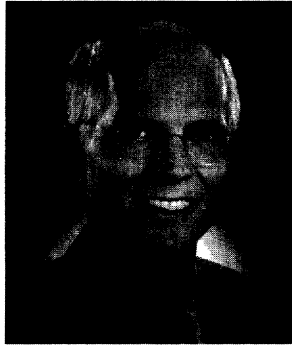


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# GOVERNANCE ISSUES FOR NONPROFIT HEALTHCARE ORGANIZATIONS AND THE IMPLICATIONS OF THE SARBANES-OXLEY ACT

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## INTRODUCTION

The topic of “corporate governance” has received attention during the past few years. This attention has increased recently due to high-profile corporate scandals that have received extensive and prolonged media coverage. As a result, officers, directors, and outside professional advisors are seeking ways to respond to the scrutiny of regulators, legislators, the general public, and constituency groups such as investors and investment analysts.

Many of these scandals have occurred in the for-profit, general business environment. However, beneath these high-profile events, there have been corollary legal activities in the nonprofit and tax-exempt arenas. These developments reflect a significant undercurrent of changes for healthcare organizations. The combination of these events is destined to provide dramatic inducement for healthcare organizations to evaluate and modify their organization and operations. At the same time, the passage of the American Competitiveness and Corporate Accountability Act of 2002, widely known as the Sarbanes-Oxley Act (“SOXA”), is an example of the legislative response to these “scandals” and corporate governance issues. SOXA is also an opportunity for healthcare organizations to stay “ahead of the compliance curve” by adapting and “transposing” the legislation from the for-profit, publicly-traded corporate arena to the nonprofit sector.

This Article will briefly describe some of the recent corporate scandals and the lessons they may provide in the area of nonprofit healthcare governance. It will then describe various sources of guidance and standards, as well as enforcement activities, that are stimulating the evolution of corporate governance for nonprofit healthcare organizations. Those stimuli arise out of traditional state and federal sources such as state corporate and licensing laws, federal tax and Medicare certification statutes, and accreditation criteria. New stimuli are also rising from more active federal tax and healthcare regulatory efforts along with state attorney general initiatives. The Article will then briefly analyze some specifics of SOXA within this rapidly evolving

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environment and evaluate some of the implications that it contains or suggests for healthcare organizations in the corporate governance legal arena.

### I. THE IMPACT OF HIGH PROFILE, FOR-PROFIT SCANDALS

The terms corporation and scandal have become so frequently intertwined in recent years that many individuals may believe that you cannot have one without the other. The publicity has been exacerbated by prominent individuals associated with the corporations, such as Ken Lay at Enron, Bernard Ebbers at WorldCom, Martha Stewart's relationship to ImClone Systems, Richard Grasso's compensation at the New York Stock Exchange, and many others. The media's personification of these scandals has consequences in many directions.

Enron apparently took advantage of an accounting loophole that allowed the company to use gross value instead of net value when calculating profits from energy contracts. It then compounded the distortion by selling the same product repeatedly to sham partnerships created by Enron executives.<sup>1</sup> WorldCom created its own "loophole" by treating ongoing operating costs as capital investments, which resulted in lower annual operating expenses since they were spread into the future.<sup>2</sup> In these and other situations, the performance and independence of auditors have raised fundamental fiduciary business practice questions. Those questions have also been turned upon the governing boards and their audit committees. This is one reason why SOXA focuses so much attention on the independence of outside auditors as well as the composition and operation of board audit committees.

With respect to the healthcare field, perhaps the highest profile "corporate scandal" has been with HealthSouth Corp. ("HealthSouth"). This company rapidly grew from the mid-1980s to become the largest United States provider of outpatient surgery, diagnostic imaging, and rehabilitation services, with almost 1,700 sites in all fifty states and abroad.<sup>3</sup> HealthSouth stands accused of significant accounting fraud and widespread abuse of Medicare reimbursement regulations.<sup>4</sup> The Securities and Exchange Commission ("SEC") has pursued enforcement actions, and the Department of Justice filed an eighty-five-count indictment against Richard Scrushy, the former CEO who has been portrayed as the mastermind of a multibillion-dollar scheme to defraud investors.<sup>5</sup> At the time of the indictment, fourteen former Health-

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1. For a discussion of the various corporate scandals, the role of auditors, and the response of the Sarbanes-Oxley Act, see Ethan G. Zelizer, *The Sarbanes-Oxley Act: Accounting for Corporate Corruption?*, 15 LOY. CONSUMER L. REV. 27 (2002).

2. *Id.*

3. J. Reeves, *Health System Replaces Directors*, PHILA. INQUIRER, Dec. 3, 2003, at C03.

4. Reed Abelson & Melt Freudenheim, *The Scrushy Mix: Strict and So Lenient*, N.Y. TIMES, Apr. 20, 2003, at A1.

5. Melt Freudenheim & Eric Lichtblau, *Former HealthSouth Chief Indicted by U.S.*, N.Y. TIMES, Nov. 5, 2003, at C1.

South executives and accounting managers, including all five of its former chief financial officers, had already pleaded guilty to various fraud charges.<sup>6</sup>

These cases have resulted in scrutiny beyond standard regulatory enforcement, shareholder lawsuits, and criminal charges. This is reflected by a lawsuit filed against HealthSouth by the Teachers Retirement System of Louisiana (“System”).<sup>7</sup> In its lawsuit, the System sought to change the way the company was governed rather than recover financial losses on its investments. Pointing to a variety of corporate governance issues involving the board and several of its members, the System pursued the dismissal of five long-time board directors at a promptly-scheduled shareholders meeting.<sup>8</sup> Drawing an analogy from recent military activity, a lawyer for the System stated, “Regime change was desperately needed at HealthSouth.”<sup>9</sup>

The *Wall Street Journal* devoted an entire supplement to current concerns about governance and its relationship with corporate scandals.<sup>10</sup> The twelve-page section included topics such as how to be a good director, the best method for selecting directors, and the degree of disclosure or “transparency” that companies should provide.

These recent developments carry significant implications for the governance of healthcare organizations, including the individuals who may believe they are simply performing community service on a governing board for a community hospital. For instance, the federal government is taking a position that the criminal law components for violation of SOXA constitute a “lower intent” crime, heightening exposure for officers on boards who sign financial statements and independent members of board audit committees.<sup>11</sup> In addition, Moody’s Investors Service is considering extending governance ratings to nonprofit hospitals and health systems.<sup>12</sup>

Sage Givans, a member of HealthSouth’s audit committee, described the difficulties and challenges for a governing board in this new era in his testimony before the House Energy and Commerce Committee’s Oversight and Investigations subcommittee in November 2003:

At HealthSouth, we had numerous controls and systems in place that should have helped detect this fraud. Unfortunately, when high-level management conspires to commit a criminal act, I don’t know of any corporate governance policy that would prevent such behavior. How to prevent this type

6. *Id.*

7. Michael Tomberlin, *Louisiana Pension Fund Seeks to Remove HealthSouth Board*, BIRMINGHAM NEWS, Sept. 10, 2003.

8. Chris Gautreau, *Pension Plan Forces HealthSouth Changes*, BATONROUGE ADVOC., Dec. 3, 2003, at 1.A.

9. Reeves, *supra* note 3.

10. WALL ST. J., Oct. 27, 2003, at R1-12.

11. Julie Peotrowski, *HealthSouth’s Most Wanted*, MOD. HEALTHCARE, Nov. 10, 2003, at 6.

12. Mary Chris Jaklevic, *Rating Adjustment*, MOD. HEALTHCARE, Dec. 1, 2003, at 12.

of fraud in the future is certainly a challenge for boards all across the country.<sup>13</sup>

The lessons that these for-profit corporations, like HealthSouth, have learned over recent years can be instructive for nonprofits and their boards.

## II. HISTORICAL CONTEXT FOR NONPROFIT VOLUNTEER BOARDS

In order to achieve and maintain their tax-exempt status, nonprofit organizations must operate for the benefit of the public. One factor that can indicate an organization is operating for the good of the public is control by a board that is drawn from the community and that does not hold a direct economic interest in the organization.<sup>14</sup> As a result, nonprofit boards have historically been composed of volunteers, who are often laypersons with respect to the operations of the organization that they govern. Volunteer board members may have once believed that they were personally insulated from liability due to their "volunteer" status, or that decisions made in their volunteer board member capacity could not expose their organization to liability. However, evolving law and emerging principles of corporate responsibility indicate otherwise.

In the mid-1960s, *Darling v. Charleston Community Memorial Hospital*<sup>15</sup> represented a turning point for hospitals and their governing boards. In that case, the Illinois Supreme Court connected a hospital governing board's powers with a medical staff member's negligent actions in finding the hospital liable for negligent medical and hospital treatment. In affirming the appellate court's decision, the Illinois Supreme Court stated that a hospital's licensure regulations, accreditation standards, and bylaws, which delineate a governing board's responsibilities, collectively establish that it is "both desirable and feasible that a hospital assume certain responsibilities for the care of the patient."<sup>16</sup>

While courts have found hospitals liable based upon their board's actions or inactions, courts have been reluctant to extend liability to board members individually. This is in part due to "volunteer director" immunity state legislation that began to emerge over a decade ago. To date, at least seventeen states<sup>17</sup> have enacted legislation to protect volunteer directors;

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13. Peotrowski, *supra* note 11.

14. BRUCE R. HOPKINS, *THE LAW OF TAX-EXEMPT ORGANIZATIONS* 137 (6th ed. 1992).

15. *Darling v. Charleston Cmty. Mem'l Hosp.*, 211 N.E.2d 253 (Ill. 1965).

16. *Id.* at 257.

17. See CAL. CORP. CODE § 5239 (West 2003); COL. REV. STAT. ANN. § 13-21-115.7 (West 2003); CONN. GEN. ST. ANN. § 52-557m (West 2003); FL. STAT. ANN. § 617.0834 (West 2003); IND. CODE ANN. § 34-30-4-2 (West 2003); KY. REV. STAT. § 411.200 (Banks-Baldwin 2003); LA. REV. STAT. ANN. § 2792.1 (West 2003); ME. REV. STAT. ANN. § 158-A (West 2003); MD. CODE ANN. § 5-417 (2003); MONT. CODE ANN. § 27-1-732 (2003); N.D. CENT. CODE § 10-33-47 (2003); NEB. REV. ST. § 25-21, 191 (2003); N.M. ST. ANN. § 53-8-25-3 (Michie 2003);



however, many of these state statutes are narrow in scope.<sup>18</sup> In light of today's corporate governance environment and considering the fact that many states either do not clothe volunteer directors with immunity or substantially limit the scope of such immunity, board members must be cognizant of exposure to liability from both a personal and global perspective. Appreciating the scope of this exposure is conditioned upon an understanding of the state and federal authorities that shape nonprofit healthcare organizations.

### III. STATE NONPROFIT CORPORATE CODE

#### A. *Standards for Directors' Duties*

Some states have statutory law that specifically governs the corporate conduct of nonprofits. A few of these states' laws are based on the Revised Model Nonprofit Corporation Act ("Model Act").<sup>19</sup> The Indiana Nonprofit Corporation Act of 1991 ("Indiana Nonprofit Act")<sup>20</sup> is similar in many essential features to other state nonprofit corporation codes in the manner in which it regulates the activities of nonprofit corporations in Indiana.

