BACK TO BASICS

James E. Orlikoff,
President, Orlikoff &
Associates, Chicago, Ill.
(773) 268-8006
Mary Totten, President,
Totten & Associates,
Oak Park, Ill.
(708) 383-1115

Governance in the Spotlight: What the Sarbanes-Oxley Act Means for You

Following a wave of high-profile corporate business and governance scandals, Congress passed the Public Company Accounting Reform & Investor Protection Act of 2002 (Public Law 107-240), better known as the Sarbanes-Oxley Act. This legislation contains the most sweeping and comprehensive set of public-company governance, financial and accounting reforms enacted in more than 30 years. The Sarbanes-Oxley Act, intended to protect investors and renew public trust in corporations and their boards, set the stage for even broader reforms promulgated by the stock exchanges and other business and investor protection groups.

These emerging requirements and standards are widely perceived as governance "best practices" for both for-profit and not-for-profit organizations alike. Attorneys, consultants and governance experts agree that it is only a matter of time before the Sarbanes legislation and the rules and regulations designed to implement it, will be broadly applied to not-for-profit governance and used as the yardstick against which board performance and accountability are measured.

Sarbanes at a Glance

While the Sarbanes-Oxley Act leaves many questions unanswered and allows federal agencies broad discretion in enforcing its requirements with publicly-held companies, the following provisions are applicable to nonprofit organizations:

• The role of independent directors and their representation on audit and other key board committees

• Executive compensation and loan arrangements

• New disclosure requirements for changes affecting the company's financial status and the adequacy of company financial statements and controls

• Detailed codes of ethics, business conduct and comprehensive conflict-of-interest policies.

Each of these areas is discussed in more detail below.

Independent directors. Independent directors are the linchpin of many of the public-company reforms. To be considered "independent," directors must be free of relationships with the company/organization or its management that might influence their decisions. Relationships affecting director independence include employment, vendor, or consulting arrangements, as well as indirect links through family, business or charitable organizations in which the board member may hold an officer or director position.

Sarbanes-Oxley and the related rules of stock-listing organizations (such as the New York Stock Exchange) sharpen the focus on the role of independent directors by specifying governance oversight activities in which only independent directors should be involved. For example, independent directors must meet together at regular intervals without either inside directors or management present. Several important governance-related committees, such as the audit committee, the nominating committee, the corporate governance committee, and the compensation committee must be staffed solely by independent directors.

Audit committee. The new reforms make it clear that the audit committee bears direct responsibility for hiring and firing the CEO, determining CEO compensation, and overseeing the company's external auditors. Because of the importance of maintaining the audit's integrity, committee members are prohibited from receiving any compensation from the company other than directors' fees and expense reimbursement.

The Act also requires that:

• The external auditor reports directly to the audit committee, *not* to company management.

• Audit committees must be given the authority and resources to hire outside attorneys, consultants and other advisors as they think necessary.

• The audit committee must oversee the external auditor directly and resolve any disagreements between management and auditors about financial reporting.

• Audit committees must establish procedures to receive anonymous employee concerns about accounting or auditing practices.

• External auditors are prohibited from providing certain nonaudit services to the companies they audit, such as consulting, bookkeeping, appraisal or valuation services, design and implementation of financial information systems, actuarial services, legal services unrelated to the audit, and management or human resources functions.

• The audit committee must rotate the lead external audit partner at least every five years.

• All audit committee members must be financially literate.

• Audit committees must have at least one member who is a financial expert; if no committee members are financial experts, the company must disclose that fact in its financial filings.

The SEC is proposing to define a "financial expert" as someone who has an understanding of generally accepted accounting principles (GAAP); experience in applying GAAP to how estimates, accruals and reserves are accounted for; experience in preparing or auditing financial statements; experience with internal controls and procedures for financial reporting; and a detailed understanding of audit committee functions.

Most likely, a health care financial expert would be defined somewhat differently—with a more specific emphasis on health care that reflects the field's unique and complex financial, reimbursement and regulatory demands.

Nominating committee. This committee is responsible for setting board membership criteria and identifying qualified candidates. By requiring that the nominating committee comprise only independent directors, the reforms place key decisions about board candidates in the hands of independent directors, rather than management.

Corporate governance committee. The role of this committee is to prepare and recommend corporate governance guidelines to the full board that would address such issues as director qualifications, duties, and educational needs and programs. The governance committee would also be responsible for recommending appropriate ethics and business-conduct codes for directors, officers and company employees. These duties could also be carried out by the nominating committee.

