

Rice M. Tilley, Jr.
Haynes and Boone, LLP
201 Main Street, Suite 2200
Fort Worth, Texas 76102
Phone – 817.347.6611
Fax – 817.348.2384

IMPACT OF SARBANES-OXLEY ON NON-PROFIT ORGANIZATIONS

JPMorgan

Private Client Services

Fort Worth, Texas

April 7, 2005

I. Background -- Director Fiduciary Duties

- A. Duty of Care -- Directors must take adequate steps to inform themselves in making decisions and must act as an ordinary prudent person would act in the same circumstances.
- B. Duty of Loyalty -- Directors must place the interests of the organization above their own and act in what they reasonably believe is in the best interest of the organization.
- C. Constituencies (to whom do the directors and officers owe the above duties?)
 - 1. Profit organizations -- shareholders
 - 2. Non-Profit organizations:
 - a. members
 - b. “public good” - Attorney General of the State of Texas
 - c. Sec. 501(c)(3) -- IRS

- d. “zone of insolvency” -- creditors

II. Sarbanes-Oxley Act of 2002

- A. Genesis -- Enron, WorldCom, etc.
- B. Thrust -- new (and much stricter) standards of corporate governance for **publicly-held companies** (that are registered with the SEC):
 - 1. Enhance the role and responsibilities of Audit Committees;
 - 2. Improve the standards for auditor independence;
 - 3. Require greater financial disclosures; and
 - 4. Heighten the standard of management accountability.

C. Impact on Non-Profit Organizations

- 1. Mandatory:

- a. Whistle-blower protection-

It is a federal crime for anyone to “knowingly, with the intent to retaliate, take any action harmful to any person...for providing to a law enforcement officer any truthful information relating to the commission of a federal offense.”

- b. Document destruction-

It is a federal crime to alter, cover up, falsify, or destroy any document or make a false entry in accounting records with the intent of obstructing a federal investigation.

- 2. Currently not mandatory, but “trickle down”:

- a. Audit Committee-

- (1). Must be member of Board and “independent.”
“Independence” means not part of management team and does not receive (either directly or indirectly) any compensation as a consultant for other professional services (except Board service may be compensated).
 - (2) One “financial expert”

- (3) If small organization, can combine with Finance Committee
 - (4) Non-profits with budgets of more than \$500,000, or which receive federal funding, should have an outside audit (and keep Audit Committee separate from Finance Committee).
 - (5) Hire, fire, and deal directly with outside auditors
- b. Auditors-
- (1). Lead and reviewing partner must rotate off every 5 years.
 - (2). Cannot provide non-audit services. However, tax services (such as the preparation of the Form 990) can be provided if pre-approved by the Audit Committee.
- c. Certified financial statements-
- (1). CEO has responsibility for financial condition of organization and for accurate financial statements.
 - (2). CEO hired for fund-raising capabilities and doesn't have financial expertise? He (or she) must be complemented by a skillful financial officer.
 - (3). Form 990 or 990-PF -- can be signed by any officer, but CEO is responsible for reviewing it before filing to insure accuracy.
 - (4). Ultimate responsibility for accuracy and completeness of financial statements and Form 990 or 990-PF -- Audit Committee and Board.
- d. Insider transactions/conflicts of interest-
- (1). Board should have full knowledge of, and approve, all transactions between the organization and "insiders."
 - (2). "Insider" -- organization officers, directors, trustees, and management persons in decision-making positions, major donors, and members of the immediate families of any of the preceding; controlled and affiliated organizations and trusts; and businesses in which any of the preceding are in significant positions of authority (owner or manager).

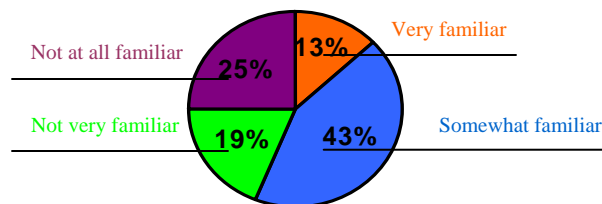
- (3). Test -- would you be embarrassed to read details of these transactions in the Startlegram (Fort Worth Star Telegram)?
 - (4). Loans by organization to:
 - (a). Directors -- prohibited by Art. 1396-2.25.
 - (b). Officers -- not illegal, but not recommended (and must be approved by Board).
 - e. Disclosures-
 - (1). Organizations should be in a position to provide to their donors, clients, public officials, the media, and others with an accurate picture of their financial condition.
 - (2). Current law requires tax-exempt organizations to make their Forms 990 or 990-PF freely available to anyone who requests them.
 - (3). Get ready for electronic filing of Forms 990 and 990-PF.
3. Why “trickle down”?
- a. Donors -- “If you want our money, we expect you to comply with Sarbanes-Oxley.”
 - b. State Attorney Generals -- In New York, Attorney General Eliot Spitzer has proposed new requirements for non-profits that mimic the requirements of Sarbanes-Oxley.
 - c. Many Boards will, on their own, decide that for public relations and fundraising purposes, they will want to show the world that they comply with the *spirit* of Sarbanes-Oxley.
 - d. Reporters for broadcast and print media -- “Are you complying with Sarbanes-Oxley -- if not, why not?”
4. “One size not fit all”
- a. Whether an organization should adopt any or all of the above (currently) non-mandatory requirements is a decision uniquely within the prerogative of each organization’s Board of Directors