The Indiana Nonprofit Act mandates that a nonprofit corporation have a board of directors.<sup>21</sup> The Articles of Incorporation of a nonprofit corporation "may authorize a person or group of persons . . . to exercise some or all of the powers that would otherwise be exercised by a board of directors."<sup>22</sup> However, the non-director person or group of persons authorized to exercise those powers normally reserved for members of the board of directors must abide by the duties and responsibilities imposed on corporate directors.<sup>23</sup>

The duties for directors of nonprofit corporations in Indiana, and the standards for those duties, are set out in the Indiana Nonprofit Act. In this respect, the Indiana Nonprofit Act has followed the precedent set by the Indiana Business Corporation Law<sup>24</sup> ("Indiana Corporation Law") in its

OKLA. STAT. ANN. tit. 18, § 866 (West 2003); S.D. CODIFIED LAWS § 47-23-32 (Michie 2003); VA. CODE ANN. § 8.01-220.1:4 (Michie 2003); W. VA. CODE § 55-7C-3 (2003).

18. Even though Indiana Code section 34-30-4-2 does provide limitation of liability for directors, it does not protect the directors from incurring the cost of defense.

19. REVISED MODEL NONPROFIT CORPORATION ACT (1967) [hereinafter MODEL ACT]. The Model Act represents, in essence, suggestions of the American Bar Association as to how state laws should be formulated. Kevin M. Boyle, *Nonprofit Corporation Act of 1991: Introduction to Significant Changes*, 35 RES GESTAE 462, 462 n.2 (1992). The Model Act has been adopted in some form by several states other than Indiana, including Alaska, Georgia, Montana, and Oregon. *Id.* Other states are considering adopting the Model Act as well. *Id.*

20. IND. CODE § 23-17 (2004).

21. *Id.* § 23-17-12-1(a).

22. *Id.* § 23-17-12-1(c).

23. *Id.* § 23-17-12-1(c)(1).

24. *Id.* § 23-1.

adoption of statutory standards for directors of business corporations.<sup>25</sup> Specifically, a nonprofit corporate director is required to discharge his or her duties, based on facts then known to him or her, “(1) [i]n good faith, (2) [w]ith the care an ordinarily prudent person in a like position would exercise under similar circumstances, [and] (3) [i]n a manner the director reasonably believes to be in the best interests of the corporation.”<sup>26</sup>

The Indiana Nonprofit Act thus imposes both a duty of care and a duty of loyalty on a nonprofit director.<sup>27</sup> Traditionally, neglect, mismanagement, and improper (but disinterested) decision-making have been addressed under a board member’s duty of care. Separately, issues relating to fraud, self-dealing, improper diversions of corporate assets, misappropriation of corporate opportunities, and other conflicts of interest have been raised under a board member’s duty of loyalty.<sup>28</sup> While many states treat the duty of care as separate and distinct from the duty of loyalty, the Indiana Nonprofit Act combines them.<sup>29</sup>

In addition to the duties of care and loyalty, the Indiana Nonprofit Act designates standards of conduct for a director of a nonprofit corporation. In discharging his or her duties of care and loyalty, a director is permitted to rely on information, opinions, reports, or statements, including financial statements and other financial data, prepared or presented by certain persons delineated by the statute in whom confidence by the director is justified.<sup>30</sup> Nevertheless, a director is not acting in good faith if the director has knowledge concerning a matter in question that makes reliance—that would otherwise be statutorily permitted—unwarranted.<sup>31</sup>

The provisions in the Indiana Nonprofit Act that mandate the duties and standards of conduct for nonprofit directors contain language that is quite similar to that in the Model Act.<sup>32</sup> However, while both the Indiana Nonprofit Act and the Indiana Corporation Law require “willful misconduct or recklessness” by a director in order for him or her to be held liable under Indiana

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25. Paul J. Galanti, *Business Organizations*, 20 IND. PRAC. SERIES § 53.10, 102 (Supp. 2003).

26. IND. CODE §§ 23-17-13-1(a)(1)-(3) (2004).

27. “The Duties of Care and Loyalty are the common terms to describe the standards which guide all actions a director [or officer] takes. These standards are derived from a century of litigation principally involving business corporations and are equally applicable to nonprofit corporations.” Harvey J. Goldschmid, *The Fiduciary Duties of Nonprofit Directors and Officers: Paradoxes, Problems, and Proposed Reforms*, 23 J. CORP. L. 631, 638 (1998).

28. *Id.* at 646.

29. David W. Barrett, Note, *A Call for More Lenient Director Liability Standards for Small, Charitable Nonprofit Corporations*, 71 IND. L.J. 967, 986 (1996).

30. See IND. CODE § 23-17-13-1(b) (2004).

31. *Id.* § 23-17-13-1(c).

32. Compare IND. CODE §§ 23-17-1 to -30 with MODEL ACT, *supra* note 19.

law,<sup>33</sup> the Model Act establishes a standard of “gross negligence” for liability of corporate directors.<sup>34</sup>

### B. Case Law Interpretation of Fiduciary Duties

There is a dearth of case law addressing and interpreting the statutory duties of a director of a nonprofit corporation. Under the common law, directors of Indiana nonprofit corporations have a general duty of loyalty and must act in good faith.<sup>35</sup> In one instance, the Indiana Court of Appeals, in *Kirtley v. McClelland*,<sup>36</sup> held that a director, despite a desire to support the organization, appropriated an opportunity belonging to the nonprofit unit owner’s association, breaching his fiduciary duty of loyalty as a member of a board of a nonprofit organization.<sup>37</sup>

Additionally, case law suggests that the suitable standard of care to be followed by directors of nonprofit corporations is “aligned with principles of corporate duty and not the strict ‘prudent man’ standard of trust law.”<sup>38</sup> The Supreme Court of Louisiana, in *Mary v. Lupin Foundation*,<sup>39</sup> looked to a business corporation statute in interpreting a statutory provision concerning duties of directors of nonprofit corporations.<sup>40</sup> The Louisiana statute required nonprofit directors to discharge their duties in good faith, with the diligence, care, judgment, and skill that an ordinary prudent person in a like position would exercise under similar circumstances.<sup>41</sup>

Recent comments by the chief justice of the Delaware Supreme Court were an important reminder of the viability, but limitations, of the “business judgment rule” for corporate directors. Chief Justice Veasey provided some relief by commenting that this protective “rule” is “alive and well,” but also noted that directors have a proactive oversight role under Delaware corporate law. Fiduciary duties are met by processes that demonstrate a board or

33. *Id.* §§ 23-17-13-1(d), 23-1-35-1(e).

34. See MODEL ACT, *supra* note 19, at § 8.30. The Model Act solely provides that “[a] director is not acting in good faith if the director has knowledge concerning the matter in question that makes reliance permitted by subsection (b) unwarranted,” and does not have the explicit “willful misconduct or recklessness” language found in Indiana Code section 23-17-13-1(d)(2). *Id.*; see also Barrett, *supra* note 29, at 990.

35. Galanti, *supra* note 25, at 102.

36. *Kirtley v. McClelland*, 562 N.E.2d 27 (Ind. Ct. App. 1990).

37. *Id.* at 36.

38. Galanti, *supra* note 25, at 103 (citing *Stern v. Lucy Webb Hayes Nat’l Training Sch. for Deaconesses & Missionaries*, 381 F. Supp. 1003 (D.D.C. 1974) and *Oberly v. Kirby*, 592 A.2d 445 (Del. 1991)).

39. *Mary v. Lupin Found.*, 609 So. 2d 184 (La. 1992).

40. *Id.* at 187. “Provisions relating to nonprofit corporations have been conformed generally to those relating to business corporations.” *Id.*

41. *Id.*; LA. REV. STAT. ANN. § 12:226(A) (West 1994).

committee is operating in good faith and being proactive and inquisitive.<sup>42</sup> This is an interpretation that would be equally applicable to directors of nonprofit corporations.

### C. State Licensure and County Hospital Statutes

Most healthcare organizations are licensed by the state in which they operate. State licensure laws for hospitals<sup>43</sup> set forth the governing board's legal responsibilities and discretionary powers, while naming the board as the supreme authority of the hospital. Indiana's hospital licensure statute makes the board generally responsible for the management, operation, and control of the hospital.<sup>44</sup> Indiana's hospital licensure statute and regulations<sup>45</sup> expressly hold the board responsible for specific issues related to the medical staff and bylaws,<sup>46</sup> management,<sup>47</sup> patient care,<sup>48</sup> the institutional plan and

42. Alison Carpenter & Susan Webster, *Corporate Governance: Business Judgment Rule Still Alive, Delaware's Veasey Tells Directors' Group*, 12 Health L. Rep. (BNA) 1645 (Oct. 30, 2003).

43. Hospitals are the typical focus for discussions of nonprofit healthcare organizations. However, other healthcare organizations may obtain nonprofit status as well. A few examples include community mental health centers, nursing facilities, rehabilitation centers, and residential facilities.

44. IND. CODE § 16-21-2-5 (2004).

45. See generally *id.* §§ 16-21-2-5 to -15; IND. ADMIN. CODE tit. 410, r. 15-1.4 (2004).

46. Under Indiana law, the governing board's responsibilities with respect to the medical staff include the following:

- (A) "Ensure the medical staff has approved bylaws and rules and that they are reviewed and approved at least triennially." IND. ADMIN. CODE tit. 410, r. 15-1.4-1(a)(3)-(4),(b)(4);
- (B) "Assume responsibility of appointment, reappointment, and assignment of privileges to medical staff members." IND. CODE § 16-21-2-5;
- (C) "Ensure that the medical staff is accountable and responsible to the Board for the quality of care provided to patients." IND. ADMIN. CODE tit. 410, r. 15-1.4-1(a);
- (D) "Maintain a liaison with the medical staff." *Id.* r. 15-1.4-1; and
- (E) "Ensure that the criteria for selection for medical staff membership are individual character, competence, education, training, experience, and judgment." *Id.*

47. Under Indiana law, the governing board must, among a variety of duties relating to management, (A) appoint a chief executive officer ("CEO"), (B) develop in writing, responsibilities and authority of the CEO, (C) require the CEO to develop policies and programs in a variety of areas, and (D) require the CEO (or designee) to attend board and committee meetings and act as the board's representative at medical staff meetings. IND. ADMIN. CODE tit. 410, r. 15-1.4-1(c).

48. Under Indiana law, the governing board must (A) "ensure all patients are admitted to the hospital only by a licensed practitioner who has been granted admitting privileges;" (B) ensure a qualified licensed physician who is a member of the medical staff is responsible for the care and treatment of each problem present at admission or that develops during hospitalization; (C) make sure that the hospital provides required emergency care services; (D) ensure that policies are developed to cover impaired physician limited practice problems; and (E) ensure the hospital has certain policies on organ and tissue donation. *Id.* r. 15-1.4-1(d).

budget,<sup>49</sup> and contracts.<sup>50</sup>

A governing board may have to be attentive to other licensing restrictions. For instance, in order to qualify as a “county hospital” in Indiana, a hospital must meet various statutory and regulatory requirements, which delineate unique responsibilities of a county hospital’s governing board.<sup>51</sup> In addition to such state licensing requirements, governing boards must also adhere to a variety of federal authorities, including, among many, those relating to Medicare certification and participation and the requirements of the Internal Revenue Service (“IRS”) for tax-exempt status, as discussed below.

#### IV. FEDERAL AUTHORITIES

##### A. *Conditions of Participation*

In order to participate in the Medicare and Medicaid programs, healthcare organizations must meet and maintain compliance with specific requirements established by the Centers for Medicare and Medicaid Services (“CMS”) of the United States Department of Health and Human Services. These requirements, known as conditions of participation, vary depending upon the type of healthcare organization.

