are not only encouraged to have counsel review

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107. *Id.*
108. *Id.*
board materials, but also to seek the advice of counsel when making decisions.\footnote{See Geoffrey C. Hazard, Jr. & Edward B. Rock, A New Player in the Boardroom: The Emergence of the Independent Directors’ Counsel, 59 BUS. LAW. 1389 (2004) (discussing the development and role of independent counsel for independent directors in the boardroom).}

Not only are for-profit boards compensated at a level that encourages focus and attention to detail, they are also provided with counsel to explain matters taken up by the board and, as protection against personal liability, the directors have Director and Officer Insurance.\footnote{Directors and Officer Insurance (“D&O") is often confused with Error and Omission insurance. D&O Insurance is concerned with the performance and duties of management. Matthew S. Chambers, Last Ditch Options: An Assessment of Independent Director Liability and a Proposal for Congressional Action in Light of the Employee Stock Option Backdating Scandal, 42 GA. L. REV. 569, 587 (2008). It can include coverage for employment practices, including harassment and discrimination suits, as well as fiduciary liability. Geoffrey Christopher Rapp, New Direction for Shareholder Environmental Activism: The Aftermath of Caremark, 31 WM. & MARY ENVTL. L. & POL’Y REV. 163, 171 (2006) (“Director and Officer insurance policies make it unlikely that a director will be forced to pay for fiduciary breaches.”).} The pillars of compensation, legal counsel, and insurance associated with for-profit board service enhance efficiency, productivity, and limit personal liability.

2. Nonprofit Board Members Are There to Serve

It is not unusual for the incestuous director relationship, common in the for-profit sector, to be replicated on nonprofit boards: “The potential for the intersection among for-profit boards and nonprofit boards exists.”\footnote{Two additional examples of this cross-pollination are Faye Wattleton and Brad Boston. Faye Wattleton is co-founder and president for the Center for the Advancement of Women (CFAW), an independent, women focused, national opinion research, education, and advocacy corporation. See Center for the Advancement of Women, http://www.advancewomen.org/discover/media_center/presidents_bio/ (last visited Jan. 11, 2010). As noted on the CFWA website: From 1978 to 1992, as president of the Planned Parenthood Federation of America (PPFA), Ms. Wattleton played a leading role in defining the national debate over reproductive rights and health, and in shaping family planning policies and programs around the world. Ms. Wattleton presently serves on the boards of directors of Columbia University, New York Blood Center, Jazz at Lincoln Center, Pardee RAND Graduate School and the United Nations Association of the United States of America. Ms. Wattleton formerly served on the board of directors of Estée Lauder Companies as chairperson of the audit & nominating and board affairs committees, as well as, formerly serving on the board of directors of Well-Choice, Inc, Savient Pharmaceuticals and the Quidel Corporation. Id.} For
example, the Whitney Museum of American Art has twenty-seven members on its board of trustees. 116 Twenty of these members serve on one or more boards. 117 Robert J. Hurst, a Whitney trustee, is a partner of Crestview Partners, L.P., a private equity firm specialized in contrarian investments. 118 Hurst serves on eleven additional boards, including five for-profit boards: VF Corp., AirClic, Inc., Goldman, Sachs & Co., the Edgewater Funds, and Paris Re Holdings, Ltd., and six nonprofit organizations: NYC 2012, Inc., a nonprofit which promoted New York City to host the 2012 Olympics, The Jewish Museum, 9/11 United Services Group, the National Gallery of Art, the Aspen Institute, and the Central Park Conservancy. 119 When nonprofits are fortunate enough to attract directors with for-profit experience, there is a noteworthy benefit. Because of his exposure to corporate practices and policies, Mr. Hurst will bring his experiences and knowledge base into each board meeting—whether it be for-profit or nonprofit—as will many other board members who hold board positions in the nonprofit and for-profit sectors simultaneously.

Directors may have different motivations for serving on nonprofit boards, which changes both how they view their role and the expectations that the


117. See id.


organization has of them. This trend perpetuates “the common folklore . . . that nonprofit board members should bring to the organization the three W’s: wealth (donations and fundraising), wisdom (monitoring and oversight), and work (operational duties).” Nonprofit board members are often selected for their wealth or their work. The last of the three Ws, wisdom, unfortunately appears to be the least sought-after attribute in the board member recruitment process. These directors might have no prior governance or business experience. They are often community leaders with a passion for the organization’s mission.

Nonprofit boards, generally larger than for-profit boards, are challenged to recruit effective members in light of the long list of responsibilities, possible liability, time commitment, and the lack of resources available for training and support. The list of responsibilities of the nonprofit board is long and includes leading of strategic planning, determining the organization’s mission and purpose, designing and conducting program evaluations, grant writing, conducting executive staff and ED/CEO evaluations, interviewing important hires, attending community meetings, fundraising, drafting conflict of interest policies, conducting board training, speaking to the media, attending community, city, and statewide meetings to represent the organization, reviewing financial records, taking minutes of all meetings, opening mail, responding to inquiries of the board, providing guidance in all ethical and financial matters, drafting employee policies, and setting compensation.

There is often no compensation available for nonprofit directors and little available for reimbursement of commuting expenses or meals. “Only about 2% of nonprofit board members receive an annual fee and about 4% receive a

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121. Id. at 207.
122. Nonprofits are interested in acquiring unrestricted funding. See id. at 208 (noting that board directors on nonprofit boards favor a board full of individuals who are willing and able to donate money without restrictions). Traditional funders, foundations, governments, and, to some extent, corporations often earmark funds for direct program services. This leaves little funding available to supplement programs or for capacity building.
123. See id.
124. See id.
125. See O’Regan & Oster, supra note 120, at 206 (stating that nonprofit boards are generally larger).
126. Id. at 207 (“But the particulars of what the directors should be doing are more complicated for the nonprofit.”).
127. See infra note 112 and accompanying text.
per-meeting fee,” unusual outside of large and complex nonprofit organizations.128

Charles Prince, CEO of Citigroup and a member of Juilliard School’s board, said that “nonprofits carry ‘even more of a burden of responsibility’ . . . . ‘They don’t have the check and balance of shareholder activists showing up at annual meetings to point out problems.’”129 A recent study by Professor Judith L. Miller found that nonprofit board members struggled to identify any persons or groups to whom they were accountable.130 This lack of accountability, including lack of accountability to shareholders, forces nonprofit boards to explain their conduct to a broad range of parties with competing agendas, such as donors, governmental authorities, clients, and staff members.131 These competing interests often push nonprofit board members to pursue differing goals in their board responsibilities.132 When nonprofits accommodate these interests, it can be difficult for them to articulate and strive toward a coherent mission.133

The adversities faced by nonprofit board members undermine power and independence in the boardroom. Professor Judith Miller has “found that nonprofit board members rubberstamp management’s proposals without [evaluating] the effect those proposals would have on the organization.”134 She further noted that “boards frequently defer[red] to staff and the chief executive officer,” even when circumstances appeared to mandate a more diligent oversight regime.135 In a recent study, Professor Edward Glaeser confirmed Miller’s findings that nonprofit organizations are often captured by their staff and tend to evolve towards “worker cooperatives,” especially as the net worth of the organization increases.136 Other empirical studies also corroborate that “[l]arge or small . . . most voluntary agencies are unusually

131. Miller, Board as a Monitor, supra note 130, at 442.
133. Id. at 1986 (citing O’Regan & Oster, supra note 121, at 205–06).
134. Miller, Board as a Monitor, supra note 130, at 438.
135. Id.
dependent on the quality of their executive leadership and, therefore, more subject to idiosyncratic rather than structural factors.\textsuperscript{137}

In spite of similar duties and legal obligations, nonprofit and for-profit boards operate differently. Nonprofit board members are often unable to pay sufficient attention to the materials and lack the knowledge to manage, monitor, or exercise independence.\textsuperscript{138} As imagined, the majority of nonprofit boards are disadvantaged in terms of resources, finances, and talent.\textsuperscript{139} The significant differences between the resources available to nonprofit boards and for-profit boards should not be glossed over. The deficits in terms of resources, training, experience, and support in the nonprofit arena can leave a nonprofit management environment vulnerable and unable to detect or remedy programmatic and fiscal problems. Nonprofits with weak governance are most susceptible to fraud and other types of mismanagement. These disadvantages for nonprofit boards will not be addressed by further regulation involving additional disclosures.