based upon a variety of facts and circumstances unique to that organization. Examples of such factors:

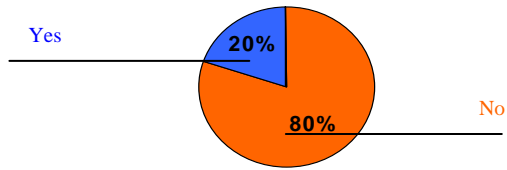
- (1). the size, location, and business sophistication of the organization;
- (2). the industry it serves (e.g., health and higher education have higher than average responsibilities to the public);
- (3). whether the organization is a private foundation or a public charity;
- (4). the nature of its tax-exempt status (e.g., whether it is an operating or grant-making organization); and
- (5). the unique characteristics of its charitable mission and sponsorship; for example:
 - (a). Organizations in smaller communities can not reasonably be expected to have multiple committees all filled with “independent” directors; and
 - (b). Multi-corporate systems will be called upon to consider the application of these requirements to both the parent entity and to its multiple affiliates; e.g., is their adoption at the parent level sufficient?

b. Grant Thornton survey of over 300 non-profit organization:

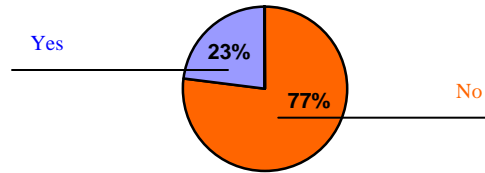
1. Awareness - How familiar are you with the Sarbanes-Oxley Act of 2002 relating to corporate governance reform?



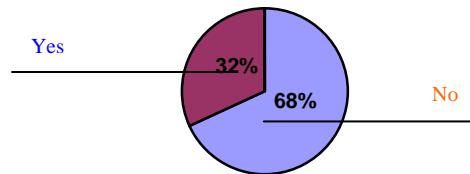
2. Making Changes – Has your organization made any changes to its governance policies as a result of the Sarbanes-Oxley Act?



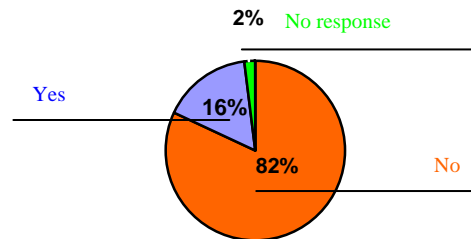
3. Audit Committee – Does your organization have an audit committee or its equivalent¹



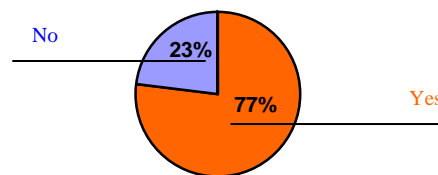
4. Internal Control – In light of recent accounting scandals, have you evaluated your internal structure?