The conditions of participation for hospitals require a hospital to have an effective governing body that is legally responsible for the conduct of the hospital as an institution.<sup>52</sup> CMS has promulgated six general standards that

49. Under Indiana law, the governing board must (A) oversee the preparation of the institutional plan, which shall include, but not be limited to, the programs and services provided and an annual operating budget prepared in accordance with generally accepted accounting principles; and (B) ensure the plan is reviewed and updated annually. *Id.* r. 15-1.4-1(e).

50. Under Indiana law, the governing board must (A) ensure that any contractor providing services does so as to ensure that the hospital is compliant with all applicable laws; (B) ensure that all contracted services are performed in a safe and effective manner and are included in the hospital’s quality assessment and improvement program; and (C) ensure that the hospital maintains a list of all contracted services, including the scope and nature of the services. *Id.* r 15-1.4-1(f).

51. *See generally* IND. CODE §§ 16-22-3-1 to -30. In Indiana, the county hospital statute places various responsibilities upon the board relating generally to the following: (A) the medical staff and bylaws; (B) management requirements; (C) financial matters; (D) patient care; (E) the hospital’s budget; and (F) contracts. *Id.*

52. 42 C.F.R. § 482.12 (2004). Aside from the condition of participation addressing the governing body of a hospital, there are several other conditions that must be satisfied for a hospital to participate in Medicare. *Id.* The conditions for participation that relate to administration are specifically titled Compliance with Federal, State, and local laws (§ 482.11) and Patient’s rights (§ 482.13). Those conditions for participation relating to basic hospital functions include: Quality assessment (§ 482.21); Medical staff (§ 482.22); Nursing services (§ 482.23); Medical record services (§ 482.24); Pharmaceutical services (§ 482.25); Radiologic services (§ 482.26); Laboratory services (§ 482.27); Food and dietetic services (§ 482.28); Utilization review (§ 482.30); Physical environment (§ 482.41); Infection control (§ 482.42); Discharge planning (§ 482.43); and Organ, tissue, and eye procurement (§ 482.45). The

regulate the way a board must govern a hospital. The standards extend broadly to the following areas of operation: (i) Medical Staff,<sup>53</sup> (ii) Chief Executive Officer,<sup>54</sup> (iii) Care of Patients,<sup>55</sup> (iv) Institutional Plan and Budget,<sup>56</sup> (v) Contracted Services,<sup>57</sup> and (vi) Emergency Services.<sup>58</sup> CMS has published interpretative guidelines with respect to the conditions of participation to assist hospitals with their corporate compliance and corporate governance initiatives.<sup>59</sup>

### *B. Accreditation Requirements*

Many hospitals utilize independent accreditation organizations for marketing and managed care contracting purposes. Another benefit of the accreditation process is that it may substitute for CMS's survey and certification process through a process known as "deeming." CMS has recognized

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conditions of participation relating to optional hospital services include: Surgical services (§ 482.51); Anesthesia services (§ 482.52); Nuclear medicine services (§ 482.53); Outpatient services (§ 482.54); Emergency services (§ 482.55); Rehabilitation services (§ 482.56); and Respiratory care services (§ 482.57). There are additional conditions of participation for specialty hospitals. *See* 42 C.F.R. pt. 482, subpt. E.

53. A hospital governing board must (A) assure the approval of the medical staff's bylaws; (B) appoint members of the medical staff after considering recommendations of the existing members; (C) ensure that the medical staff is accountable to the board for quality of care; and (D) establish categories of practitioners and ensure that the members of the medical staff are selected based upon the individual character, competence, training, experience, and judgment. 42 C.F.R. § 482.12(a).

54. A hospital governing "board must appoint a chief executive officer who is responsible for managing the hospital." *Id.* § 482.12(b).

55. A hospital governing board must (A) ensure there are hospital policies that provide for patients to be under the care of an appropriate professional staff following admission; and (B) ensure an appropriate physician is on duty or on call at all times. *Id.* § 482.12(c).

56. A hospital governing board must have an overall institutional plan with an annual operating budget prepared in accordance with general accepted accounting principles that includes all anticipated income and expenses. *Id.* §§ 482.12(d)(1)-(2). The plan must provide for capital expenditures for at least a three-year period. *Id.* § 482.12(d)(3). The plan must include and identify in detail the objective of, and the anticipated sources of financing for, each anticipated capital expenditure in excess of six hundred thousand dollars (\$600,000). *Id.* § 482.12(d)(4).

57. A hospital "governing board must ensure that a contractor of services (including one for shared services and joint ventures) furnishes services that permit the hospital to comply with all applicable conditions of participation." 42 C.F.R. § 482.12(e).

58. If emergency services are provided, a hospital governing board must (A) ensure that emergency services are organized under the direction of a qualified member of the medical staff and integrated with other departments of the hospital and (B) ensure there are adequate medical and nursing personnel qualified in emergency care to meet procedures established for the hospital and the needs anticipated by the hospital. *Id.* §§ 482.12(f), 482.55.

59. CTRS. FOR MEDICARE & MEDICAID SERVS., Hospitals Interpretive Guidelines and Survey Procedures, at <http://www.cms.hhs.gov/manuals/pub07pdf/AP-a.pdf> (last visited Feb. 25, 2004).

certain national accrediting bodies as “deemed organizations.”<sup>60</sup> Because of the deemed organizations’ high standards, CMS has granted them “deeming authority” to review hospitals for certification in addition to accreditation.<sup>61</sup> Hospitals which meet an appropriate deeming authority’s high standards are granted “deemed status” and become exempt from the CMS survey and certification process so long as they maintain this status.<sup>62</sup> A primary accrediting organization for hospitals is the Joint Commission on Accreditation of Healthcare Organizations (“JCAHO”).<sup>63</sup> JCAHO has identified specific standards and elements of performance that are applicable to how a board shall govern a hospital.<sup>64</sup>

### C. IRS Pronouncements

A healthcare provider may qualify for tax-exempt status under Internal Revenue Code § 501(c)(3) if it is organized and operated exclusively for charitable purposes.<sup>65</sup> In order to fulfill this charitable purpose requirement, the healthcare provider must operate to meet the community benefit standard.<sup>66</sup> This is the starting point for a governing board to appreciate some of the outside “constituencies” being served as a quid pro quo for the organization’s tax-exempt status. According to the governing regulations, the organization must be engaged “primarily in activities which accomplish one

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60. CTRS. FOR MEDICARE & MEDICAID SERVS., Conditions of Participation (May 3, 2002), at <http://www.cms.hhs.gov/copl/>.

61. 42 C.F.R. § 488.5 (2004); see also JOINT COMM’N ON ACCREDITATION OF HEALTHCARE ORGS., Federal Deemed Status and State Recognition (Sept. 2002), at [http://www.jcaho.org/about+us/government+relations/fed\\_st\\_rec.htm](http://www.jcaho.org/about+us/government+relations/fed_st_rec.htm).

62. *Id.*

63. Another accrediting organization that has “deeming authority” is Health Facilities Accreditation Program, which is commonly known as “HFAP.” AM. OSTEOPATHIC ASS’N, About Healthcare Facilities Accreditation Program (2003), at <http://www.aoa-net.org/Accreditation/HFAP/about.htm>.

64. The present JCAHO standards require a hospital governing board to perform a variety of specific and general functions, including (i) define governance responsibilities in writing, (ii) provide for organizational management and planning, (iii) demonstrate a commitment to the organization’s community, (iv) define the qualifications and competence for the medical staff and provide adequate resources for the care and services provided, and (v) annually evaluate performance in relation to the organization’s vision, missions, and goods. JOINT COMM’N ON ACCREDITATION OF HEALTHCARE ORGS., COMPREHENSIVE ACCREDITATION MANUAL FOR HOSPITALS: THE OFFICIAL HANDBOOK (2004). It is interesting to note that the recent JCAHO standards blur some of the distinction between an organization’s board of directors and its management under the topic of “Leadership” standards.

65. I.R.C. § 501(c)(3) (2003).

66. Rev. Rul. 69-545, 1969-2 C.B. 117 (describing the community benefit standard). For a discussion of the issues and steps for healthcare organizations applying for tax-exempt status, see Janet E. Gitterman & Marvin Friedlander, *Health Care Provider Reference Guide*, available at [www.irs.gov/pub/irs-tege/eotopic04.pdf](http://www.irs.gov/pub/irs-tege/eotopic04.pdf) (last visited Feb. 24, 2004).

or more of its exempt purposes . . . [with no] more than an insubstantial part of its activities . . . not in furtherance of an exempt purpose.”<sup>67</sup>

The concept of “community benefit” may vary with the type of healthcare organization. For hospitals, the focus of attention will be on the people within the community being served, nondiscriminatory treatment of Medicare and Medicaid patients, the extent of charity care provided, and the availability of an emergency room without regard for a person’s ability to pay.<sup>68</sup>

Beyond serving the public constituency, a governing board of a tax-exempt organization must at the same time protect against activities that result in “private inurement” and “private benefit.” The restriction against “private inurement” is a strict prohibition against any part of the organization’s net earnings inuring in whole or in part to the benefit of any “private shareholder or individual.” In practice, since nonprofit corporations do not have shareholders, the target for this prohibition is generally referred to as “insiders”—individuals with an interest in or opportunity to influence the activities of the organization.<sup>69</sup> Violation of the prohibition against private inurement results in a loss of tax-exempt status. Therefore, a governing board must be attentive to this concept and the severe consequences of the strict liability exposure.

A second prohibited activity relates to “private benefit.” The targeted area of potential beneficiaries extends beyond “insiders,” but a violation does not necessarily result in loss of tax-exempt status. Any “private benefit” must be both qualitatively and quantitatively incidental compared to the public benefit and charitable purpose otherwise being served.<sup>70</sup> While many of the recent corporate scandals have involved excessive benefits for corporate insiders, the concept of “private benefit” for tax-exempt governing boards requires that attention be given to benefits provided for non-insiders. An organization and its management may often have an “explanation” for such “private benefits,” and the governing board’s duty requires a “peripheral vision” and inquisitiveness to determine the degree to which such benefits are appropriate and insubstantial.

Internal Revenue Code § 4958 was enacted as part of the Taxpayer Bill of Rights 2<sup>71</sup> imposing “intermediate sanctions” short of tax exemption revocation on certain “excess benefit transactions” between the organization

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67. Treas. Reg. § 1.501(c)(3)-1(c) (as amended in 1990).

68. A good review of the basic principles discussed in this section was provided by T.J. Sullivan, Tax Law Update, Presentation at American Health Lawyers Association Annual Meeting (June 29-July 2, 2003). For a description of the factors evaluated in determining a “community benefit” for a hospital, see Rev. Rul. 69-545, 1969-2 C.B. 117.