C. Nonprofit Regulation in a Pre-Sarbanes-Oxley World

The lack of regulation is not the biggest problem facing nonprofits. Nonprofits are regulated by state laws, the IRS, and informally by donors through their ability to walk away and leave the nonprofit without sufficient funding. Donors can obtain information about nonprofits from IRS Form 990.\textsuperscript{140} Most 501(c)(3) charities file IRS Form 990 annually with the IRS.\textsuperscript{141} Information from Form 990 can be used by donors to assist in deciding where to contribute their funds and time.\textsuperscript{142} In the past, nonprofits did not have to provide the public with Form 990 unless the request was made in person at the nonprofit’s office.\textsuperscript{143} But currently, “regulations require that a 501(c) organization make copies of its three most recent Forms 990 for anyone who requests them, whether in person or by mail, fax, or e-mail.”\textsuperscript{144} Since July 1998, the IRS has scanned and posted Forms 990 on the Internet as it receives

\textsuperscript{137} Ralph M. Kramer, \textit{Voluntary Agencies and the Personal Social Services, in THE NONPROFIT SECTOR} 240, 244 (Walter W. Powell ed., 1987).

\textsuperscript{138} See O’Regan & Oster, \textit{supra} note 120, at 208 (noting the difficulty with “meddling” board members among nonprofits).

\textsuperscript{139} See \textit{supra} notes 120–26.


\textsuperscript{141} Quality 990, \textit{About Form 990}, http://www.qual990.org/value_of_990.html (last visited Jan. 11, 2010).

\textsuperscript{142} See id.

\textsuperscript{143} Id.

\textsuperscript{144} Id.
them.\textsuperscript{145} In 1999, the California Attorney General created a website where users can search for information concerning nonprofit organizations.\textsuperscript{146} Though it does not provide access to informational forms filed by charities, such as Forms 990, it does link to the Guidestar website where those items can be searched.\textsuperscript{147} The approximately 350,000 religious congregations are considered public charities, but are not required to register with the IRS.\textsuperscript{148} Religious organizations are exempt from filing Form 990.\textsuperscript{149} They remain exempt, even though they have significant financial assets. In 2006 alone, religious institutions received $96.82 billion in donations\textsuperscript{150} and $2.2 billion in federal grants to provide social services.\textsuperscript{151} But religious organizations are not inherently less likely to engage in poor decision-making or wrongdoing. Bearing this in mind, along with considerable assets so many nonprofits maintain, all nonprofits with revenues in excess of $25,000 should now be required to file Form 990 with the IRS.

Individual states have always had the first line of responsibility for regulating nonprofit organizations. And, to this day, state regulations vary considerably.\textsuperscript{152} But generally, state laws tend to uniformly cover a nonprofit’s ability to conduct ethical business through contract, consumer protection, and fundraising laws.\textsuperscript{153} States regulate nonprofits most often through the State

\textsuperscript{145} Id.


\textsuperscript{147} Id.

\textsuperscript{148} WING ET AL., supra note 19, at 139.


\textsuperscript{152} See MARION R. FREMONT-SMITH, GOVERNING NONPROFIT ORGANIZATIONS: FEDERAL AND STATE LAW AND REGULATION 53–54, 306 (2004); NORMAN I. SILBER, A CORPORATE FORM OF FREEDOM: THE EMERGENCE OF THE MODERN NONPROFIT SECTOR 20–23 (2001). See also Norman I. Silber, Nonprofit Interjurisdictionality, 80 CHI.-KENT L. REV. 613, 618 (2005) (noting that nonprofit law at the federal level traditionally focused on “issues directly connected with taxation” while state law focused on issues of “fiduciary duties and governance principles”). Over time there has been an “extension of federal supervision into areas . . . for which the states have been principally responsible.” Id.

Attorney General’s Office.¹⁵⁴ Most have strong public policy interests in safeguarding the funds of nonprofits because states often support nonprofits through licensing and funding in the form of grants and forgone tax revenue on charitable contributions to nonprofits.

Between the 1940s and the 1960s, several states passed legislation requiring registration and reporting of charities in an effort to enhance the power of the state attorneys general.¹⁵⁵ But it has long been demonstrated that state attorney general offices have neither the person-power, nor the will, to monitor nonprofits effectively.¹⁵⁶ For example, in 2002, the New York State Attorney General’s Charities Bureau had six accountants to oversee 40,000 charities and was primarily responsible for helping charities comply with state requirements rather than aggressively policing them.¹⁵⁷ At that time, the Bureau relied on information kept on three-by-five-inch index cards to track the organizations—requests for the money to computerize the operation had been repeatedly rejected.¹⁵⁸ In the words of Professor Harvey Dale, a long-time observer of the nonprofit world:

[G]overnment regulators (and most particularly attorneys general, to whom the law confides the principal role in policing charities) tend to allocate their scarce regulatory resources to other more politically potent portions of their domains. In most states, the Charity Bureau of the Attorney General is inactive, ineffective, overwhelmed, or some combination of these.¹⁵⁹

The oversight by state attorneys general has been generally ineffective. But the attorneys general in sixteen “key” states¹⁶⁰ supervise charities in a way that manages to positively impact their compliance with the laws.¹⁶¹ These sixteen states are key states because they contain 57% of all public charities.¹⁶² In

¹⁵⁴. FREMONT-SMITH, supra note 152, at 301.
¹⁵⁸. Id.
¹⁵⁹. Swords, supra note 156, at 413.
¹⁶¹. Id.
¹⁶². Id.
most of these sixteen key states, there is no funding earmarked for charitable oversight and enforcement, and in spite of this, the states still perform well in the area of regulation.\textsuperscript{163}

There have been several instances of vigorous and successful prosecutions of nonprofits by states’ attorneys general as well as various U.S. Attorney Generals. New York’s Attorney General investigated the misuse of the funds by Hale House, a nonprofit founded to care for homeless infants and toddlers.\textsuperscript{164} The investigation resulted in the installation of an interim board of directors.\textsuperscript{165} Furthermore, in agreement with prosecutors, former President Dr. Lorraine Hale pleaded guilty to a single larceny charge, and her husband, Jesse DeVore, pleaded guilty to a fraud charge. The husband and wife each received five years probation and are paying restitution.\textsuperscript{166}

In 2002, the U.S. Attorney General prosecuted the former chief executive of the United Way of the National Capital Area after the media revealed that the organization misappropriated $1.6 million. An audit revealed personal purchases on the corporate credit card and other financial mismanagements.\textsuperscript{167} As a result, the chief executive was sentenced to twenty-seven months in jail and faced civil lawsuits.\textsuperscript{168} In 2002, the Easter Seals Iowa chapter fired its former president, who subsequently pleaded guilty to two theft charges, resulting in a loss of $230,000 to the organization.\textsuperscript{169} The misappropriation was revealed in an audit, and the former president received three-years probation.\textsuperscript{170}

Additionally, in 2005, the U.S. Attorney’s Office in the Eastern District of California indicted forty-nine people, alleging a scheme to misappropriate money intended for Hurricane Katrina relief victims.\textsuperscript{171} The U.S. Attorney sought restitution.\textsuperscript{172}

\textsuperscript{163} There is information available about states which earmark charity registration fees for oversight and enforcement functions. Id. at 4.

\textsuperscript{164} Scandal at Hale House, N.Y. TIMES, May 20, 2001, at WK16.

\textsuperscript{165} Joseph P. Fried, For Hale House Couple, A Struggle After the Fall, N.Y. TIMES, Sept. 7, 2003, at N37.

\textsuperscript{166} Id.