Executive Compensation. The duties of this committee include all issues related to the CEO's and other senior executives' compensation, including identifying future performance goals, evaluating whether past goals have been met and overall assessment of appropriate standards for the CEO's and other senior officers' compensation.

Risky Compensation Practices

1. Employing stock option look-alikes as compensation mechanisms.
2. Offering reverse split-dollar life insurance.
3. Providing loans to executives.
4. Using the organization's financial performance as the primary basis for providing incentive awards.
5. Hiring the same firm to provide both audit and consulting services.
6. Conducting piecemeal reviews of executive compensation and benefits.
7. Reporting less than total compensation on IRS Form 990.
8. Asking management to prepare data on executive compensation and benefits for board review.

Source: Clark Consulting, North Barrington, Ill., 2002

The public-company reform rules reflect the strong and growing congressional and regulatory concern about excessive executive compensation and "perks." Some of these concerns are reflected in the requirement that only independent directors sit on a company's compensation committee. However, in case this committee is not rigorous enough in its procedures for relating CEO performance to compensation, Sarbanes-Oxley also requires CEOs or CFOs to pay back any bonus or similar "reward" for good financial results, if the company's financial statements are later restated, as a result of misconduct or significant failure to comply with financial reporting standards. Another notable reform emerging from Sarbanes-Oxley is the flat prohibition against loans or other kinds of "extensions of credit" to directors and senior officers (e.g., the CEO of a for-profit corporation) including guaranteeing or securing personal loans for officers or directors. The Act also raises questions about a number of other practices, such as reverse split-dollar life insurance, a fairly common executive benefit provided to not-for-profit hospital CEOs; salary advances; or advancement of expenses for legal defense incurred by an officer or director.

In addition to their roles in the above key committees, independent directors must also make sure there are ways for concerned shareholders and employees to communicate directly with them in order to avoid situations in which legitimate whistle-blower and stakeholder concerns are "brushed under the rug" and never communicated to non-management directors.

Disclosure requirements and executive certifications. To enhance the quality and timeliness of important financial and operational information available to public-company investors, Sarbanes-Oxley specifies numerous events and transactions that must be disclosed promptly to investors, such as information about off-balance-sheet transactions; cancellations of significant contracts; and incurrence of significant debt and defaults, or potential defaults under current debt instruments. As has been widely reported, Sarbanes-Oxley has also imposed rules that the CEO and CFO certify the accuracy of financial statements and other information filed by the company with the Securities and Exchange Commission (SEC). Certification of all quarterly and annual reports must stipulate that:

• Financial statements fairly represent the organization's financial condition and operational results.

• The report does not contain any untrue statement or omit material facts.

• The CEO and CFO have designed internal controls to ensure that: they possess all relevant information; they have personally evaluated the effectiveness of internal controls within the last three months; and that they have presented their conclusion about the effectiveness of the internal controls in the report.

• The CEO and CFO have disclosed to the auditors and audit committee all significant deficiencies in the organization's internal controls and any fraud, whether material or not, that involves management or other employees who have a significant role in the company's internal controls.

Codes of ethics and business conduct. In a clear nod to the Enron debacle, Sarbanes-Oxley requires public companies to adopt a code of ethics for the company's CFO and other senior financial officers. Furthermore, any waivers of the company's conflict-of-interest policy must be reported promptly in an SEC filing. The New York Stock Exchange has proposed requiring all companies listed on the exchange to adopt a code of business conduct. Other exchanges and listing organizations, as well as shareholder activists, can be expected to demand that companies both have and comply with such codes of ethics and conduct.

Sarbanes-Oxley Creep

As anticipated, several developments indicate that the bar on governance of not-for-profit organizations is already being raised in the wake of Sarbanes-Oxley. In other words, the governance-related requirements of Sarbanes-Oxley are beginning to "creep" into the not-for-profit health care world.

The Internal Revenue Service recently stated that it was likely to implement modifications to the Form 990 reporting requirements for tax-exempt organizations. The IRS Announcement 2002-87 stated:

It may be argued that there are similarities between the need for veracity in the public information used by shareholders in making investment decisions and the need for veracity in the public information used by contributors and others in making decisions regarding exempt organizations.

The modifications are intended to increase the public's confidence in the integrity of information disclosed by tax-exempt organizations and in their leaders' integrity. Some of the measures include requiring that tax-exempt organizations:

• Disclose whether they have adopted conflict-of-interest policies

• Disclose whether their board audit committee members are all independent

• Disclose other information concerning transactions or financial relationships with substantial donors, officers, directors and key employees.