69. See Sullivan, *supra* note 68, at 2; see also Gitterman & Friedlander, *supra* note 66, at 4.

70. Gen. Couns. Mem. 37,789 (Dec. 18, 1978).

71. Taxpayer Bill of Rights 2, Pub. L. No. 104-168, § 1311, 110 Stat. 1452 (1996).



and “disqualified persons.”<sup>72</sup> Final regulations were issued by the IRS in 2002.<sup>73</sup> This is a tool for heightened regulatory enforcement, allowing the IRS to avoid the “death penalty” of losing tax-exempt status, presented by the strict prohibition on private inurement. As a result, governing boards will now face increased scrutiny in this area.<sup>74</sup> Briefly, this statute imposes a significant excise tax on the value of excess benefits the organization provides to a “disqualified person,”<sup>75</sup> with a very steep tax if not promptly corrected. Targeted transactions include ones in which the disqualified person pays less than fair-market value for a good or service, receives unreasonable compensation, or where there is inappropriate “revenue sharing.”<sup>76</sup>

While the threat of intermediate sanctions hangs over an organization’s management and governing board, the IRS has provided some guidance for compliance. In this era of internal investigation and self-reporting encouraged by corporate compliance activity, the IRS has announced a desire to solicit comments on the scope and content for voluntary compliance program guidance.<sup>77</sup> More immediately, the regulations issued by the IRS provide a “rebuttable presumption” procedure to establish the reasonableness of compensation transactions.<sup>78</sup> The governing board is brought directly into the process, and is required to approve the transaction based upon appropriate data as to comparability, while documenting the basis for its determination.<sup>79</sup>

The IRS has also provided encouragement through published guidance in the area of conflicts of interest. In 1997, the IRS developed a conflicts of interest policy for tax-exempt organizations that can help illuminate and avoid potential private inurement, private benefit, and intermediate sanctions violations.<sup>80</sup> The IRS focuses its attention on “interested persons,” which

72. See Sullivan, *supra* note 68, at 4-8; see also Gitterman & Friedlander, *supra* note 66, at 5-6.

73. Excise Taxes on Excess Benefit Transactions, 67 Fed. Reg. 3076 (Jan. 23, 2002) (codified at Treas. Reg. §§ 53.4958-1 to 53.4958-8 (2004)).

74. For an extensive discussion of this topic and its application for healthcare providers, see the presentation by Gerald M. Griffith, *Dealing with Excess Benefit: The New Tax Compliance Challenge*, Presented at the Hospitals and Health Systems Law Institute, American Health Lawyers Association (Feb. 6-7, 2003).

75. “Disqualified persons” are persons in a position, whether by organizational title or other means, to exercise substantial influence over the organization. See Sullivan, *supra* note 68, at 5; see also Gitterman & Friedlander, *supra* note 66, at 4.

76. See Sullivan, *supra* note 68, at 4.

77. Announcement 2001-14, 2001-1 C.B. 648 (2001); see also Griffith, *supra* note 74, at 22.

78. Treas. Reg. §§ 53.4958-1(d)(4)(iv), -6(b) (2004); see Griffith, *supra* note 74, at 8-16; Stephen T. Miller, *Rebuttable Presumption Procedure is Key to Easy Intermediate Sanctions Compliance*, TAX NOTES TODAY 92-63 (May 11, 2001).

79. See Sullivan, *supra* note 68, at 8.

80. See Lawrence M. Brauer & Charles F. Kaiser, *Tax Exempt Organizations Community Board and Conflicts of Interest Policy*, Presented at the IRS Exempt Organizations Continuing Professional Education Technical Instruction Program for Fiscal Year 1997 (updated in 2000), available at <http://www.irs.gov/pub/irs-tege/topic-c.pdf> (last visited Apr. 5, 2004).

includes a trustee or director, a principal officer, or a member of a committee with board-delegated powers who has a direct or indirect financial interest in the organization.<sup>81</sup> Adoption of the conflicts of interest policy is only the first step for the governing board. The board must then develop a process for evaluating disclosures and a procedure to deal with conflicts. The procedures should include minutes of meetings that reflect the board's understanding and application of the policy and its relationship to the organization's charitable purpose.<sup>82</sup>

## V. REVIEW OF RECENT STATE ATTORNEY GENERAL INITIATIVES

As questions about "corporate governance" escalate in the for-profit arena, state attorneys general are taking a closer look at the way in which non-profit boards govern their organizations. They are initiating investigations, filing lawsuits, and lobbying for legislation to safeguard the interest of the communities that nonprofits serve. This activity will directly or indirectly affect governance issues for nonprofit organizations in every state.

### A. *Minnesota: Allina Health System and Management Excesses*

Minnesota's Attorney General, Mike Hatch, initiated an investigation against his state's largest healthcare system, Allina Health System ("Allina"), in 2001. Subsequent to the investigation, Hatch raised various issues with respect to how Allina and its HMO, Medica, both nonprofit companies, managed certain funds. Specifically, Hatch claimed that as much as forty-seven percent of the health insurance premiums paid to Medica were spent on Allina's administration rather than on medical care for its members.<sup>83</sup> This greatly exceeded the ten percent that Medica had reported.<sup>84</sup>

Hatch pointed to specific expenditures to support his allegations. Examples included expensive outings for Medica employees, lavish company parties, questionable executive compensation, and hefty consultant fees.<sup>85</sup> While Hatch acknowledged that these administrative costs and "perks" were not necessarily illegal, he stated that they do raise questions of possible mismanagement.<sup>86</sup> Consequently, he filed a lawsuit against Allina.

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81. A sample conflict of interest policy ("Sample Policy") recommended by the IRS is included in Brauer & Kaiser, *supra* note 80, at 25 and Gitterman & Friedlander, *supra* note 66, at 30.

82. See the Sample Policy discussed, *supra* note 81.

83. *Attorney General Files Suit Against Allina*, MINNEAPOLIS STAR TRIB., Mar. 22, 2001, available at <http://thenationalcoalition.org/SuitAgainstAllina.htm> [hereinafter *Attorney General*].

84. *Id.*

85. *Id.*

86. *Id.*

Allina settled the lawsuit with the Attorney General at the end of 2001. As a result, the parties entered into a Memorandum of Understanding, which placed certain restrictions on expenses, executive compensation, third party contracts, relations with affiliates, and the interaction between the Allina and Medica management.<sup>87</sup> Hatch's efforts to protect the community did not end with Allina, as he also initiated investigations against two other large health plans: HealthPartners and Blue Cross and Blue Shield of Minnesota.<sup>88</sup> He also issued a memorandum on "Corporate Responsibility," which is directed to both for-profits and nonprofits, urging political leaders to take "aggressive action to stop the hemorrhaging of our corporate institutions and financial markets."<sup>89</sup>

### *B. North Dakota: Banner Health System and Community Assets*

In 2002, North Dakota's Attorney General, Wayne Stenehjem, filed a lawsuit against Banner Health System ("Banner"), a charitable nonprofit organization authorized to do business in North Dakota.<sup>90</sup> Banner had operated five nursing homes in North Dakota, which it sold in 2001.<sup>91</sup> The litigation centered around Banner's removal of certain assets, including the funds from the sale of these facilities, from North Dakota for use in other states. The Attorney General maintained that this money belonged to the North Dakota communities in which the nursing homes had operated.<sup>92</sup>

Throughout the litigation, the Attorney General argued that Banner, as a nonprofit organization, was required to hold these proceeds and contributions in a constructive trust for the benefit of the community these entities had served.<sup>93</sup> However, the district court dismissed the case, stating that the Attorney General had failed to allege facts to satisfy the elements necessary to impose a constructive trust.<sup>94</sup> The Attorney General appealed the district court's decision. The Attorney General's appeal, as well as litigation initiated by Banner in federal court, remained open until recently, when the parties

87. Memorandum of Understanding between Allina and the Minnesota Office of the Attorney General, at <http://www.ag.state.mn.us/consumer/PDF/allina/MemUnder.pdf> (last visited Feb. 25, 2004).

88. *Attorney General*, *supra* note 83.

89. OFFICE OF MINN. ATT'Y GEN. MIKE HATCH, Corporate Responsibility, at [http://www.ag.state.mn.us/pdf/corporate\\_Responsibilities\\_Report.pdf](http://www.ag.state.mn.us/pdf/corporate_Responsibilities_Report.pdf) (last visited Feb. 25, 2004).

90. *Banner Health System, North Dakota AG Settle Claims Over Charitable Assets*, 12 Health L. Rep. (BNA) 1903 (Dec. 18, 2003) [hereinafter *Banner Health System*].

91. *Id.*

92. *Id.*

93. See *Banner Health Sys. v. Stenehjem*, No. A3-02-121, 2003 U.S. Dist. LEXIS 2702, at \*2 (D.N.D. Feb. 25, 2003).

94. *Id.*

agreed to settle for one million dollars, contingent upon both parties dismissing all pending litigation.<sup>95</sup>

### C. *New Hampshire: Community Benefits Statute*

Various states have enacted community benefits legislation that requires nonprofit hospitals to publicly disclose what community benefits and services they are providing in exchange for their tax-exempt status.<sup>96</sup> Many states<sup>97</sup> with this type of legislation require the nonprofit hospital to annually file a report with the state attorney general's office or the state department of health regarding the level of benefit the nonprofit provides to the community it serves.<sup>98</sup>

New Hampshire's community benefits statute (N.H. REV. STAT. ANN. §§ 7:32-c to 7:32-l (1999)) is the most extensive in scope, extending not only to nonprofit hospitals but also to "healthcare charitable trusts," including community health centers and visiting nurses associations.<sup>99</sup> The framework of the New Hampshire legislation is structured around three themes: (1) public accountability, (2) community involvement, and (3) collaboration among charitable entities.<sup>100</sup>

The notion of public accountability is addressed in the legislation by placing a reporting duty upon § 501(c)(3) entities, requiring them to file an annual community benefits report with the attorney general.<sup>101</sup> Since the effective date of the legislation, the New Hampshire Attorney General has been reviewing these reports in an attempt to provide nonprofits with "best practices."<sup>102</sup>

The community involvement element requires the nonprofit hospital to obtain community input in determining the community's needs.<sup>103</sup> This in-

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95. See *Banner Health System*, *supra* note 90, at 1903. Litigation involving the sale of Banner assets in South Dakota and issues similar to those raised in the North Dakota litigation is still pending in both South Dakota state and federal courts. *Id.*

96. MICHAEL W. PEREGRINE & JAMES R. SCHWARTZ, *THE APPLICATION OF NONPROFIT CORPORATION LAW TO HEALTHCARE ORGANIZATIONS* 53 (Am. Health Lawyers Ass'n 2002).

97. The states that have this type of public disclosure requirement include California, Georgia, Idaho, Indiana, Minnesota, New Hampshire, New York, Pennsylvania, and Utah. See *id.*

98. *Id.*

99. *Id.* at 53-54.

100. See OFFICE OF HEALTH PLANNING & MEDICAID, N.H. DEP'T OF HEALTH & HUMAN SERVS., *TELLING OUR STORY: NEW HAMPSHIRE'S COMMUNITY BENEFITS REPORT 2* (2002) [hereinafter *TELLING OUR STORY*], available at <http://www.dhhs.nh.gov/DHHS/HPR/Library/Research/Community-benefits.htm>.

101. See N.H. DEP'T OF JUSTICE, *GUIDELINES FOR PREPARATION OF THE COMMUNITY BENEFITS PLAN PURSUANT TO RSA 7:32-e* [hereinafter *GUIDELINES*], available at <http://www.doj.nh.gov/publications/combenguide.html> (last visited May 20, 2004).