\textsuperscript{172} Id.
As the foregoing demonstrates, prosecutions of nonprofits for financial mistakes do occur and are a real concern for nonprofits and their boards. Once a state regulator decides to prosecute a nonprofit, it typically seeks remedies such as restitution, imposition of fines, removal of directors and executives, and, in some instances, dissolution of the charity.\footnote{Biesmesderfer & Kosaras, \textit{supra} note 160, at 2.}

Though state attorneys general historically have been responsible for charities’ accountability, because of a lack of resources, the IRS has also become the primary regulator of nonprofit behavior.\footnote{See U.S. Gen. Acct. Off., S. Rep. No. GAO-02-526, at 26 (2002), available at http://www.gao.gov/new.items/d02526.pdf.} The IRS regulates nonprofits through its ability to grant or withhold nonprofit status to organizations. Section 501(c)(3) of the Internal Revenue Code requires that nonprofits seeking charitable status meet certain requirements and refrain from certain activity.\footnote{Prohibited activity includes the use of earnings to benefit a private individual. 26 I.R.C. § 501(c)(3) (2006).}

II. THE RISE OF SARBANES-OXLEY

In 2002, the federal government adopted Sarbanes-Oxley in response to public concern over highly publicized, fraudulent activity by public corporations.\footnote{Paula J. Dalley, \textit{Public Company Corporate Governance Under the Sarbanes-Oxley Act of 2002}, 28 Okla. City U. L. Rev. 185, 185 (2003).}  Such notable debacles include Enron, Tyco, Adelphia, WorldCom, and HealthSouth.\footnote{Penelope Patsurias, \textit{The Corporate Scandal Sheet}, FORBES (2002), http://www.forbes.com/2002/07/25/accountingtracker.html.} As a response, Sarbanes-Oxley seeks to facilitate sound governance and fiscal transparency through accurate disclosure and processes in publicly-traded corporations.\footnote{Sarbanes-Oxley Act of 2002, 15 U.S.C. § 7241 (2006) In addition to Sarbanes Oxley, publicly traded corporations are regulated and examined by a number of bodies including the Internal Revenue Service, the Exchanges, the threat of Shareholder suits, and the Securities and Exchange Commission.} It requires corporations to disclose whether or not—and if not, the reason therefore—an issuer has adopted a code of ethics for senior financial officers, its principal financial officer, comptroller or principal accounting officer, or any persons performing similar functions.\footnote{Id.} Such a code of ethics should articulate standards to protect the corporation from conflicts of interest.\footnote{Id.} It also requires the corporation to create an internal structure to ensure material accuracy of

\footnote{173. Biesmesderfer & Kosaras, \textit{supra} note 160, at 2.}
\footnote{175. Prohibited activity includes the use of earnings to benefit a private individual. 26 I.R.C. § 501(c)(3) (2006).}
\footnote{178. Sarbanes-Oxley Act of 2002, 15 U.S.C. § 7241 (2006) In addition to Sarbanes Oxley, publicly traded corporations are regulated and examined by a number of bodies including the Internal Revenue Service, the Exchanges, the threat of Shareholder suits, and the Securities and Exchange Commission.}
\footnote{179. \textit{Id.}}
\footnote{180. \textit{Id.}}
financial reports, provide protections for whistle-blowers, and establish rules of conduct for lawyers.\textsuperscript{181}

There is little doubt that Sarbanes-Oxley is the most important piece of legislation in the area of corporations since the adoption of the federal securities laws in the 1930s.\textsuperscript{182} Sarbanes-Oxley has become synonymous with the phrases “good corporate governance” and “best practices.”\textsuperscript{183} The mandates of Sarbanes-Oxley have been enhanced through rules implemented by stock exchanges, including the New York Stock Exchange and the Nasdaq.\textsuperscript{184} The explicit and the implicit reforms attributable to Sarbanes-Oxley will collectively be referred to as “Sarbanes-Oxley Reforms” herein.

Corporations, attorneys, and accountants have made great strides in their individual arenas to meet the varied demands of Sarbanes-Oxley Reforms.\textsuperscript{185} But critics have come from every corner and hit upon all facets of Sarbanes-

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\begin{itemize}
  \item 184. One such enhancement is the New York Stock Exchanges’ imposition of the definition and requirement to have independent directors on the board or directors. See Securities Exchange Act of 1934, Exchange Act Release No. 48,745 (Nov. 4, 2003).
\end{itemize}
Oxley Reforms. Various lawyers, firms, and representative associations complained that Sarbanes-Oxley Reforms may adversely impact the attorney–client relationship; accountants complained, among other things, that the attempts toward auditor independence would not be successful, and prohibitions against consulting and auditing services were unnecessary; small businesses and representative groups complained that the cost of compliance would be enormous; CEOs complained about the complexity and distraction caused by the Act; and others complained that the requirements of the Act will threaten competitiveness. Critics feared small company delistings, fewer Initial Public Offerings (“IPOs”), and reduced profit margins due to the compliance costs associated with Sarbanes-Oxley.

In the six years that have passed since enactment, the fears and doubts about Sarbanes-Oxley Reforms’ impact on capital formation have subsided. With respect to IPOs, in 2007, there were 296 IPOs raising $65.1 billion; in 2006, there were 236 IPOs raising $50 billion; in 2005, there were 221 IPOs raising $39 billion; in 2004, there were 260 IPOs raising $51.9 billion; and prior to Sarbanes-Oxley, in 2003, there were 88 IPOs raising $18.6 billion. A high percentage of venture or financial-sponsor-backed IPOs helped to increase IPO activity. Complaints that compliance is a distraction have been abandoned as the view that corporate responsibility should be an ongoing focus of management has gained favor.


Sarbanes-Oxley covers a broad range of reform. While Sarbanes-Oxley is applicable to only a small fraction of business enterprises, it has had a ripple effect throughout the economy. Small businesses, nonreporting entities, large nonprofits, and organizations doing business with reporting companies have proactively adopted many Sarbanes-Oxley-like measures. The voluntary adoption of these measures has been referred to as “creep.” Creep is the voluntary adoption of Sarbanes-Oxley practices as well as the gratuitous introduction and application of Sarbanes-Oxley practices.

The reforms mandated by Sarbanes-Oxley in the areas of Auditor Independence, Corporate Responsibility, and Financial Disclosure are most applicable to the nonprofit sector. These changes will be discussed in this section of the Article.

A. Auditor Independence

Sarbanes-Oxley restrains registered public accounting firms engaged in an audit for a public-company client from providing certain nonauditing services, including, but not limited to, bookkeeping, appraisals or valuation services, human resources functions, broker–dealer or actuarial investments advisory services, legal or expert services, and any other investment services. The board must preapprove all auditing services and non-auditing services outside of the enumerated list. The lead auditing partner must change at least every

190. The titles of Sarbanes-Oxley are: Title I, Public Company Accounting Oversight Board; Title II, Auditor Independence; Title III, Corporate Responsibility; Title IV, Enhanced Financial Disclosures; Title V, Analysis Conflicts of Interest; Title VI, SEC Resources and Authority; Title VII, Studies and Reports; Title VIII, Corporate and Criminal Fraud Accountability; Title IX, White-Collar Crime Penalty Enhancements; Title X, Corporate Tax Returns; Title XI, Corporate Fraud Accountability. Sarbanes-Oxley Act of 2002, 15 U.S.C. § 7201 (2006).


194. Id. The second usage of the term “creep” can be seen when accounting firms amend their general auditing practices to comply with Sarbanes-Oxley and then apply these processes to all auditing clients regardless of their reporting status. See Blanchard, supra note 192, at 59, 65.