The IRS has also recently announced that it is aggressively increasing its scrutiny of CEO compensation in tax-exempt organizations.

Clark Consulting, an executive compensation and benefits firm based in North Barrington, Ill., recommended in their September 2002 issue of *CEO Hotline,* that not-for-profit organizations discontinue eight compensation practices common in the health care field (see "Risky Compensation Practices," page 2).

In November 2002, the Coalition for Nonprofit Healthcare published a *Corporate Responsibility Guidebook* urging not-for-profit health care organizations to "implement selected Sarbanes-Oxley provisions now."

Further, The Office of the Inspector General last year released a questionnaire-style guide targeted at health care boards. The guide is designed to help governing boards ensure that their organizations have effective compliance programs and meet Medicare requirements.

Several states are also considering applying Sarbanes requirements to state statutes. For example, a bill introduced in California in May 2004 (Senate Bill 1262) would hold nonprofit, tax-exempt organizations in that state to many Sarbanes-like standards, including the composition and function of their boards and board committees. In addition, the New York State Attorney General introduced legislation modifying the state's Not-for-Profit Corporation Act to incorporate a

Ahead of the Pack

Some 230 health care organizations responding to a 2003 survey conducted by Clark Consulting, North Barrington, Ill., indicated that they have already implemented several reforms recommended by Sarbanes-Oxley and the stock exchanges.

Specifically, consultants found:

• More than half have separate audit, compensation and governance committees. Most have had these committees for more than two years.

• More than two-thirds already have a governance committee charged with periodically reviewing the governance process and evaluating the effectiveness of the board, its committees, and individual members. Most of these have had one in place for more than two years.

• More than half (66 percent) are bringing information on CEO compensation to the board as a whole, and a similar number have been doing so for more than two years.

• A majority (86 percent) have had a policy addressing directors' conflicts of interest for more than two years.

• Almost as many (70 percent) have had a policy on business ethics and practices for more than two years.

• Three-quarters of surveyed health care organizations periodically review total compensation for all executives, not just the CEO, and 64 percent have been doing so for more than two years.

• Most (83 percent) have formally reviewed their governance process to evaluate its effectiveness.

• Roughly the same number (84 percent) have formally reviewed their corporate bylaws and policies to ensure that they match actual practice.

• A majority (72 percent) have changed their bylaws and policies to better match actual governance practices and processes.

• More than half (64 percent) have reviewed the new rules set by Sarbanes-Oxley and the SEC.

number of provisions similar to those included in the Sarbanes-Oxley Act.

But, perhaps, most importantly for health care organizations, many financial, legal and governance experts believe Sarbanes-Oxley requirements will eventually be extended to not-for-profits by the courts, legislators, regulators, bond underwriters or liability insurers as the rules come to be viewed as best practices in governance. For example, Moody's Credit Rating has said its ratings may take governance practices into account. The Coalition for Nonprofit Health Care, the American Governance & Leadership Group, the Governance Institute and the American Health Lawyers Association have all urged health care organization boards to take the new rules seriously. The Health Care Compliance Association, Minneapolis, is even starting to consider good governance a compliance issue.

Two hundred and thirty health care organizations responding to a 2003 survey conducted by Clark Consulting suggests that hospital boards are already reviewing how their corporate and governance policies, procedures and practices compare with Sarbanes-Oxley and other governance reform mandates and are taking steps to adopt reforms (see "Ahead of the Pack," page 3).

Writing in the January 2004 issue of *American Governance Leader,* Clark Consulting's Managing Director David Bjork said that boards may be focusing too narrowly on Sarbanes-Oxley, which concentrates primarily on the audit function, not on governance generally.

According to Bjork, the proposed listing requirements of the New York and American Stock Exchanges and NASDAQ are broader, clearer and more useful for real governance reform than those required by Sarbanes-Oxley, and they represent a consensus based on many governance reform proposals, such as those by the Conference Board, the Business Roundtable, the National Association of Corporate Directors and the Council of Institutional Investors. Yet, few Clark Consulting survey respondents indicated they had looked at the broader set of recommendations coming from these organizations. The survey found that:

• Only 14 percent had formally reviewed the new rules proposed by the stock exchanges.

• Only 46 percent had formally reviewed other proposals for governance reform.

• Only 21 percent have a policy calling for regular meetings in executive session.

• Very few of the boards that do not already have separate audit, compensation and governance committees are considering establishing them.

• Very few of the responding organizations that do not already bring CEO compensation information to the board as a whole are considering doing so.