102. See *TELLING OUR STORY*, *supra* note 100.

103. See *GUIDELINES*, *supra* note 101.

volves seeking assistance from public officials and the community-at-large.<sup>104</sup> Specifically, this requirement has prompted New Hampshire healthcare entities to hold public forums, organize focus groups, and survey the public in order to identify the community's needs and determine how best to respond to them.<sup>105</sup>

Moreover, the statute also encourages collaboration among healthcare charitable trusts in the preparation of community need assessments.<sup>106</sup> While New Hampshire's legislation does not mandate such collaboration, it strongly suggests it in order to minimize duplication of efforts and control costs.<sup>107</sup>

#### D. Indiana: Conner Prairie and Donor's Intent

Earlham College ("Earlham") was made the trustee of a public charitable trust, established by Eli Lilly ("Lilly") for the purpose of creating and operating an Indiana history museum, now known as Conner Prairie. In 2003, the President of Earlham, as the controlling member of the nonprofit corporation, fired all of the non-Earlham affiliated board members of the nonprofit corporation created to oversee the museum's affairs.<sup>108</sup> Earlham's action led to a dispute between the dismissed former board members, now operating as a nonprofit organization named "Save the Prairie," and the college.

Prior to the mass dismissal, the board had been working with Earlham to determine whether the museum could be completely separated from Earlham and how to divide up various gifts from Lilly that were given to Earlham for the benefit of Earlham and Conner Prairie.<sup>109</sup> The negotiations apparently broke down when the museum board rejected Earlham's interpretation of Lilly's intent regarding the extent of the funds that should be allocated to Earlham rather than Conner Prairie.<sup>110</sup>

Ultimately, the Save the Prairie group sought assistance from Indiana Attorney General, Steve Carter, claiming that Earlham improperly shifted about \$30 million to itself that was donated by Lilly and intended for Conner Prairie.<sup>111</sup> The Attorney General initiated his investigation in June 2003 and

104. *Id.*

105. *Id.*

106. *Id.*

107. *Id.*

108. See Save the Prairie, Inc., *Save the Prairie*, at <http://www.savetheprairie.org/files/index.pdf> (last visited Feb. 22, 2004); see also Earlham College, *Earlham Resumes Management of Conner Prairie* (June 11, 2003), at <http://www.earlham.edu/~publicaf/connerprairie061103.html>.

109. Mary Sell, *Prairie Issue Revolves Around \$130 Million*, PALLADIUM-ITEM (July 2, 2003), available at <http://www.pal-item.com/news/stories/20030702/localnews/582000.html> [hereinafter *Prairie Issue*].

110. *Id.*

111. WISHTV8, *Attorney General to Investigate Conner Prairie Dispute* (June 24, 2003), at <http://www.wishtv.com/global/story.asp?s=1334287&ClientType=Printable>.

is continuing to review whether or not charitable donations given to Earham were being used as intended by Lilly.<sup>112</sup>

### *E. Maryland: CareFirst and Conflict of Interest*

In 2001, CareFirst, formerly known as Maryland Blue Cross/Blue Shield Company, announced its intention to convert from a nonprofit insurer to for-profit status.<sup>113</sup> As a result of CareFirst's announcement, Maryland Attorney General, Joseph Curran, Jr., announced his interest in CareFirst's proposal.<sup>114</sup> He stated that the issue was not only whether to allow the conversion, but also whether, as a nonprofit, CareFirst should be forced to alter its conduct to conform with that expected of a nonprofit entity.<sup>115</sup>

One of Curran's concerns regarding the conversion centered around CareFirst's disclosure of its proposed compensation packages for its executives, which collectively equaled \$42 million dollars.<sup>116</sup> Curran feared that the insiders who negotiated would be well compensated, while Marylanders and the Maryland healthcare system would be left behind.<sup>117</sup>

After reviewing an opinion by the Maryland Attorney General<sup>118</sup> and CareFirst's application for the conversion, the Maryland Insurance Administration ("MIA") rejected CareFirst's proposed conversion because it was not in the public interest as required by Maryland law.<sup>119</sup> At the same time, Curran continued to express concerns over protecting the charitable assets and the public.<sup>120</sup> Subsequent to MIA's decision to reject CareFirst's conversion

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112. *Id.*

113. OFFICE OF MD. ATT'Y GEN. J. JOSEPH CURRAN, JR., News Release, *Attorney General Takes Issue with Conversion, Urges Marylanders to Read Abell Foundation Report* (Dec. 3, 2001), at <http://www.oag.state.md.us/Press/2001/1203d01.htm> [hereinafter *Conversion*].

114. *See id.*

115. *See id.* The Abell Foundation Report criticized CareFirst for significantly changing its purpose and focus. *Id.* CareFirst formerly functioned as an insurer for high-risk individuals. *Id.* However, it took steps to eliminate coverage for the under-insured portion of the population, except through an expensive open enrollment program offered only twice a year. *Id.* The State subsidized this program, leading to net earnings for the company. *Conversion, supra* note 113. This was in addition to the significant reserves that CareFirst also carried, which were above industry standards. *Id.*

116. OFFICE OF MD. ATT'Y GEN. J. JOSEPH CURRAN, JR., *Curran Responds to Disclosure of Compensation Packages for CareFirst Execs* (Mar. 7, 2002), at <http://www.oag.state.md.us/Press/2002/030702.htm>.

117. *Id.*

118. *See generally* 87 Op. Md. Att'y Gen. 02-019 (2002) (opinion that the Maryland Insurance Commissioner had the authority to review certain transactions associated with the proposed merger and conversion of CareFirst to for-profit status).

119. *See* MD. ATT'Y GEN. REPORT 2003-02-032 (2003) [hereinafter REPORT]. *See also* OFFICE OF MD. ATT'Y GEN., *Attorney General Applauds Process, Commissioner's Decision in Proposed CareFirst Sale* (Mar. 5, 2003), at <http://www.oag.state.md.us/Press/2003/030503.htm> [hereinafter *Commissioner's Decision*].

120. *See Commissioner's Decision, supra* note 119.

proposal, the Attorney General testified during the 2003 Legislative Session. His testimony focused on his support of substantive changes to Maryland law in order to address the threat to the public interest posed by CareFirst's questionable management practices.<sup>121</sup> The changes were enacted into law as a part of the emergency nonprofit health service plan reform legislation.<sup>122</sup>

## VI. THE RECENT ARRIVAL OF "CORPORATE COMPLIANCE"

During the past twenty-five years, healthcare providers, both institutional and individual, have become more interested in and educated about the regulatory environment in which they conduct business or practice. This stems from external enforcement pressures exerted on healthcare providers to conform their business practices to a variety of state and federal regulations or face significant criminal and civil penalties. Well-publicized cases involving violations of the Anti-Kickback Statute are examples of such enforcement activities that assisted in getting both the healthcare providers' and the public's attention.<sup>123</sup>

The high profile pressure facing today's healthcare providers has been largely instigated by the federal and state fraud and abuse laws created in the last quarter of the twentieth century. These laws have been used by a variety of federal and state enforcement agencies to prohibit illegal activities, recover substantial overpayments, and assess fines and penalties. These federal statutes include the Anti-Kickback Statute,<sup>124</sup> the False Claims Act,<sup>125</sup> the Stark law,<sup>126</sup> the civil monetary provisions of various laws,<sup>127</sup> the federal healthcare program exclusion provisions, and healthcare fraud statutes affecting governmental and nongovernmental third-party payors.<sup>128</sup>

Many states have also enacted fraud and abuse statutes designed to address varying public policy considerations. These statutes often follow not only the federal Anti-Kickback and False Claims statutes, but also the physician self-referral prohibitions found in the Stark law. Additionally, prohibitions against fee-splitting and deceptive trade practices, along with consumer protection statutes and professional licensing statutes, have been designed and interpreted to protect the public from fraudulent, abusive, and unprofessional conduct.

121. REPORT, *supra* note 119.

122. *Id.*

123. *See, e.g.*, United States v. Greber, 760 F.2d 68 (3d Cir. 1985); United States v. Kats, 871 F.2d 105 (9th Cir. 1989); United States v. Bay State Ambulance & Hosp. Rental Serv., 874 F.2d 20 (1st Cir. 1989).

124. 42 U.S.C. § 1320a-7b(b) (2004).

125. 31 U.S.C. § 3729 (2004).

126. 42 U.S.C. § 1395nn (2004).

127. *Id.* § 1320a-7a.

128. 18 U.S.C. §§ 1035, 1345 (2004).

Congress and the Department of Health and Human Services (“HHS”) have attempted to provide direction and encouragement in conjunction with the multiple sources for penalties and prosecution. In 1987, Congress directed the Secretary of HHS to promulgate “safe harbor” regulations that would describe the business practices and relationships, regardless of the provider’s state of mind, which would be free from prosecution.<sup>129</sup> The safe harbors<sup>130</sup> that have been developed and proposed<sup>131</sup> have emphasized the importance and benefit of caution and compliance in structuring transactions and relationships. Additionally, since 1998, the Office of Inspector General (“OIG”) of HHS has developed eleven different compliance program guidance documents in order to assist those providers with development of compliance programs oriented toward the fraud and abuse laws.<sup>132</sup> Further, the OIG provides direction annually through the publication of its “Work Plan,”<sup>133</sup> identifying the types of enforcement activities that it intends to pursue in the coming year, organized by types of providers. For healthcare providers, this Work Plan can be useful in identifying high-risk compliance problem areas, which should be incorporated into the provider’s compliance program for review and management.<sup>134</sup>

A major impetus for healthcare providers to develop compliance programs began on November 1, 1991, with the publication of the United States Sentencing Guidelines for organizations involved in federal criminal violations.<sup>135</sup> A crucial component of the federal sentencing guidelines is the recognition of sentencing credit for organizations that utilize an “effective

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129. 42 U.S.C § 1320a-7b(b)(3).

130. The safe harbors are located at 42 C.F.R. § 1001.952 (2004).

131. To date, the Secretary of HHS through its Office of Inspector General has promulgated twenty-four safe harbors under the Anti-Kickback Statute to guide the myriad of healthcare providers contracting with the federal and state governments under the Medicare and Medicaid and TriCare programs.

132. The compliance plans address the following healthcare organizations: Hospitals (63 Fed. Reg. 8987 (Feb. 23, 1998)); Home Health Agencies (63 Fed. Reg. 42,410 (Aug. 7, 1998)); Clinical Laboratories (63 Fed. Reg. 163 (Aug. 24, 1998)); Third-Party Medical Billing Companies (63 Fed. Reg. 70,138 (Dec. 18, 1998)); Durable Medical Equipment Suppliers (64 Fed. Reg. 36,368 (July 6, 1999)); Hospices (64 Fed. Reg. 54,031 (Oct. 5, 1999)); Medicare + Choice Organizations (64 Fed. Reg. 61,893 (Nov. 15, 1999)); Nursing Facilities (65 Fed. Reg. 14,289 (Mar. 16, 2000)); Individual and Small Group Physician Practices (65 Fed. Reg. 59,434 (Oct. 5, 2000)); Ambulance Suppliers (68 Fed. Reg. 14,245 (Mar. 24, 2003)); Pharmaceutical Manufacturers (68 Fed. Reg. 23,731 (May 5, 2003)).

133. OFFICE OF INSPECTOR GEN., DEP’T OF HEALTH & HUMAN SERVS., *Work Plan Fiscal Year 2004*, at <http://oig.hhs.gov/publications/docs/workplan/2004/Work%20Plan%202004.pdf> (last visited Mar. 9, 2004).

134. *Id.*

135. U.S. SENTENCING COMM’N, 2003 SENTENCING GUIDELINE MANUAL ch. 8, *available* at <http://www.ussc.gov/2003guid/CHAP8.htm> (last visited Mar. 9, 2004) [hereinafter SENTENCING GUIDELINES].



program to prevent and detect violations of law.”<sup>136</sup> The importance of the Sentencing Guidelines “recommendation” for an effective compliance program, and its relevance for a governing board, received a significant boost following the *Caremark*<sup>137</sup> decision in 1996.