196. Id.
five years, and, in addition, the auditor is required to report to the audit committee, which must be comprised of independent directors.197

B. Corporate Responsibility

Many companies have their own view of corporate responsibility.198 Corporate responsibility involves a company incorporating economic, environmental, and social impacts into their business decisions as well as following regulations and procedural guidelines.199 The U.S. Securities and Exchange Commission is required to instruct the securities exchanges to prevent the listing of corporations that do not meet certain requirements.200 Officers of periodic reporting companies are required to certify that they have reviewed such filings and, based on their knowledge, that the report does not contain an untrue statement of material fact or omit a material fact necessary to make the statement not misleading.201 Further, the officer must certify that the financial statement in the filings fairly represents the true financial condition of the company.202 The signing officer is also required to certify his or her responsibility for establishing and maintaining internal controls, and to have designed, evaluated, and presented conclusions in the report about internal controls to ensure that material information relating to the issuer and its consolidated subsidiaries is made known to such officer by others within those entities.203

197. Id. at 773.
201. Id. at 777. Periodic reports, both 10-Ks and 10-Qs, are required by the Securities Exchange Act of 1934. Id. at 776. Reporting companies are defined as those with more than $10 million in assets and whose securities are held by more than 500 owners. These companies need to file annual and other periodic reports. MELVIN ARON EISENBERG, CORPORATIONS AND OTHER BUSINESS ORGANIZATIONS 209 (9th ed. 2005).
203. Id.
1. Director Independence

While guidelines about Director Independence do not appear in the Act itself, they are required by the Stock Exchanges and are considered a part of Sarbanes-Oxley Reforms. Each exchange has its own rules. The rules may vary slightly, but are consistent on most material matters. Under the NYSE’s rules, a director is considered independent if he or she does not have a material relationship with the listed company. An affirmative finding of independence must be made by the board, and any conflicts must be deemed immaterial. The independence determination must be disclosed to shareholders in a proxy statement. Employment, affiliation, or compensation over the past three years might prevent a director from being independent for board purposes.

2. Committee Requirements

Stock Exchange listed company committees engaged in governance, director selection, compensation, and auditing functions, must be comprised exclusively of independent directors. These committees must also have publicly available charters which articulate the purpose and responsibility of each committee.

3. Governance guidelines

Listed companies must also develop and adopt certain governance guidelines and make these available to the public. The governance guidelines must cover a broad range of specific topics, including but not limited to, director education, training, qualifications, responsibility, management succession, and an annual self-evaluation report.

4. Code of ethics

Stock Exchange listed companies must also develop and adopt codes of ethics for its officers, directors, and employees. These codes must be available to the public and should cover conflicts of interest, use of company

205. Listed Company Manual § 303A.02(a).
206. Id.
207. Id.
208. Id. § 303A.02(b)(i).
209. Id. §§ 303A.02, 303A.04, 303A.05, 303A.07.
211. Id. § 303A.09; NASDAQ Stock Market Rules, supra note 204, at R. 5250(b)(1).
assets, and contain language encouraging the reporting of any illegal or unethical activity.  

C. Enhanced Financial Disclosures

Sarbanes-Oxley requires that reporting companies disclose matters having a significant impact of the company’s financial statement; prohibits personal loans to directors or executives; and requires reporting of insider activities by directors, executives, and shareholders with more than 10% of any class of shares.  

Under Sarbanes-Oxley, each reporting company must file its ethics code for senior financial officers and a management assessment of internal controls. Reporting companies must disclose whether the audit committee has a financial expert. As a response to corporate scandals, it is possible that Sarbanes-Oxley has bolstered investor confidence in the markets. It has been suggested that similar regulations can be the answer to an embattled nonprofit sector.

III. NONPROFITS SCANDALS AND REGULATORY RESPONSES

Nonprofit malfeasance did not historically generate the amount of public outcry associated with the recent Enron scandal. Perhaps there is a direct relationship between public outrage to management malfeasance and individual harm. In the Enron case, individuals were injured, there were layoffs, job losses, and millions in retirement funds lost. These major losses affected not only the employees of Enron but the market as well. It also sparked new discussion on ways to prevent this type of loss from happening ever again.

In contrast, nonprofit malfeasance does not result in donor harm. The injury caused by nonprofit malfeasance is often to those individuals who rely on nonprofits for services through the reduction in quality programming and subsequent donations. But the impact of nonprofit malfeasance may be detrimental to the role of a nonprofit’s ability to fundraise and carry out its

216. Id. at 789.
217. Id. at 790.
218. Part of this confidence building is also related to Sarbanes-Oxley’s increased Corporate and Criminal Fraud Accountability found in Title VIII and the White-Collar Crime Penalty Enhancements found in Title IX. See id. at 746.
mission. As problems arose due to fraud by publicly-traded companies, the media and the public began to examine nonprofit corporations for similar behavior. Nonprofits have operated with minimal scrutiny from the media and regulators because the dollar amounts at stake are minimal and regulatory resources are scarce.

Even though donors, big and small, expect no return on their donations, and there are no shares, dividends, or proxy statements to watch for, nonprofits are still big businesses with a large economic impact.\(^\text{221}\) Evaluating nonprofits in terms of their size, revenue, employees, and expenditures reveals striking similarities to their for-profit counterparts.

From 1995 to 2002, $1.28 billion was lost in nonprofit scandals.\(^\text{222}\) Among them were Nature Conservancy, a nonprofit which buys land for nature preserves (allegations of insider retail estate purchases from board members), Bishop Estate of Hawaii, a one-hundred-year-old trust, charged with educating the children of Hawaii (allegations of corruption involving state supreme court judges and many powerful elites), and the United Way of the National Capital Area\(^\text{223}\) (allegations of financial fraud).\(^\text{224}\)


\(^{224}\) Allegheny Health is another example of financial fraud that stemmed from misappropriation of funds by its CEO, including comingling of funds, which led to one of the largest bankruptcies among nonprofit companies. See Lawton R. Burns et al., The Fall of the House of AHERF: The Allegheny Bankruptcy, HEALTH AFFAIRS, Jan./Feb. 2000, at 7, 10; Lisa Goldstein, The Failure of AHERF: 5 Important Lessons, HEALTHCARE FIN. MGMT., Aug. 2008, at 52, 52.
Such high-profile scandals draw the attention of lawmakers and donors to the functioning of nonprofit boards and the role of directors. In addition to financial losses, nonprofit fraud and mismanagement can cause the erosion of donor confidence.\(^{225}\) After the United Way scandal, donations dropped from $45 million to $18 million.\(^{226}\)

It is apparent that the market conditions, criminality, irresponsibility, and mismanagement that led to the sweeping reforms implemented through Sarbanes-Oxley exist in the nonprofit sector. But Sarbanes-Oxley does not extend to nonprofit corporations.\(^{227}\) Enhanced media and public scrutiny raises awareness for the necessity of the nonprofit boards to comply with corporate formalities and to follow their legal duties.\(^{228}\) Similar to Sarbanes-Oxley, regulation will make it easier for nonprofits to rebuild the trust of its donors.

But the adoption and application of Sarbanes-Oxley-like regulation must be carefully considered in terms of its broad applicability to the nonprofit sector. Only the largest for-profit corporations are governed by Sarbanes-Oxley. Perhaps it is inappropriate, in terms of cost–benefit, for smaller organizations to comply with Sarbanes-Oxley-like regulations.

A. Nonprofit Regulation in a Post Sarbanes-Oxley World

Sarbanes-Oxley is a high-water mark for the regulation of corporations and is the backdrop for the consideration of nonprofit regulatory reform. Commentators suggest that states should adopt Sarbanes-Oxley-like provisions in the area of nonprofit governance to stem the tide of scandals and bolster contributors’ confidence in the sector. Some notable efforts toward state regulation of the nonprofit sector have already commenced. Legislators in California, Massachusetts, New York, and Texas have introduced measures to increase state regulation over nonprofit organizations (“baby SOX”).

After Congress passed Sarbanes-Oxley, “the New York Legislature led the way by taking up a wide-ranging bill, championed by the state attorney general that would mandate Sarbanes-Oxley-like reforms for the nonprofit sector.”\(^{229}\) In January 2003, then-New York Attorney General Elliot Spitzer began a charge to apply Sarbanes-Oxley-type accounting disclosure provisions to the

\(^{225}\) Whoriskey & Salmon, supra note 223, at A7.

\(^{226}\) Id.