Next Steps for Health Care Governing Boards

Governance reforms, such as Sarbanes-Oxley, are likely to be applied to not-for-profit health care organizations in a variety of ways. Forward-looking boards will voluntarily adopt relevant public-company financial and governance requirements because they consider them to be best practices. State attorneys general will likely apply them to help protect the public interest in nonprofit organizations. Bond underwriters, insurers and investors in debt instruments will likely require that such standards be met before they issue, insure or invest in debt securities. Over time, the courts and the IRS are likely to hold not-for-profit organizations to standards of performance and accountability similar to those required for their public company counterparts. Underwriters of directors' and officers' liability insurance also will take such standards into account when writing and pricing D&O coverage.

Given that Sarbanes-Oxley and other similar reforms are moving their way, not-for-profit health care organizations should consider taking a number of steps now. (See "*First Steps,*" *this page*).

Clearly, health care boards are rapidly entering a new era of accountability, scrutiny, and perhaps even increased exposure to regulatory sanctions and liability. Whether or not boards are held directly accountable to the provisions of Sarbanes-Oxley, effective boards will read the handwriting on the wall and begin to seriously evaluate their structures and practices to ensure that they would, at a minimum, pass regulatory, legal and media muster. More importantly, boards should aggressively adopt governance best practices to assure that they actively contribute to the ongoing success of their organizations.

First Steps

• Hospital and health system governing boards should decide which of the new recommended standards should be adopted by their organizations.

• Boards should review their composition to ensure a majority of board members are independent or outside directors.

• If the board has not already done so, it should establish a board audit committee composed solely of outside directors and seek individuals for that committee who would be considered financial experts in health care.

• To foster transparency and full disclosure, health care organizations should decide how to best communicate with their communities. For example, should a health care organization's annual report disclose such material facts as JCAHO violations or malpractice litigation, which may have a bearing on the organization's future, much like the information that publicly-traded companies are expected to disclose?

• Boards also should determine what types of responsibilities they will take on that may have been previously delegated to the CEO, such as oversight of executive compensation and succession planning.

• Boards should ensure that they have a strict conflict-of-interest policy in place that they actively enforce.

• Boards should regularly conduct and document rigorous self-assessments. Such assessments should lead to an action plan for improvement that guarantees that their policies and practices will result in a high level of board performance and accountability.

What If the Whistle-blower Is a Current Employee?

If the organization determines that the qui tam relator is a current employee, everyone must resist any urge to retaliate against him or her in any way. This includes termination or discipline for pilfering organization documents and providing them to the DOJ. The CFCA protects relators from reprisal, requiring that any employee who is discharged, demoted, suspended, threatened, harassed or in any manner discriminated against because of lawful acts done to further a qui tam lawsuit is entitled "to be made whole." This might include reinstatement, paying the employee twice the amount of any back pay, and compensating for any special damages and reasonable attorneys' fees. Most states have similar whistle-blower protection laws.

Does this mean that the whistle-blower has an unwritten, lifetime employment contract with the organization, terminable only at his or her option? No, but it means that the organization should have persuasive, well-documented support for any disciplinary action taken. The hospital needs a higher level of proof to support any discipline than would be otherwise necessary because it is certain that the whistle-blower will claim retaliation, and management must be in a position to convince the jury otherwise.

Internal Investigations Are a Must

OIG investigations are serious matters and can involve significant civil and criminal sanctions. In appropriate cases, criminal charges can be lodged against the hospital and its principal officers. A criminal conviction or plea by the hospital will result in exclusion from the Medicare and Medicaid program and will likely result in the hospital's closure. A criminal conviction of an individual will likely result in jail time if the loss to the federal program exceeds $40,000. The stakes are high, and legal counsel experienced in handling such investigations and dealing with federal agents and assistant U.S. attorneys is crucial. Hospital leadership should be certain that such representation is in place.

The need for an internal investigation cannot be emphasized enough. There is no acceptable alternative to performing this task. If it reveals that no problem exists, fine; if it reveals that there is a problem, it must be faced. Understand from the outset as well, that the hospital must take every step the investigation dictates.

Finally, hospital leaders must ask why this matter wasn't caught earlier by the hospital's compliance program. This question shouldn't be asked accusatorily. Rather, it is a way to determine how the organization's compliance program can be improved. **T**

HOWARD E. O'LEARY, *J.D., a health care fraud investigation and litigation attorney with the law firm of Dykema Gossett PLLC, Washington, D.C. He can be reached at: holeary@dykema.com.* SETH M. LLOYD, *J.D., is a corporate governance and compliance attorney with Dykema Gossett PLLC, Detroit. He can be reached at: slloyd@dykema.com.*