Central to any corporate compliance program is the role of the organization’s governing board. This important role was emphasized and discussed in a recent joint publication of the OIG and the American Health Lawyers Association.<sup>138</sup> In that publication, not only are the traditional fiduciary duties of loyalty and due care described, but with respect to the oversight responsibility of the latter, corporate board compliance activities are discussed in a way that requires the board to assure that the organization (1) has a functioning information reporting system and (2) such a system provides the board with timely information that will enable the organization to achieve compliance with applicable laws.<sup>139</sup>

In the face of an ever increasing compilation of healthcare statutes and regulations, and the expanding array of technological advances and broad service offerings, an effective compliance program, with its attendant policies, protocols, and procedures, is a crucial managerial tool today for healthcare providers and their governing boards to achieve meaningful oversight of their organization’s day to day activities.

## VII. SARBANES-OXLEY AND RELATED PRINCIPLES

In response to the Enron implosion, President George W. Bush signed SOXA on July 30, 2002.<sup>140</sup> SOXA is designed to uphold the integrity of financial reports submitted to the SEC by publicly-traded companies and protect the shareholders of such companies from severe financial loss.<sup>141</sup>

136. *Id.* § 8C2.5(f). For healthcare providers, the Department of Health and Human Services through its OIG has, in fact, published compliance program guidance documents. The content of such compliance program guidance documents will play a significant role in determining whether the organization has developed an effective compliance program to ensure compliance with the various laws under which it is obligated to conduct its activities. See U.S. Dep’t of Health & Human Servs. Office of Inspector Gen., *Fraud Prevention and Detection Compliance Guidance* at <http://www.oig.hhs.gov/fraud/complianceguidance.html#1> (last visited May 3, 2004).

137. *In re Caremark Int’l Inc. Derivative Litigation*, 698 A.2d 959 (Del. Ch. 1996).

138. OFFICE OF INSPECTOR GEN., U.S. DEP’T OF HEALTH & HUMAN SERVS. & AM. HEALTH LAWYERS ASS’N, *Corporate Responsibility and Corporate Compliance: A Resource for Health Care Boards of Directors*, at <http://oig.hhs.gov/fraud/docs/complianceguidance/040203CorpRespRscceGuide.pdf> (last visited Mar. 9, 2004) [hereinafter *Corporate Responsibility*].

139. *Id.*

140. Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, 116 Stat. 745 (2002) (codified in scattered sections of 15 U.S.C.) [hereinafter SOXA].

141. Cynthia A. Glassman, SEC Comm’r, *Sarbanes-Oxley and the Idea of “Good” Governance*, Speech Before the American Society of Corporate Secretaries (Sept. 27, 2002), at <http://www.sec.gov/news/speech/spch586.htm>. The Commissioner stated that the impetus behind the quick government response to the Enron and other corporate scandals is the “effect

SOXA and the SEC's quick regulatory response to Enron and other corporate scandals reflect strict governance standards that require top corporate officials in publicly traded companies to be held accountable for a company's financial accountings and disclosures and to act as the "conscience" of the company, all in an effort to prevent fraudulent acts and potentially harmful conflicts of interest.<sup>142</sup> Failure to adhere to these new corporate governance standards will subject such officials to substantial penalties.<sup>143</sup>

The corporate governance policies of SOXA include: heightened accountability for financial reports that are submitted to the SEC along with augmented disclosures concerning the internal controls of a company; enhanced professional responsibility of corporate attorneys to report evidence of a material violation of the securities laws; internal independent corporate audit committees; and external auditor independence.<sup>144</sup> Two other areas that SOXA highlights include prohibiting company officials from fraudulently influencing the company's external auditor and enhanced conflict of interest provisions making it unlawful for a company to extend a personal loan to any director or executive officer, except for certain commercial loans that would be made to the general public.<sup>145</sup>

#### A. Accountability for Financial Reports

One of the key aspects of SOXA's new corporate governance standards is the heightened amount of responsibility executive officers have in overseeing the financial reports submitted to the SEC<sup>146</sup> and the corresponding

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these scandals have had on innocent investors." *Id.* Approximately "88 million shareholders, representing 51 percent of U.S. households, invest in the markets today . . ." *Id.* The Commissioner stated that the increase in the number of shareholders is largely due to the popularity of employee 401(k) plans. *Id.* These employee stock plans have provided many benefits for employee investors, but these plans have also led many employees to invest most of their money in one company instead of diversifying their stock portfolio; thus, placing these investors at risk of a greater financial loss if there is financial fraud perpetrated by the company. *Id.*

142. *Id.*

143. SOXA § 1106, 15 U.S.C. § 78ff(a) (2004). The enactment of SOXA increased the criminal penalties for those who violate any of the SEC laws, rules, or regulations. A person who commits a willful violation can receive up to a \$5,000,000 fine or up to twenty years in prison or both; if it is not possible to convict a "natural" person, then a fine of up to \$25,000,000 may be imposed upon a company. *Id.*

144. SOXA §§ 201-501 (codified in scattered sections of 15 U.S.C.).

145. *Id.*

146. SOXA § 302(a)(6), 15 U.S.C. § 7241. The Chief Executive Officer ("CEO") or Chief Financial Officer ("CFO") of a company is required to certify in each financial report filed with the SEC that such officer has: (1) reviewed the report; (2) determined that the report contains all relevant information and such information is not false or misleading; (3) determined that the report is an accurate description of the financial health of the company; (4) evaluated the company's internal controls regarding financial matters and reported to the external auditors any substantial deficiencies in the internal controls that could possibly affect the outcome of the financial report; (5) reported to the external auditors any fraud regarding those employees who

penalties for failure to comply. Three basic requirements included within this enhanced responsibility and oversight for financial reporting are: (1) maintain all of the internal controls within the company that oversee the company's financial reporting practices; (2) provide a written annual evaluation of the effectiveness of such internal controls; and (3) review and attest to the annual evaluation by the external auditor and submission of that attestation along with the company's financial report to the SEC.<sup>147</sup>

Concerning the first requirement, an independent Public Company Accounting Oversight Board ("PCAOB")<sup>148</sup> was established; it will require internal control policies and procedures relating to a company's "maintenance of accounting records, the authorization of receipts and disbursements," the protection of assets, and its "process for preparing financial statements in accordance with generally accepted accounting principles."<sup>149</sup> Under the second requirement, the executive officers of a company are required to prepare an annual written evaluation of the company's internal control systems that recognizes the executive's responsibility for the control systems and identifies any "material weaknesses" in any of the control systems.<sup>150</sup>

take part in the internal controls of the company; and (6) "indicated in the report whether or not there were significant changes in internal controls or in other factors that could significantly affect internal controls." *Id.*

147. SOXA §§ 302, 404, 15 U.S.C. §§ 7241, 7262.

148. SOXA §§ 101-09, 15 U.S.C. §§ 7211-19. The PCAOB is not an agency of the government but instead is a nonprofit corporation, formed for the purpose of overseeing financial audits of publicly-traded companies. *Id.* The PCAOB also has the power to investigate, inspect, and sanction public accounting firms. *Id.* Furthermore, to promote high professional standards, the PCAOB may promulgate rules or orders concerning any aspect of the auditing process. *Id.*

149. PUB. CO. ACCOUNTING OVERSIGHT BD., Briefing Paper, Proposed Auditing Standard—An Audit of Internal Control Over Financial Reporting Performed in Conjunction With an Audit of Financial Statements, Oct. 7, 2003 at 2, available at [http://www.pcaobus.org/rules/2003-10-07\\_Proposed\\_Auditing\\_Standard.pdf](http://www.pcaobus.org/rules/2003-10-07_Proposed_Auditing_Standard.pdf) [hereinafter Proposed Auditing Standard].

150. Management's Reports on Internal Control over Financial Reporting and Certification of Disclosure in Exchange Act Periodic Reports, 68 Fed. Reg. 36,636, 36,642 (June 18, 2003). The SEC stated that the Committee of Sponsoring Organizations of the Treadway Commission control framework met its criteria regarding the evaluation of a company's internal control mechanisms. *Id.* See also COMM. OF SPONSORING ORGS. OF THE TREADWAY COMM'N ("COSO"), Internal Control—Integrated Framework—Executive Summary, available at [http://www.coso.org/Publications/executive\\_summary\\_integrated\\_framework.htm](http://www.coso.org/Publications/executive_summary_integrated_framework.htm) (last visited Dec. 30, 2003). COSO is a private organization with the goal of improving the quality of financial reporting through business ethics, appropriate internal controls, and corporate governance. *Id.* COSO sets forth five components of internal control: (1) control environment that sets the corporate mood and operating style; (2) assessment of potential financial risks; (3) control activities consisting of policies and procedures regarding all financial aspects of a company; (4) a process for monitoring internal control systems with appropriate reporting procedures for deficiencies; and (5) the identification of pertinent financial information or factors that could possibly affect the company's financial status and proper communication among all levels of a company. PCAOB, An Audit of Internal Control over Financial Reporting Performed in Conjunction with an Audit of Financial Statements, Proposed Auditing Standard A-50-51 (Oct. 7, 2003), available at <http://www.pcaobus.org/rules/Release2003-017.pdf>. The

Concerning the third requirement, the external auditor's review will evaluate the executive's evaluation and reveal whether there are any material weaknesses that should have been included in the internal control report.<sup>151</sup> If all requisite steps are followed regarding the enhanced financial reporting standards, the result should be a strong set of checks and balances that promote the new and improved corporate conscience concerning corporate accountability and responsibility.

### *B. Ethical Obligations for Corporate Counsel*

SOXA has also had a dramatic effect on the relationships among corporations and their legal counsel. Section 307 of SOXA requires attorneys "appearing and practicing before the Commission . . . to report evidence of a material violation of securities law or breach of fiduciary duty . . . by the company . . . to the chief legal counsel or the chief executive officer."<sup>152</sup> If the chief legal counsel or chief executive officer does not respond appropriately to the attorney's report, the attorney must then report the material violation "up the ladder" to the corporation's audit committee.<sup>153</sup> This may appear to be irrelevant for nonprofit organizations since SOXA principally relates to publicly-traded, for-profit corporations. Nonetheless, the "ripple effect" of these relatively narrow provisions reveals how a legislative initiative in one arena can spread to have an impact beyond the initial confines of the statute.

The SEC significantly expanded § 307 by publishing its final rules regarding professional conduct for attorneys on February 6, 2003.<sup>154</sup> First, the final rules broadly defined what attorneys would be considered as "appearing

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PCAOB also sets forth certain requirements pertaining to the external auditor's attestation report. *Id.*

151. Proposed Auditing Standard, *supra* note 149.

152. SOXA § 307, 15 U.S.C. § 7245; *see also* 17 C.F.R. § 205.2 (2004). "Material violation" is defined as an activity that would violate any federal or state laws, any securities laws, or "a material breach of fiduciary duty arising under federal or state law." *Id.*

153. SOXA § 307, 15 U.S.C. § 7245 (suggesting that an appropriate response would be issuing sanctions or providing remedial measures concerning the material violation); 17 C.F.R. § 205.3.