\(^{227}\) Bates, II & Schubert, supra note 181, at 1.


state’s nonprofit organizations." 230  Spitzer sought to strengthen state laws “to protect donors.” 231  After Spitzer’s interest, other states, including Massachusetts and California, attempted to introduce Sarbanes-Oxley-like provisions applicable to nonprofits. California was the first state to enact these Sarbanes-Oxley-styled regulations. The California Integrity Act of 2004 enhances disclosures required of nonprofits operating in California. 232  Massachusetts introduced a similar bill:

- The Massachusetts attorney general . . . proposed his own bill similar to New York’s. Neither bill passed. Numerous other states have followed suit by introducing comparable Sarbanes-Oxley-like bills that ultimately failed to pass. Several states, however, have passed acts codifying some Sarbanes-Oxley-like reforms for nonprofit organizations. California’s Nonprofit Integrity Act of 2004 being, perhaps, the most well-known. 233

In 2004 the Texas State Board of Accounting recommended to the governor, lieutenant governor, and speaker of the House that Texas not adopt additional layers of regulations for nonprofits. 234  The board believed that standards should be developed nationally, but did not believe that SOX-like legislation was needed for officers and directors. 235  The effect of these various bills can be summarized as follows:

The unifying theme of these Sarbanes-Oxley-inspired bills and actions is their reliance upon disclosure mechanisms (e.g., officer-certified financial

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231. Id.
235. Id.
statements), governance mandates (e.g., audit committees), executive compensation review and approval, whistleblower protection, and auditing requirements (e.g., independent audits performed by CPAs) to induce corporate integrity.236

In addition to attempts at increased state regulation, the post-Sarbanes-Oxley era ushered in new proposals for nonprofit regulation from the Office of the Inspector General for Health and Human Services, the United States Sentencing Commission, and the National Association of Insurance Commissioners.237 In 2003, the General Accounting Office (“GAO”) entered the realm of regulating nonprofits by promulgating rules for nonprofits receiving federal funds. The GAO regulations focus on auditor independence,238 enforcing the idea that an organization should not be performing its own auditing and consulting services.239 Auditing companies should be separate and independent from their clients.240

The flurry of proposed state legislation in California, Massachusetts, New York, and Texas, considering or requiring Sarbanes-Oxley-type disclosures by nonprofit organizations, gained the attention of the media as well as U.S. Senators. In 2004, the Senate Finance Committee held a hearing titled Charity Oversight and Reform: Keeping Bad Things from Happening to Good Charities.241 At the outset of the Hearing, Senator Max Baucus acknowledged the vital role the charities play in American Society.242 He noted the depth of assistance ranging from repairing national parks from fires in the west to the soup kitchens serving the elderly.243 Senators Baucus and Charles Grassley expressed concern over recent charitable scandals, insufficient transparency, and inflated salaries.244 Those giving testimony before the Committee discussed failed boards, mismanagement, industry reform, and reform as


240. Id.


242. Id. at 2 (opening statement of Hon. Max Baucus).

243. Id. at 2–3 (opening statement of Hon. Max Baucus).

244. Id. at 1–3.
applicable to small nonprofits. Following several hearings including testimony from the director of the IRS, state attorneys general, and leaders from the nonprofit world, some members of Congress sought increased disclosure from, and oversight of, nonprofits. Ultimately, in June 2006, the Committee passed a series of measures designed to address potential abuses in the nonprofit sector through increased penalties for political activities, overvaluation of donations, and top officials engaged in illegal financial transactions.

In 2004, the IRS committed to increasing its review of 501(c)(3) agencies’ activities. On June 22, 2004, Mark W. Everson, then-Commissioner of the IRS, testified before the Senate Finance Committee:

I share your view that we must quickly and effectively act now. If these abuses are left unchecked, I believe there is the risk that Americans not only will lose faith in and reduce support for charitable organizations, but that the integrity of our tax system also will be compromised.

The Commissioner continued, calling for laws forcing nonprofit organizations to disclose greater amounts of information:

Disclosure is an important way for the IRS to identify participants in abusive transactions. However, our disclosure scheme, which originally was developed to address the taxable sector, does not yet fit all tax-exempt participants because the method of reporting does not fit all tax-exempt entities well [since some entities do not have to report under the current scheme].

In addition to the 501(c)(3) status, the IRS requires that certain nonprofits complete and file the Form 990.

In response to the nonprofit scandals, including the United Way excessive compensation scandal, in 2005, the IRS adopted new regulations.

249. Id.
250. Id.
251. IRS, Filing Requirements: Exempt Organizations, http://www.irs.gov/charities/article/0,,id=96103,00.html (last visited Jan. 11, 2010). Religious institutions are not required to file the Form 990. Id. Donors and members of the public that support these organizations through contributions are therefore not able to readily determine how these funds are used.
These new regulations make executives and directors personally liable for excessive compensation. The IRS can also impose immediate sanctions on nonprofit leaders who provide excess benefits to board members or other control persons. Even more recently, the IRS has designed a new Form 990 for nonprofits. This new form will focus on the internal workings of these organizations and make internal activities more visible to the public—achieved through the reporting of transactions between board members and officers and the nonprofit entity. These changes have substantially increased the IRS enforcement presence.

B. The Voluntary Adoption of Sarbanes-Oxley-Like Measures in the Nonprofit Sector

Reform often follows destabilizing events, as seen in response to corporate scandal. But within a few years, following the passage of Sarbanes-Oxley, several large nonprofits, led by the healthcare sector and education companies, voluntarily adopted various Sarbanes-Oxley-type disclosure requirements as “best practices.” Many of these firms perceive benefits of preemptively adopting Sarbanes-Oxley-type policies in the face of the attention their industry received from Congress and the IRS. Attorney Gerald L. Blanchard argues:

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257. IRS Press Release, supra note 253.
258. A. Nagorski, Sarbanes-Oxley Isn’t Just for Public Firms, INTERNAL AUDITOR, June 2006, at 20, 20; see also Cinda Becker, Transparent Motives: UPMC Blazes Trail for Not-for-Profits in Sarbanes-Oxley Compliance, MODERN HEALTHCARE, July 31, 2006, at 28, 28 (discussing the University of Pittsburgh Medical Center’s preemptive Sarbanes-Oxley “compliance”).
259. See Becker, supra note 258, at 28.
For example, the nonprofit University of Pittsburgh Medical Center has taken steps to become SOX certified by its outside auditor. The Fitch ratings service issued a report in 2005 called “Sarbanes-Oxley and Not-For-Profit Hospitals: Increased Transparency and Improved Accountability,” in which it encourages hospitals to adopt SOX standards for corporate governance and financial transparency. Likewise, Moody’s has issued a special comment called “Governance of Not-for-Profit Healthcare Organizations,” in which it discusses how compliance with best corporate governance and financial accountability practices plays into the rating process for bonds. Thus, the large nonprofit organizations like hospitals are beginning to adopt SOX-like controls and systems, even though they are not technically required to do so. Ratings agencies, accounting firms, and the investment community are beginning to expect that nonprofits will move toward SOX compliance.  

The perceived benefits of voluntarily adopting Sarbanes-Oxley-like policies include increased public confidence in both the individual nonprofit corporation and the nonprofit sector as a whole, as well as improved internal accountability among nonprofit directors. Some nonprofit directors believe the application of Sarbanes-Oxley-type disclosure requirements to nonprofit entities is inevitable and prefer to have the policies in place as a preemptive measure.  

C. Sarbanes-Oxley as a Required Regulatory Scheme Should Be Restricted to the Largest Nonprofits  

Sarbanes-Oxley applies to the largest corporations, those publicly-traded and regulated by the SEC. Since 2004, these companies, representing more than 95% of the total U.S. market capitalization, have been subject to all of the new rules created by Sarbanes-Oxley. Large organizations can more easily invest in the infrastructure to achieve compliance with Sarbanes-Oxley than publicly-traded small and mid-size corporations. And they may need the regulation more than smaller organizations because large organizations are vulnerable to mismanagement due to their size as opposed to smaller
organizations that may be vulnerable due to detached governance. Further, financial mismanagement when an organization is not regulated, can be devastating, as seen with Enron, Tyco, and WorldCom. Arguably, Sarbanes-Oxley has aided in the restoration of investor confidence in publicly-traded companies through, among other measures, transparency and financial controls.