5. Whistle-blower policies – Does your organization have a “whistle-blower” policy?²

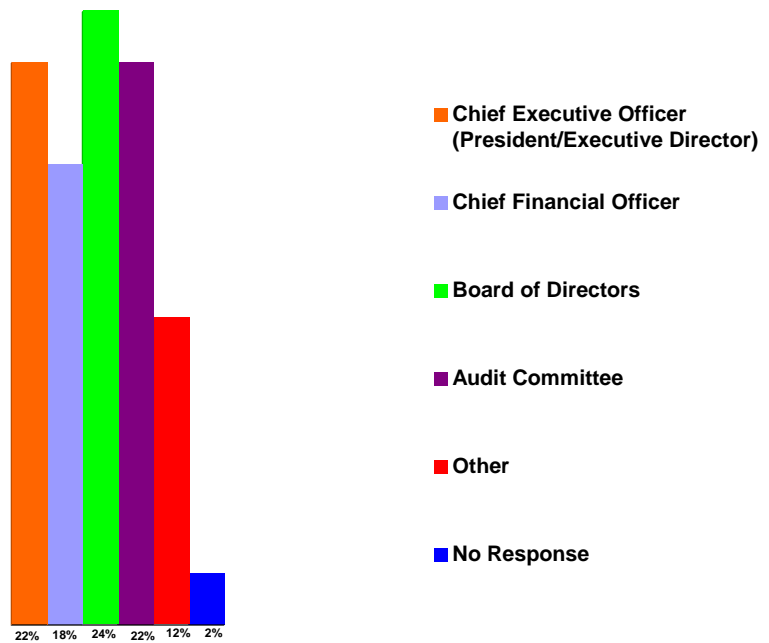


6. Records – retention policies – Does your organization have a records-retention policy?



¹ Of those with audit committees, seventy-five percent said that their audit committee does include a financial expert

7. Independence – Who, in your organization, is responsible for engaging the audit firm and determining the scope of work?



III. Liability/Indemnification

A. Officer liability

1. Art. 1396-2.22 of the Texas Business Non-Profit Corporation Act provides that an officer of a non-profit organization will not be liable to the corporation or any other person for an action taken or omission made by the officer in his or her capacity as an officer unless the officer's conduct was not exercised –

- a. In good faith;
- b. With ordinary care; and
- c. In a manner the officer reasonably believes to be in the best interest of the organization.

2. Art. 1396-2.22 does not affect the liability of the organization for an act or omission of the officer.

B. Art. 1396-2.22A of the Texas Non-Profit Corporation Act provides the circumstances under which an organization may indemnify a director or officer for losses incurred by such person in acting on behalf of a non-profit organization.

² Of those organizations without a whistle-blower policy, only twenty-one percent are considering instituting one.

For maximum protection, these indemnification provisions contained in the Texas Non-Profit Corporation Act should also be contained in the organization's Articles of Incorporation and Bylaws.

C. Texas Charitable Immunity and Liability Act of 1987

1. Although principals of tort law apply to non-profit organizations, the Texas "Charitable Immunity and Liability Act of 1987 eliminates the liability of volunteers acting in the course and scope of duties as an officer, director, or trustee, limits employee liability for damages based on an act or omission in the course and scope of employment to \$500,000 for each person and \$1,000,000 for each single occurrence of injury to property, and limits the organization's liability to the same amount of money damages.

2. These limitations on liability do not apply in various circumstances including:

a. Intentional or willful acts or acts done with conscious indifference or reckless disregard for the safety of others; and

b. If the organization does not have liability insurance coverage in effect for the same amount as the maximum liability for any act or omission covered by the state statute.

D. Volunteer Protection Act of 1997

1. The Volunteer Protection Act of 1997 (42 U.S.C. 14501, et seq.) is a federal law which pre-empts state law (except where the state law provides additional protection from liability relating to volunteers or to any category of volunteers in the performance of services for a non-profit organization). Generally, the Act provides that no volunteer of a non-profit organization will be liable for harm caused by an act or omission of the volunteer on behalf of the organization or entity if:

a. The volunteer was acting within the scope of his or her responsibilities at the time of the act or omission;

b. If appropriate or required, the volunteer was properly licensed, certified, or authorized in the state in which the harm occurred, and the activities were undertaken within the scope of the volunteer's responsibilities;

c. The harm was not the result of willful or criminal misconduct, gross negligence, reckless misconduct, or a conscious flagrant indifference to the rights or safety of the individual harmed by the volunteer; and

d. The harm was not caused by the volunteer's operation of a motor vehicle, vessel, aircraft, or other vehicle for which the state requires the operator

or the owner of the vehicle, craft, or vessel to: (i) possess an operators license, and (ii) maintain insurance.

2. Generally, punitive damages may not be awarded against a volunteer in an action brought for harm based on the action of a volunteer acting within the scope of the volunteer's responsibilities to the non-profit organization unless the claimant establishes by clear and convincing evidence that the harm was proximately caused by an action of such volunteer which constituted willful or criminal misconduct, or a conscious, flagrant indifference to the rights or safety of the individual harmed.

E. D&O Insurance

F. King Foundation – Dallas; suit by Attorney General and new Board of Directors v. former President and Secretary; excessive compensation

Jury verdict –

1. Repay \$7.5 million to Foundation
2. Punitive damages \$14 million