154. Implementation of Standards of Professional Conduct for Attorneys, 68 Fed. Reg. 6296 (Feb. 6, 2003) (codified at 17 C.F.R. § 205). The rationale behind the promulgation of the standards of professional conduct for attorneys was to protect shareholders and promote shareholder confidence in public companies by requiring attorneys employed or retained by such companies to respond swiftly and affirmatively to any possible material violation of the SEC's rules. *Id.* Section 205.1 sets forth that the professional standards supplied by the SEC shall supplant any conflicting state standards. *Id.* The SEC explained in the final rule that their standards are not meant to preempt more stringent state standards. *Id.* However, the SEC's standards will apply over less stringent or conflicting state standards. *Id.* In addition to the already codified rules that have extended the original professional standards of SOXA, the SEC is still considering the requirement of a "noisy withdrawal"—whereby the withdrawing attorney must notify the SEC of his or her withdrawal—by an attorney who did not receive an appropriate response from a company after reporting evidence of a material violation. *Id.*

and practicing” before the SEC.<sup>155</sup> Second, the final rules allow corporate counsel to skip a step in the chain of command by reporting a suspected material violation directly to the audit committee, thus bypassing the chief legal officer or chief executive officer.<sup>156</sup> Furthermore, under certain circumstances, a reporting attorney who reasonably believes that he or she did not receive an appropriate response in a reasonable amount of time from the audit committee may report the suspected material violation to the SEC without the consent of the corporation.<sup>157</sup> Third, the SEC imposes the same disclosure requirements on any supervisory attorney as on the subordinate reporting attorney.<sup>158</sup> Finally, the final rules set forth that an attorney not in compliance with the standards of professional conduct will be subject to civil penalties and SEC disciplinary actions.<sup>159</sup>

In response to the SEC’s new standards of professional responsibility for attorneys, the American Bar Association’s (“ABA”) House of Delegates revised its Model Rules of Professional Conduct, specifically Rules 1.6 and 1.13, to allow attorneys to comply with the reporting responsibilities of SOXA

155. 17 C.F.R. §§ 205.2, 205.3. The SEC defines “appearing and practicing” before the SEC as: (1) any form of communication with the SEC; (2) representing a corporation in a SEC administrative proceeding or any other type of investigation or activity with the SEC; (3) advising clients on any aspect of securities laws or the SEC’s rules and regulations in preparation of filing any documentation; and (4) providing advice to a corporation concerning whether or not information is required to be filed with the SEC. *Id.* See also Implementation of Standards of Professional Conduct for Attorneys, 68 Fed. Reg. at 6296. The SEC set forth that an attorney “appearing and practicing” before the Commission need not be employed as an in-house attorney for a company—there only needs to be an attorney-client relationship and such a relationship can be formed without evidence of a formal retainer. *Id.* A clarification in the final rules explains that attorneys are not considered as “practicing or appearing” before the Commission if they had no notice or never intended a document to be filed with the SEC. *Id.*

156. 17 C.F.R. § 205.3(b)(4) (setting forth that the reporting attorney must reasonably believe “that it would be futile to report evidence of a material violation to the issuer’s chief legal officer and chief executive officer”).

157. *Id.* § 205.3(d)(2). The SEC sets forth three sets of circumstances in which a reporting attorney may report the material violation to the SEC without the corporation’s approval: (1) stopping an issuer from committing a material violation that would adversely affect the financial interest of the corporation or its investors; (2) preventing a corporation from committing perjury, suborning perjury or committing an act that is likely to “perpetrate a fraud upon the Commission;” or (3) remedying a material violation that caused great financial injury to the corporation or its investors “in the furtherance of which the attorney’s services were used.” *Id.*

158. *Id.* § 205.4 (2004). See also *id.* § 205.2(b) (defining “appropriate response” as a response to the reporting attorney in which such attorney reasonably believes that: no material violation has occurred or is likely to occur in the future; the company has taken steps to remedy any ongoing material violations or prevent any violations from occurring in the future; or the company, with the consent of the audit committee, has hired another attorney to investigate and evaluate whether a material violation has occurred).

159. *Id.* §§ 205.6-205.7. Section 205.6 also sets forth that attorneys acting in good faith in complying with the SEC rules will not be “subject to discipline or otherwise liable under inconsistent standards imposed by any state.” 17 C.F.R. §§ 205.6-205.7. Moreover, section 205.7 gives the SEC exclusive rights to enforce its required standards of professional conduct. *Id.*

and to disclose confidential information to prevent financial injuries. The ABA extended Model Rule 1.6 beyond disclosure of acts that will result in bodily harm or death; now an attorney may also disclose confidential information without consent to preclude any “substantial injury to financial interests or property of another.”<sup>160</sup> Before the revision of Model Rule 1.13, attorneys were only allowed to report unlawful acts of a company to a higher authority within the company; now under certain circumstances, an attorney may also report such unlawful acts to the SEC.<sup>161</sup> Thus, the ABA has removed many of the ethical obstacles that formerly served as deterrents to reporting “up the ladder.” Although the Model Rules were amended to reflect the goals of SOXA, the states must now (because the Model Rules are not legally binding) decide whether to revise their own rules of ethics to comply with the SEC’s standards or to maintain the status quo.

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160. MODEL RULES OF PROF’L CONDUCT R. 1.6 (2003), available at <http://www.abanet.org/leadership/2003/journal/119a.pdf> (last visited Mar. 9, 2004) [hereinafter MODEL RULES]. Rule 1.6 states in relevant part:

A lawyer may reveal information relating to the representation of a client to the extent the lawyer reasonably believes necessary: to prevent reasonably certain death or substantial bodily harm; to prevent the client from committing a crime or fraud that is reasonably certain to result in substantial injury to the financial interests or property of another and in furtherance of which the client has used or is using the lawyer's services; to prevent, mitigate or rectify substantial injury to the financial interests or property of another that is reasonably certain to result or has resulted from the client's commission of a crime or fraud in furtherance of which the client has used the lawyer's services; to secure legal advice about the lawyer's compliance with these Rules . . . .

*Id.*

161. *Id.* at R. 1.13, available at [http://www.abanet.org/cpr/mrpc/new\\_rule1\\_13.pdf](http://www.abanet.org/cpr/mrpc/new_rule1_13.pdf) (last visited Mar. 9, 2004). Rule 1.13 states in relevant part:

If a lawyer for an organization knows that an officer, employee or other person associated with the organization is engaged in action, intends to act or refuses to act in a matter related to the representation that is a violation of a legal obligation to the organization, or a violation of law that reasonably might be imputed to the organization, and that is likely to result in substantial injury to the organization, then the lawyer shall proceed as is reasonably necessary in the best interest of the organization. Unless the lawyer reasonably believes that it is not necessary in the best interest of the organization to do so, the lawyer shall refer the matter to higher authority in the organization, including, if warranted by the circumstances to the highest authority that can act on behalf of the organization as determined by applicable law. Except . . . if despite the lawyer's efforts . . . the highest authority that can act on behalf of the organization insists upon or fails to address in a timely and appropriate manner an action, or a refusal to act, that is clearly a violation of law, and the lawyer reasonably believes that the violation is reasonably certain to result in substantial injury to the organization, then the lawyer may reveal information relating to the representation whether or not Rule 1.6 permits such disclosure, but only if and to the extent the lawyer reasonably believes necessary to prevent substantial injury to the organization.

*Id.*

### C. Role of Independent Auditors Internally and Externally

SOXA also requires an “independent” accounting firm to perform the financial audits for a corporation.<sup>162</sup> One safeguard through which SOXA ensures auditor independence is by requiring auditors to submit reports directly to a corporation’s audit committee,<sup>163</sup> composed of board members who are not employed by or under contract (e.g., as an independent consultant) with the corporation. Another significant safeguard is that an accounting firm providing auditing services is prohibited from contemporaneously supplying the corporation with non-audit services including a wide variety of financial and management consulting services.<sup>164</sup> However, SOXA does allow certain non-auditing services to be performed by the same accounting firm subject to pre-approval by the corporation’s audit committee.<sup>165</sup>

Auditor independence is also safeguarded by the requirement of audit partner rotation.<sup>166</sup> To maintain a “fresh look” with regard to the external auditing team, the SEC requires that audit partners, the persons who are primarily responsible for coordinating and overseeing the audit, be rotated to another assignment after five years of consecutive service with the same corporation.<sup>167</sup> SOXA provides a similar safeguard regarding independent

162. SOXA § 204, 15 U.S.C. § 78j-1(k) (2004). Auditors must provide the audit committee with information regarding all accounting processes to be employed during the audit, “all alternative treatments of financial information within generally accepted accounting principles that have been discussed with management officials” of the corporation, the consequences of utilizing such alternative treatments, which treatment is favored by the auditors, and finally, any substantial written communication between the auditors and the corporation’s management regarding the audit. *Id.*

163. *Id.*

164. SOXA § 201, 15 U.S.C. §§ 78j-1(g)-(h). Prohibited non-auditing services include: services related to accounting records; “financial information systems design and implementation; actuarial services; internal audit outsourcing services;” managerial duties; financial investment services; “legal services and expert services unrelated to the audit; and any other service that the [PCAO] Board determines, by regulation, is impermissible.” *Id.*

165. SOXA §§ 201-02, 15 U.S.C. § 78j-1(g)-(i). Any non-auditing service not mentioned in § 201 may be allowed but must be pre-approved by the corporation’s audit committee. *Id.* Moreover, the specific services listed in § 201 may be performed by a corporation’s auditing team if the PCAOB determines that an exemption of such services is necessary for the protection of a corporation’s shareholders or in the public’s best interest. *Id.* The pre-approval requirement is waived if: 1) the total amount paid to the accounting firm for non-audit services does not exceed five percent of the compensation paid by the corporation to the accounting firm during the fiscal year; 2) the corporation did not consider the services to be non-auditing services at the time the accounting firm was hired to perform auditing services; and 3) such services are promptly reported to the corporation’s audit committee and the committee approves such services prior to the completion of the audit. *Id.*

166. SOXA § 203, 15 U.S.C. § 78j-1(j).

167. *Id.* See also Strengthening the Commission’s Requirements Regarding Auditor Independence, 68 Fed. Reg. 6006, 6017 (Feb. 5, 2003); 17 C.F.R. § 210.2-01(f)(7)(ii) (2004). The SEC defines an audit partner as a person “who is a member of the audit engagement team who has responsibility for decision-making on significant auditing, accounting, and reporting matters . . . .” 17 C.F.R. § 210.2-01(f)(7)(ii). An audit partner includes lead or coordinating

auditors: it is unlawful for an accounting firm to perform a financial audit of a corporation that has hired one of its former employees who “participated in any capacity” in a previous audit of that corporation during the one year time period preceding the initiation of any subsequent audit.<sup>168</sup> The SEC defines this one-year time lapse as a “cooling off” period in which any conflicts of interest could dissipate.<sup>169</sup>

### VIII. IMPLICATIONS FOR THE NONPROFIT HEALTHCARE ORGANIZATION

Just as the development of “corporate compliance” incentivized health-care organizations to respond to specific concerns, such as billing matters, SOXA provides a similar incentive for entities to internally develop a governance compliance program. While SOXA principally relates to for-profit, publicly-traded companies rather than nonprofits,<sup>170</sup> it can assist them in identifying issues of concern in order to develop an appropriate governance compliance program. Some of the specific suggestions that SOXA lends to nonprofits are set forth below.