Sarbanes-Oxley can similarly benefit the largest nonprofit organizations, those with assets of $10,000,000 or more (“jumbo nonprofits”). In 2005, jumbo nonprofits represented 1% of nonprofits registered with the IRS and 6% of the returns filed by nonprofit charitable organizations. These nonprofits account for 90% of the total asset holdings and 83% of the total revenue reported by nonprofit charitable organizations.

Sarbanes-Oxley-like reforms—if applied to jumbo nonprofits—would be a rational application of best practices, and would be more likely to achieve the desired results of transparency and strong governance. This restrained application of Sarbanes-Oxley would track donor dollars and perhaps public interest to a larger degree than a broad application of similar reform to all nonprofits.

D. What About the Little Guy? Doesn’t He Need Reform?

In a recent study of major nonprofit scandals reported between 1995 and 2001, Margaret Gibelman and Sheldon R. Gelman concluded that poor governance was the principle source of nonprofit scandal. Their research

266. GLASS, LEWIS & CO., RESTATEMENTS TREND ALERT: GETTING IT WRONG THE FIRST TIME 1 (March 2, 2006) (“[T]he smallest companies are where strong internal controls arguably are needed most, because they are where the risk of restatement is the highest.”) available at http://www.glasslewis.com/downloads/Restatements2005Summary.pdf.


268. Andy Serwer, Stop Whining About SarbOx!, FORTUNE, Aug. 7, 2006, at 39 (noting that the market value of the Wilshire 5000 index, a proxy for all public companies in the U.S., increased 54% in the four years after SOX was signed).

269. Loomis, supra note 265, at 1.


272. Id.

found that a lack of oversight and accountability left the nonprofits vulnerable to exploitation.274

The application of Sarbanes-Oxley-like reform for the nonprofits sector en masse is ill conceived. The nonprofit sector is heterogeneous.275 As Gerald Blanchard explains, “Over two-thirds of all 501(c)(3) organizations have less than $25,000 in gross receipts and represent everything from the school/parent/teacher organizations to local sports leagues.”276 The organizations which are not necessarily business-like ventures are less likely to have savvy boards and should not be squeezed into the for-profit regulatory mold of Sarbanes-Oxley. Nonprofits have unique attributes that should be respected as we move toward reform. Reform in this area must be respectful and innovative in order to accurately value the organizations and their missions. Before the Senate Finance Committee, Diana Aviv, CEO of Independent Sector, explained the following:

In the last 25 years, the charitable sector has grown considerably and some of its leaders are not familiar with good governance practices. The legal framework has not kept pace with growth, and the diversity of organizations, and public resources are not sufficient to ensure that laws governing the sector are properly enforced. The forms 990 and 990 PF filed annually by charities and foundations too often are inaccurate and inconsistent. These current challenges do not lend themselves to quick fixes. Changes must be given careful consideration and tested before sector-wide reform is implemented.277

The goal of nonprofit reform is to increase the likelihood of the agencies’ positive outcomes in terms of service delivery and mission accomplishment, while decreasing the opportunity for fraud and mismanagement through systematic reforms that focus on transparency, independence, ethics, and honesty.

III. GUIDANCE FOR NONPROFIT REFORM

The wholesale application of Sarbanes-Oxley to the nonprofit sector with the goals of sound governance, transparency, and accountability is shortsighted and impracticable. Sarbanes-Oxley-like reform is best suited for the largest nonprofits, which actually function more like corporations. There are lessons that all nonprofits can take away from Sarbanes-Oxley.

Strong leadership from the chairman of the board or the executive director is necessary for proactive nonprofit reform. When leadership is not interested

274. Id.
275. Charity Oversight Hearing, supra note 241, at 44 (statement of Prof. Derek Bok, President Emeritus, Harvard University).
277. Charity Oversight Hearing, supra note 241, at 42 (statement of Diana Aviv, President and CEO, Independent Sector).
in positive board change reactive reform can be seen in times of crisis such as the untimely departure of the founder, financial pressures, or ethical problems. Highly visible moments or transition, stress, or even crisis within an institution or a board, however traumatic, are particularly promising windows of opportunity for the chairman of the board or the executive director to initiate board development efforts. 278 Purposeful governance at the board level, through and by independent directors, is critical to the nonprofit sector. Committee work should be taken seriously. Those engaged in the work of shaping the future of the nonprofit should assess the board, its structure, and its needs. This process should culminate in focused director recruitment and training. In terms of finances, nonprofit directors should concern themselves with audits, compensation matters, and executive evaluation. Additionally, nonprofits should develop and adopt document retention plans, and policies addressing whistle-blowers, conflicts of interest, codes of ethics, and nepotism.

Nonprofit directors must specifically focus intently on, and, in some instances, sharpen the mission of their nonprofit. This mission should guide the nonprofit in defining objectives, conducting daily activities, providing client services and strategic planning—all aided through decisions of the board and activities of the staff. A nonprofit adhering to mission-based principles should be well positioned to seek and train the most qualified directors, executives, and staff. A nonprofit’s ability to recruit, train, and retain high-quality people in key roles is important to the work of the nonprofit in terms of fundraising and client services.

A. The Mission as a Template; Enhancing the Duty of Obedience

Nonprofits, irrespective of size, can benefit from a recommitment to their missions by thinking about recruiting, training, and retaining directors, and conducting succession planning. The first step for a board is to establish or reaffirm its mission. 279 There are several books on mission-based management that provide direction on using the mission statement as a template for daily activities. 280 These resources and others provide direction on using the mission statement as a template to board activities. 281 The goal of mission-based

281. CHAIT, supra note 278, at 131.
management is to ensure that the agency is carrying out its duties in a manner that focuses attention on the mission of the organization. A one-step implementation of this principle is to instruct directors to spot check their work by asking the fundamental question: “Have my actions advanced the mission of the organization?” If responses to this question are not clearly yes, then the board should reconsider the action. Periodic review of the mission helps to ensure that newer directors both understand and acknowledge that they are a part of the articulation of the mission.

1. Conducting a Needs Assessment

Once a board has established its mission, there are ways to make sure the organization utilizes and advances the purpose of this mission. Conducting a needs assessment is crucial to the board’s ability to do its job and carry out its mission in a consistent manner. Members of the board need to work together to identify the needs of the nonprofit. An organization can assess its needs and determine its priorities by examining existing data and conducting attitude surveys, community forums, or focus group interviews. Each organization must determine which method will be the most effective and useful for them. Once an organization determines its needs and priorities, it must establish a plan to further provide methods and strategies to fulfill these needs.

This leads the board into the next essential area: Communication. Informing the community and the organizations stakeholders of the needs of

282. BRINCKEROFF, MISSION-BASED MANAGEMENT, supra note 280, at 43.
283. Id. at 45–47.
284. ABA, GUIDEBOOK FOR DIRECTORS OF NONPROFIT CORPORATIONS 8 (George W. Overton & Jeannie Carmelelle Frey eds., 2d ed. 2002).
288. See CASEY FOUND., supra note 285, at 2.
289. Id. at 1.
the organization in order for it to carry out its mission is crucial.\textsuperscript{290} Using the results of the needs assessment and sharing the nonprofit entity’s priorities with stakeholders is an essential element for the success of community-based organizations and other nonprofits.\textsuperscript{291}

2. Communication

Caucusing with stakeholders and engaging in team building is perhaps the most effective way to communicate the needs and mission of the organization. Stakeholders are the people who hold an interest in the organization and want to see it succeed.\textsuperscript{292} This category includes funders, clients, community members, local politicians, advocates, those who believe in the mission, and those who can influence others through social networks or other means to support the mission.\textsuperscript{293} When stakeholders know the needs of the organization, they can provide strategies and incentives to others in order to meet these needs.

For example, the Social Equity Caucus operating out of California includes nine Bay Area counties and has met since 1998 “on a quarterly basis to share information and strategies, network, and develop a unified vision of social equality for the region.”\textsuperscript{294} This caucus provides members with a chance to receive feedback and information from its stakeholders and allows those members to provide ideas and recommendations for the future.

