

Good Policies: First Line of Defense for Post-Enron Governance

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The governance challenges raised in the post-Enron environment are motivating many boards and their general counsels to draft new board policies and tighten up existing ones. While the three duties of fiduciary responsibility — due care, loyalty and obedience to charitable purpose — haven't changed, the expectation of what constitutes reasonable and prudent action by an officer or director is higher and more specific.

Board-approved policies set standards and define how the board car-

ries out its most fundamental responsibilities, from CEO evaluation to oversight of the external and internal audits. Strict policies, however, are a double-edged sword. In court, documenting that strong policies were followed is the first line of defense that a board diligently executed its responsibilities. At the same time, opposing attorneys will pounce if policies are ignored. "It's fine you have a policy, but you have to follow it and demonstrate that you have followed it," stresses Michael Peregrine, health attorney with

Gardner, Carton & Douglas in Chicago.

Top 10 List

Peregrine recommends that boards adopt 10 specific policies for the new environment of increased corporate accountability. Some are familiar, but others are less common and deserve serious consideration.

1. Policy on governance. This "overarching statement" defines the individual director's three core duties and describes the board's roles and responsibilities. Peregrine recommends that the policy also include the mission statement.

2. Conflict-of-interest policy. This policy should be sufficiently detailed to define conflicts of interest, disclosure requirements and procedures for addressing conflicts that arise. Peregrine says boards need to go beyond minimal IRS requirements and address such situations as dual hospital/physician interests and board members who are involved with vendors, affiliates and competitors.

3. Confidentiality policy. This policy establishes the director's duty to keep information and decisions confidential unless they are officially released or otherwise required to be made public.

4. Corporate opportunity policy. This uncommon policy limits board members from taking advantage of a business opportunity they learn

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Sarbanes-Oxley: Coming Soon to Your State?

New York State Attorney General Eliot Spitzer reportedly plans to propose a state version of the Sarbanes-Oxley Act that would apply to not-for-profit organizations. The federal law now applies to issuers of public securities and public accounting firms and is designed to promote accuracy and reliability of information for investors.

Here are some of the provisions of Sarbanes-Oxley that could be pertinent to not-for-profits:

- Requires senior executives to certify the accuracy, honesty and completeness of financial statements;
- Requires senior executives to certify they've disclosed "all significant deficiencies" in internal controls and any internal fraud that could materially affect financial statements;
- Prohibits any action to unduly influence an auditor to make misleading statements;
- Provides for audit partner rotation and bars accounting firms from being both auditor and performing one of eight non-audit services;
- Requires companies to disclose material changes in financial or operational condition on a rapid and current basis;
- Requires disclosure of whether a financial expert serves on the audit committee;
- Asks for disclosure of a corporate code of ethics; and
- Requires attorneys to report violations.

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about through their board service. The policy defines corporate opportunity and how to address situations that arise.

For example, says Peregrine, one hospital's physician board members had an opportunity to invest in a joint venture with the hospital for ancillary services.

"The policy triggered a look into whether their investment was proper (probably yes) and if so, whether the physicians' continuing involvement on the board presented so much potential conflict that they should step down," Peregrine explains.

What's his opinion? Peregrine refers to the observation of the "Powers Committee that investigated misconduct at Enron: 'If you have to go through so many hoops to show that something is appropriate, maybe you shouldn't do it at all.'"

5. Service on other boards. This policy, also unusual until now, addresses the touchy subject of whether service on other boards could compromise a director's ability to fulfill the duties of due care and loyalty.

Should outside board service be prohibited? "No," Peregrine counsels, "but board members and senior executives should disclose all outside board service so it can be considered in three contexts:

- "Mission context. Some relationships are fundamentally inconsistent with the mission, such as a member of a Catholic hospital board serving on a

Planned Parenthood board," unless the religious board explicitly approves it.

- "Conflict of interest. These situations are normally identified through the conflict-of-interest disclosure statements."
- "Number of boards. Is an individual on so many boards that his or her ability to devote the time and diligence required is open to question?"

6. Oversight of senior management. Have you ever heard a board member, especially a newer one, ask: "Is the board entitled to that information?" This policy affirmatively defines the board's basic oversight obligations and its "duty to make inquiry," says Peregrine.

7. Policy on management's duty to disclose. This policy makes it clear management has a "duty to disclose" information about organizational performance, variances from goals, errors, ethical problems and so forth.

8. Policy on board compensation and indemnification. This policy defines whether board members are compensated for time or expenses, and the rationale for compensation. The policy should also address the organization's obligation to provide to directors and officers insurance coverage and its indemnification policy, including payment of legal defense expenses.

Peregrine advises that the policy show how compensation serves a discernible purpose and advances the mission and effective governance. It should also require that compensation is reasonable and approved by a disinterested third

party, and that appropriate reports are made to the IRS and other required agencies.

Some boards get free or discounted medical care, but Peregrine call that "very risky. We tell our clients not to do it."

9. Investment management policy. No, it's not just "the investment committee's responsibility," it's the whole board's job. This policy delineates basic investment guidelines.

10. Policy on maintaining the independence of the corporate audit. Similarly, this policy establishes the "protocol" by which the board and the audit committee fulfill their responsibilities to engage the audit firm and meet with the auditors to review reports.

Transparency

Get used to governing in the spotlight, Peregrine says. Scrutiny of what boards do and don't do is growing and won't go away.

"We will continue to see greater requirements for transparency" of both financial information and the board's oversight processes, Peregrine says.

And good policies scrupulously followed are essential. "You have a policy, but you have to follow it and demonstrate that you have followed it."

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*For more information, see the *Corporate Responsibility Guidebook*, prepared by Gardner, Carton & Douglas for the Coalition on Non-Profit Healthcare, available at www.cnhc.org. Sample policies are available from GCD for a fee.*