#### A. *Expansion and Clarity of Conflicts of Interest Policies*

Conflicts of interest, both disclosed and undisclosed, were sources of some of the most serious charges raised in the HealthSouth proceedings. The IRS has underscored the importance of this issue for tax-exempt organizations since 1997 through its imprimatur on a sample conflicts of interest policy for adoption by governing boards. SOXA focuses on company loans to directors or executives of the company. However, the concerns of the multiple “constituency groups” that oversee, regulate, or otherwise hold a nonprofit organization accountable demonstrate a broader range of potential conflict

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partners, partners who perform a subsequent level of review ensuring that the audit complies with generally accepted accounting principles, and other partners “who provide more than ten hours of audit, review, or attest services in connection with the annual . . . financial statements . . .” *Id.* § 210.2-01(f)(7)(ii)(C).

168. SOXA § 206, 15 U.S.C. § 78j-1(I). *See also* U.S. Strengthening the Commission’s Requirements Regarding Auditor Independence, 68 Fed. Reg. at 6008 n.32. Persons subject to the conflicts of interest provision include the lead partner, concurring partner, and any other person involved in the audit who has provided “more than ten hours of service during the audit period.” *Id.* The lead and concurring partners of the auditing team are not subject to the ten-hour requirement; they are always subject to the conflicts of interest provision regardless of the amount of time spent on the audit. *Id.* The prohibited time period begins the day after the prior year’s financial report to the SEC was filed and ends when the current year’s report is filed with the SEC; hence, the “one year” time period could actually be longer. *Id.* at 6009.

169. *Id.* at 6007.

170. SOXA § 1107, 18 U.S.C. § 1513(e); *see also* discussion *infra* Part VIII.F.



transactions.<sup>171</sup> The trend in nonprofit healthcare organizations to engage in business transactions and joint ventures with for-profit entities prompted the IRS to develop its conflicts of interest policy.<sup>172</sup> The challenge for governing boards now is to extend their conceptual understanding of a “conflict” beyond the realm of such financial transactions. For instance, a board member or senior manager may present a conflict for the organization in meeting its community benefit obligations, or in satisfying a credentialing standard for a healthcare professional. A conflicts of interest policy must define the “interests” of the organization in sufficiently broad terms so that full disclosures from decision makers can be secured. This will also help educate the governing board on its expanding responsibility for proper “corporate governance.”

### *B. Policies for Board Audit Committees*

SOXA contains several provisions directed at “independence” in the audit process. This was certainly an issue in the Enron and WorldCom settings.<sup>173</sup> An internal target for this concern in SOXA is a company’s audit committee. SOXA requires that the audit committee members be independent of management and a compensation relationship (e.g., as a consultant) with the company. SOXA also raises the issue of competence by implying that a financial expert serves on the audit committee.

SOXA squarely addresses the importance of an independent audit committee and the role it performs. While it may concentrate on the completeness and accuracy of financial statements, an audit committee for a nonprofit healthcare organization is faced with many other areas of inquiry and oversight. Examples of unique concerns for the nonprofit’s governing board are loss of tax-exempt status and imposition of intermediate sanctions.

Severe penalties for noncompliance in the billing, accreditation, or Medicare and Medicaid certification areas of operation reflect unique concerns for the committee arising out of the healthcare field. Training in financial literacy as well as corporate compliance will lead to increased recruitment burdens for the nonprofit organizations seeking broad community representation on its governing board.<sup>174</sup> These considerations will soon become the “best practices” and then the “standard of care” for finance and audit committees. Accordingly, nonprofit healthcare organizations will need to begin developing policies so that their committees meet these expectations.

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171. See BoardSource & Independent Sector, *New Report Offers Nonprofits Guidance on the Sarbanes-Oxley Act* (Oct. 10, 2003), at <http://www.independentsector.org/media/sarbanesoxleypr.html>.

172. See Brauer & Kaiser, *supra* note 80.

173. See Michael W. Peregrine et al., *The New “Corporate Responsibility” Law: How It Affects Health Care*, 11 Health L. Rep. (BNA) 1231 (Aug. 22, 2002).

174. See BoardSource & Independent Sector, *supra* note 171.

### *C. Evaluation and Use of Independent Auditors*

The independence of the outside auditor was an inevitable target of concern for SOXA. Several of the corporate scandals leading up to the passage of SOXA involved serious questions of independence. This has been a growing concern in recent years as accounting firms developed a variety of consulting services to be “cross-marketed” to their audit clients. SOXA responded to these developments in two primary ways that have implications for nonprofit healthcare organizations. The first is the rotation of the audit firm’s lead and reviewing partner (or the rotation of the audit firm itself) every five years. The second is a prohibition of the audit firm from providing a variety of non-audit services.

Due to the limited number of accounting firms with expertise in the essential financial features of reimbursement for healthcare services as well as accounting practices for tax-exempt entities, the utilization of independent auditors may present special problems for nonprofit healthcare organizations. Using other organizations for consulting will reinforce the organization’s commitment to avoiding conflicts of interest. This will also provide “checks and balances” for the recommendations from consultants, who may primarily focus on revenue generation without consideration of the other “constituencies” and purposes to be served by the nonprofit healthcare provider.

### *D. Policies and Protocols for Financial Reports*

A key feature of SOXA is the requirement that a company’s CEO and CFO certify the accuracy and fair presentation of the financial condition of the company when they sign the company’s financial statements. Financial and criminal penalties add “teeth” to this requirement. This requirement is intended to assure the accuracy of financial reports in order to enhance the integrity of the financial markets for lenders and investors. Once again, nonprofit healthcare organizations must be concerned with a broader range of “constituency groups” aside from the investment community.

Healthcare providers already face the possibility of severe financial and criminal repercussions threatened by regulatory agencies and other governmental authorities. Exposure to civil and criminal penalties for the submission of false claims to third party payors serves the purpose of encouraging a healthcare provider’s governing board to ensure the accuracy and completeness of the financial systems and controls. Accuracy in Form 990s, which requires the signature of an officer of the organization, is currently sporadic, but may become a source of additional individual or organizational liability.<sup>175</sup> As

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175. *See id.*

state attorneys general seek greater authority to oversee broad “community benefit” questions for nonprofit organizations, financial reports and tax returns will need to accurately disclose additional aspects of compliance. Ultimately, the governing board must develop policies and protocols for financial reporting and disclosure that address these growing concerns and potential liabilities.

#### *E. Procedures for Legal Counsel’s Advice to Board and Management*

SOXA and the ABA are raising similar issues that may dramatically affect the role of legal counsel for, and their relationship to, the publicly-traded, for-profit corporation. The focus of SOXA is to encourage an attorney for an organization to report a “material violation” of a state or federal law to the CEO or Chief Legal Officer in order to receive an “appropriate response.” The ABA’s modification of the Rules of Professional Responsibility was intended to encourage attorneys to take action—that he or she reasonably believes is necessary to address illegal activity by or on behalf of the organization—when that activity is likely to result in substantial injury to the organization. Given the multitude of regulations, statutes, and accreditation standards applicable to healthcare organizations, these developments may present difficult and complicated implications.

While these implications may appear drastic to others, “many health care lawyers are already sensitive to the manner in which compliance concerns are addressed by the client.”<sup>176</sup> The importance of this development was foreshadowed by the indictment of healthcare attorneys involved in drafting documents for a hospital system seeking a legitimate contractual relationship with referring physicians.<sup>177</sup> Government prosecutors seeking waivers of attorney-client privileges and regulatory agencies encouraging corporate compliance programs that result in self-reporting of wrongful acts are further examples of the disturbance of the “traditional” insulated attorney-client relationship for healthcare organizations. The nonprofit governing board will be required to develop reporting mechanisms that recognize and respond to the constriction of the privileged and confidential relationship, while facing increased exposure from many directions.

#### *F. Whistle-Blower Procedures and Protections*

Many states, whether by statute or court decisions, have extended protections to whistle-blowers. SOXA provides protection in the form of

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176. Peregrine, *supra* note 173, at 35.

177. *United States v. Anderson*, 85 F. Supp. 2d 1047 (D. Kan. 1999), *rev'd in part by United States v. McClatchey*, 217 F.3d 823 (10th Cir. 2000), and *aff'd in part by United States v. LaHue*, 254 F.3d 900 (10th Cir. 2001).

criminal penalties against an organization that seeks to retaliate against a whistle-blowing employee who provides information about illegal activity to federal authorities. These penalties provide enforcement “teeth” to arrangements many healthcare organizations incorporate into their corporate compliance plans in which whistle-blowers can report violations anonymously and with assurances of non-retaliation.

SOXA serves as an anticipated extension of the federal government’s expectations under various model corporate compliance plans that have been published in recent years. Nonprofit healthcare organizations are burdened with standards and obligations from many sources, so the potential variety of whistle-blowers could become a large symphony. It is reasonable to anticipate that the standards currently imposed and enforced by regulatory agencies will serve as areas of protection for whistle-blowers in light of the increased expectation of corporate compliance and self-reporting programs. This is important since § 1107 of SOXA expressly prohibits any person or organization, whether for-profit or nonprofit, from retaliating against an employee for providing truthful information to a law enforcement officer relating to the commission or possible commission of any federal offense.<sup>178</sup> It is vital for the governing board to establish a culture of compliance, since retaliation is generally imposed by supervisors and senior management. In addition, it is also important for the governing board to establish a compliance committee on the board, with mechanisms for reporting and oversight.

### *G. Document Management, Retention, and Production Policies*

One of the critical features of the Enron scandal relates to the destruction of internal financial and legal documents. Obstruction of an investigation has been an important criminal penalty in the arsenal of federal authorities. SOXA enhances this area of enforcement by making it a crime to alter, cover up, falsify, or destroy any document to prevent its use in any federal investigation or official proceeding. Healthcare organizations are currently subjected to concurrent or retrospective audits by third-party payors, government agencies, and accreditation organizations. Therefore, the availability of complete and accurate records is a significant priority.

There is increased scrutiny of tax-exempt and healthcare organizations by agencies, authorities, and other interests desiring greater transparency, accessibility, and compliance. As a result, nonprofit governing boards will need to assess the sources of such oversight. Perhaps more challenging will be to anticipate what documents, reports, or other information these entities might want to review or inspect years in the future relative to the organization’s current activities. A document management and retention policy to respond to such retrospective evaluations is an important issue for the

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178. SOXA § 1107, 18 U.S.C. § 1513(e) (2004).

governing board. The recent corporate scandals and the criminal enforcement features of SOXA in this area highlight the significance of the policy.

### IX. CONCLUSION

It is inevitable that an organization's activities today will be retrospectively judged in the future through a lens that applies future standards. Members of governing boards for nonprofit healthcare organizations must be aware of that probability as they study the rapid changes taking place with respect to the standards and expectations for corporate governance. The public to be served has become more multifaceted, and the sources for accountability have increased. The consequences of ignoring one's duties on a board are increasingly complicated and threatening for the board member and the organization.

Nonprofits should not view these various developments narrowly or in isolation. Rather, they should strive to understand the broader and deeper context of "corporate governance," so that the single legislative initiative represented by SOXA can be better appreciated. On its face, SOXA may be dismissed or given little attention since it only applies to for-profit, publicly-traded corporations. However, in the broader context, as described in this Article, SOXA can and should be more fully appreciated as a catalyst of change, enhancing the responsibilities of the nonprofit healthcare organization's governing board to meet the needs of its community.

Gone are the days when a community leader can simply "show up" for periodic meetings and fund-raising events and fulfill his or her civic duty on the community hospital board. State and federal laws, regulations, and standards are undergoing significant changes, and high-profile scandals raise the political profile of governance issues, resulting in legislative enactments and oversight investigations. The nonprofit governing board of today needs to understand these developments and anticipate the scrutiny that both it and its organization will face tomorrow.