Team building can strengthen an organization and increase productivity and dedication to the organization.\textsuperscript{295} Once a board looks past the simple text of its mission and works to include the stakeholders of the organization, they have a better chance to advance this mission. Communicating the mission and the priorities of a nonprofit entity is essential to fundraising and effective operations. This communication can be a powerful tool for both external constituents and employees.

\begin{quote}
\textsuperscript{290} BRINCKEROFF, LEADING YOUR NOT-FOR-PROFIT IN THE 21ST CENTURY, supra note 280, at 32.

\textsuperscript{291} Peggy Sasso, Searching for Trust in the Not-For-Profit Boardroom: Looking Beyond the Duty of Obedience to Ensure Accountability, 50 UCLA L. REV. 1485, 1500 (2003).

\textsuperscript{292} Mulligan, supra note 130, at 2006.

\textsuperscript{293} Id.


\end{quote}
3. Internal Investment

The next step in advancing an organization’s mission is to take time to educate the staff and middle management about the mission and the priorities of the nonprofit entity. The staff and middle management are the face of the organization and its key communicators. Middle managers play a unique and effective role in a company and can help maintain an organization. They are generally good at motivating and boosting the morale of their employees. Adoption of mission-based management is an important step in the development process and can also play a role in carrying out an organization’s vision. Treating an employee well, through respect and involvement, will produce high-quality employees who not only continue to come to work each day, but also bring a level of commitment to the organization while they work. Employees who understand and support the organization can be instrumental in advancing the mission.

B. Recruiting and Retaining Directors

Nonprofit directors do not reap the monetary benefits that they may receive as for-profit directors, such as dividends or stipends. This, coupled with the public’s growing interest in holding directors legally accountable for poor decisions, makes the search for willing and capable directors a difficult task. Recently, judges in Delaware were willing to give less deference to directors’ business decisions. Such judicial decisions do not help alleviate the high demand and low supply of qualified and willing directors.

There are several factors that will attract good, independent candidates. A well-articulated mission is important because a director will forward the

298. Id.
299. See Dale Dauten, Take Care of Your Employees; They’ll Take Care of You, BOSTON GLOBE, Dec. 3, 2006, at G4.
302. Independent is defined as someone one who is not compensated by the organizations and is not related to a member of the organizations. Self-regulatory Organizations, Exchange Act
mission to others in fundraising events. The mission should also be broad enough for a potential director to accept and support it. The candidate will need to believe their participation will further the mission. Another helpful factor is branding or prestige. This will attract skillful directors because the corporation’s brand will open doors—professional as well as social. The candidates for directorship should believe in the leadership and vision of the CEO. Clearly written expectations and duties will also attract qualified board members because they will want to work for an organization that is respectful of their time.

A necessary step in this process is defining or identifying specific recruitment needs. The board committee assigned to recruitment should consider qualifications such as leadership, work ethic, commitment to the mission, community connections, management style, expertise, other commitments, and demographics. The board should have an attorney for his reasoning skills, an accountant for her financial skills, and a specialist from the field in which nonprofit corporation deals. For example, if the nonprofit corporation is a hospital, the board should have a physician and a health care administrator. The board committee for recruitment can use a “recruiting matrix” to evaluate the board as it exists and to identify gaps in desired characteristics. Not only do some nonprofit websites have such matrices but there are professional recruitment firms that offer evaluation and recruitment strategies.

Another way to attract board members is to offer all possible precautions against personal liability. The board should give copies of the Director and Officer (“D&O”) insurance policy to candidates. They should offer the

Release No. 48,745 (Nov. 4, 2003). In establishing the test for independence, the same questions should be asked to those that live with the potential director. See id.


305. Bol et al., supra note 303, at 31.

306. Id. at 27.


maximum amount of indemnification available by law. The board should divulge gaps in coverage and help the director fill in the gaps. Finally, the board should assure renewal of the D&O policy.

The board can assure its own quality by recruiting the best and the brightest. New and talented board members come equipped with naive questions and energy. These unique resources motivate the board as a whole and may lead the board to question its method of operations. The opportunity to work with qualified and competent directors will benefit recruitment and retention. An effective code of ethics, clearly defined duties, and annual evaluations will assist in maintaining the board’s quality. New directors should go through orientation and training. To increase new board member investment in the nonprofit, they should be given options in defining their role in the nonprofit. For example, they should be able to choose between a variety of committees, advisory boards, and/or executive board positions.

Compensation is an effective recruiting method, and the nonprofit may consider compensating its board members. The board, however, should be careful with respect to the compensation of members. It is also important for the corporation to abide by the laws of the state of incorporation and IRS rules and regulations. Given the complexities in compensating board members, it may not be wise to compensate board members if doing so would

309. ABA, GUIDEBOOK FOR DIRECTORS OF NONPROFIT CORPORATIONS 262 (George W. Overton & Jeannie Carmedelle Frey eds., 2d ed. 2002).
310. Id.
311. Naïve but useful questions can include the following: What is on the agenda for this meeting? Why do we need to complete this form? Can I take a look at the balance sheet?
313. See RUNQUIST, supra note 53, at 86–87.
314. Evelyn Brody, The Board of Nonprofit Organizations: Puzzling through the Gaps Between Law and Practice, 76 FDMLR 521, 544 n.104 (2007) (citing In re Walt Disney Co. Derivative Litig., 906 A.2d 27 (Del. 2006)). One issue in Disney addressed whether only the full board, rather than just the compensation committee, could set the financial terms of the contract with incoming president Michael Ovitz. Compensation can be a sensitive topic for many exempt organizations, particularly charities, and the visibility of the Form 990 suggests that the full board at least should be aware of the compensation it pays to directors, officers, and top executives before the public.; Comm. to Save Adelphi v. Diamandopoulos § I. (Bd. of Regents of Univ. of N.Y. Feb. 10, 1997); Vacco v. Diamandopoulos, 715 N.Y.S.2d 269, 270 (N.Y. Sup. Ct. 1998); Alec Macgillis, The Princely Habits of College Presidents, BALT. SUN, Oct. 2, 2005, at 1F (discussing the spending habits of four university presidents); see ABA COORDINATING COMM. ON NONPROFIT GOVERNANCE, GUIDE TO NONPROFIT CORPORATE GOVERNANCE IN THE WAKE OF SARBANES-OXLEY 45 (2005); see also Principles of the Law of Nonprofit Orgs. § 330 cmt. b(1), reporter’s notes 1–6 (Tentative Draft No. 1, 2007); Ralph E. DeJong & Michael W. Peregrine, Director Compensation Plans for Nonprofit: Addressing the Key Legal Issues, 30 EXEMPT ORG. TAX REV. 29 (2000).
mean abdicating nonprofit status. A complex decision such as this one is a reason to find, recruit, and retain competent directors.

C. Training Directors

Once the board attracts qualified directors, it is crucial to train them. Maintaining a quality board will help recruit and retain the best directors. The first opportunity to train new directors is during recruiting. The candidate will learn about the mission and the organization during this time, and they will learn about certain risks and duties of directorship in the nonprofit arena.

The next best opportunity for training is orientation. The new board member should be given two manuals. One manual should contain relevant information that they may leave at home. Relevant information consists of, at a minimum, a history of the corporation, the corporation’s structure, its culture, and sample documents for proxies. The other should contain information that they may need to reference at meetings, such as the charter, bylaws, proper meeting procedure, the current mission statement, a list of other directors, and the organization’s annual calendar of events.

There are other ways to engage and train directors. One way to engage and train directors is to hold annual retreats. Annual retreats can renew individual commitment to the organization and its mission. They can act like extended board meetings to further an agenda. Also, retreats enhance relationships and build personal rapport. Another method to engage and train directors is to hold training sessions. If funding permits, the board should consider hiring experts on a short-term basis to conduct training. Additionally, there are many state and federally-sponsored training classes that focus on board development and director duties. A third, and highly successful method of engaging and training directors, is to create a board mentoring program. Additionally, boards should consider adopting a continuing board education requirement. If the board adopts such a requirement, both new and old members would be required to attend a certain number of hours of training each year. Continuous training teaches board members new skills and reinforce best practices.

315. See Runquist, supra note 53, at 86–87 (discussing that charities can have their tax-exempt status revoked for giving a prohibited benefit to a person).
316. ABA, supra note 309, at 229.
317. Id. at 230.
318. Id.
319. Id. at 230–31.
320. Id. at 230.
321. Bol et al., supra note 303, at 31.
D. Executive Succession—A Missing Link, Transitions, and Looking Toward the Future

Attracting and maintaining an educated and contributing board is imperative. In addition to the legal duties of nonprofit boards, there are several areas where the board’s work is required. Numerous articles discuss fundraising as a role of the board. Less attention, however, has been given to one of the board’s most important functions: continuous investment in succession planning. While experience can, of course, be of great value in board service, this very strong emphasis on retention raises concerns about possible entrenchment and poor succession planning. Assuming that nonprofit boards—already undercompensated and overworked—can keep nonprofits afloat, in compliance with applicable laws, and well funded, executive succession often threatens nonprofit organizations as the next major hurdle.

Executive Director succession is one of the leading causes of nonprofit failure in terms of providing services. Succession planning should be considered by the board as well as the executive staff of the organization. The development of any succession plan should be an evolutionary process from which organizational strengths and weaknesses can be identified and addressed, if necessary.

E. Making the Most of Sarbanes-Oxley

Borrowing some of the principles from Sarbanes-Oxley could prove effective for nonprofits. Specifically, the requirements of certification, an independent audit committee, and internal controls, as required by Sarbanes-Oxley, could help nonprofits run more effectively, sustain a healthy corporation, and fulfill their mission statement.


323. RUEL & HODGSON, supra note 98, at 12.


1. Certification

Sarbanes-Oxley requires that the Chief Executive Officer and the Chief Financial Officer (or their equivalent) certify financial records. The signatures on these statements by those who are in charge of overseeing these records further certify the accuracy and importance of the documents. Having the directors or those in charge of the financial records acknowledge the accuracy of the statements will aid nonprofits with financial accountability and transparency.

2. Independent Audit Committee

Nonprofits could benefit from enhanced audit oversight through the work of an independent audit committee. If an auditor is too close to the inner workings of the organization, it will be hard to maintain control and remain objective. A nonprofit, using an independent audit committee, would have an effective way to remain in control and have an objective point-of-view, ensuring a good financial process able to detect and perhaps prevent financial mismanagement.

3. Internal Controls

While it is important for an organization to have an independent audit system, it is also very useful to establish internal controls of an organization. The Public Company Accounting Oversight Board (“PCAOB”) has established its own set of internal operations to evaluate their financial auditing methods. The PCAOB focuses on evaluating several areas, such as identifying the risks to integrity and effectiveness of programs, implementing ways to improve in the area of integrity and effectiveness, keeping reports of the performance and finances, examining and following laws that apply, implementing safeguards and utilizing resources, and continually protecting and promoting the integrity and efficiency of the organization and its auditing measures. It would be useful for a nonprofit to follow the lead of the PCAOB and establish an effective method for internal control, including but not limited to, policies, practices of self-examination, and internal guidelines.

329. Id.
for processes. There are many sites a nonprofit can use to help them develop and maintain internal controls.330

As a summary, Chart 1 in Appendix A groups nonprofit organizations according to asset size and recommends appropriate adaptations of Sarbanes-Oxley. These adaptations, if found to be desirable practices, should be added to the current nonprofit manuals, charters, and bylaws.

CONCLUSION

Nonprofits who adopt procedures and rules similar to those required by Sarbanes-Oxley in the for-profit context will not pass a litmus test for appropriate governance. Yet, implementing certain measures makes it more likely that directors and the executive staff are asking the right questions, making it more likely than not that the appropriate actions will be taken. The call for stringent Sarbanes-Oxley-style reforms in the nonprofit sector is overly broad. The potential reforms fail to recognize the distinctions between various types of nonprofits and, as a result, attempt to force corporate reforms onto nonprofit organizations.

Revisiting the stories of John and Jeff, strong training and orientation for Jeff would empower him to carry out his legal duties while monitoring and managing the nonprofit organization. A knowledgeable and engaged nonprofit board has a better chance of ensuring that the organization’s mission is carried out and that clients like John receive the care they deserve.

### APPENDIX A

**Chart 1: Suggested Methods of Implementing the Sarbanes-Oxley Based on Size of Nonprofit**

<table>
<thead>
<tr>
<th>SOX Requirements for reporting companies</th>
<th>Jumbo Nonprofit (in excess of $10,000,000 in assets)</th>
<th>Large Nonprofits ($1,000,000 to $10,000,000 in assets)</th>
<th>Medium Nonprofits ($100,000 to $1,000,000 in assets)</th>
<th>Small Nonprofits (less than $100,000 in assets)</th>
</tr>
</thead>
<tbody>
<tr>
<td>1. Auditing</td>
<td>Auditor independence is required.</td>
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<td>Auditor independence is required.</td>
<td>The board should have an audit committee and should recruit board members with expertise in the areas of accounting and auditing. The audit committee should work closely with accounting professionals. Procedures should be set up to detect fraud.</td>
</tr>
</tbody>
</table>

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331. See Paul Arnsberger, *Charities, Labor and Agricultural, and Other Tax-Exempt Organizations*, STATISTICS OF INCOME BULLETIN (2008) (providing the numbers for this chart).

332. Auditing under the Sarbanes-Oxley Act is “an examination of the financial statements of any issuer by an independent public accounting firm in accordance with the rules of the Board or the Commission (or, for the period preceding the adoption of applicable rules of the Board under section 103, in accordance with then-applicable generally accepted auditing and related standards for such purposes), for the purpose of expressing an opinion on such statements.” Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, § 2, 116 Stat. 745, 747 (2002).
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<tbody>
<tr>
<td>Directors should not have material relationships with the organization.</td>
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<td>Directors might wear many hats in small organizations. It is very possible that only interested, non-independent persons are available for board service.</td>
<td>Directors may have material relationships with the agency. These relationships should be formally disclosed to the directors and the director should indicate that the material relationship will not inhibit his fiduciary duties.</td>
</tr>
</tbody>
</table>

2. Corporate Responsibility

a. Director Independence

### SOX Requirements for reporting companies

<table>
<thead>
<tr>
<th>Jumbo Nonprofit (in excess of $10,000,000 in assets)</th>
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<td>The board should have a number of committees. These committees should be comprised of independent directors and should have charters publicly available. Each committee should have governing standards.</td>
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<td>The board committee should serve as a liaison from the board to the staff. Committees should cover finance, human resources, audit, and budget. There will be instances where the board will need staff to sit on the committees. Committee rules and responsibilities should be established.</td>
<td>The board committee should serve as a liaison from the board to the staff.</td>
</tr>
</tbody>
</table>

### b. Committees

- **Have a statement by your nonprofit that establishes what you believe corporate governance should entail for your nonprofit.**

### c. Governance

- **Independent, non-interested board members may not be available for committee service.**
### SOX Requirements for reporting companies\(^{11}\)

<table>
<thead>
<tr>
<th>Type of Nonprofit</th>
<th>Disclose whether a code of ethics has or has not been adopted.</th>
<th>Matters that significantly impact the financial statements should be disclosed to funders and other stakeholders. These statements should be certified by an independent financial auditor and the CEO.</th>
<th>Matters that will impact financial statements should be shared with the board by the CEO and the CFO. When problems regarding cash flow or funding are discussed, a financial professional should be engaged to lead the discussion and to provide assistance in resolution. These matters should be shared with funders.</th>
<th>The CFO should make periodic reports to the Board regarding the financial status of the organization. Matters that will adversely impact the financial health of the organization should be addressed with the board as soon as practicable. The board should communicate financial concerns to funders and seek outside assistance.</th>
</tr>
</thead>
<tbody>
<tr>
<td>Jumbo Nonprofit</td>
<td>Ethical guidelines should be aspirational and disseminated throughout the agency. Leadership from the board regarding ethics can set the tone for ethical behavior.</td>
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\(^{11}\) SOX = Sarbanes-Oxley Act