



MASSACHUSETTS GOVERNANCE PRINCIPLES¹

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Following revelations concerning the Enron and WorldCom scandals in 2001-02, the issue of corporate governance rose to the top of the national agenda in the United States. To curb the practices that led to these and similar scandals by publicly held corporations, Congress enacted the Sarbanes-Oxley Act of 2002. Moreover, since nonprofit organizations also had their share of scandals involving conflicts of interest, self-dealing by insiders, excessive compensation and the like, several states have proposed laws to extend Sarbanes-Oxley-type provisions to nonprofit entities, with California being the first to actually enact such legislation.

Given this legal landscape, organizations devoted to positive social change should institute and maintain good governance practices, including transparent decision making, accurate financial reporting, and accepted auditing practices. In the discussion below, we outline the good governance principles embodied in the Sarbanes-Oxley Act and in state legislation applicable to nonprofit social sector entities.

1. The Sarbanes-Oxley Good Governance Principles

Except for provisions concerning document destruction and whistleblower protection, the governance provisions required by the Sarbanes-Oxley Act apply only to public companies and thus do not apply to social sector organizations. Nevertheless, the reforms prescribed by the Act have become the *de facto* standard for the governance of all entities. Consequently, most social sector entities, both for-profit and nonprofit, are voluntarily incorporating Sarbanes-Oxley principles into their own governance structures as a way of instilling confidence and trust among their members, donors/grantors, and other constituents.

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In 2005, the ABA Coordinating Committee on Nonprofit Governance published a “Guide to Nonprofit Corporate Governance in the Wake of Sarbanes-Oxley” in which it set forth 10 general principles “worthy of consideration for the governance of nonprofit organizations.” Those principles, which may or may not be appropriate for a particular social sector organization, are summarized as follows:

- a. **Role of Board:** The organization’s governing board should oversee the operations of the organization in such manner as will assure effective and ethical management.
- b. **Importance of Independent Directors:** The independent and non-management board members are an organizational resource that should be used to assure the exercise of independent judgment in key committees and general board decision-making. For suggestions on how to form an independent, effective board please visit: http://non-profit-governance.suite101.com/article.cfm/creating_a_nonprofit_board.
- c. **Audit Committee:** An organization with significant financial resources should have an audit committee composed solely of independent directors that should assure the independence of the organization’s financial auditors, review the organization’s critical accounting policies and decisions and the adequacy of its internal control systems, and oversee the accuracy of its financial statements and reports.
- d. **Governance and Nominating Committee:** An organization should have one or more committees, composed solely of independent directors, that focus on core governance and board composition issues, including: the governing documents of the organization and the board; the criteria, evaluation, and nomination of directors; the appropriateness of board size, leadership, composition, and committee structure; and codes of ethical conduct.
- e. **Compensation Committee:** An organization should have a committee composed of independent directors that determines the compensation of the chief executive officer and determines or reviews the compensation of other executive officers, and assures that compensation decisions are tied to the executives’ actual performance in meeting predetermined goals and objectives.
- f. **Disclosure and Integrity of Institutional Information:** Disclosures made by an organization regarding its assets, activities, liabilities, and results of operations should be accurate and complete, and include all material information. Financial and other information should fairly reflect the condition of the organization, and be presented in a manner that promotes rather than obscures understanding. CEOs and CFOs should be

able to certify the accuracy of financial and other disclosures, and the adequacy of their organizations' internal controls.

- g. Ethics and Business Conduct Codes:** An organization should adopt and implement ethics and business conduct codes applicable to directors, senior management, agents, and employees that reflect a commitment to operating in the best interests of the organization and in compliance with applicable law, ethical business standards, and the organization's governing documents.
- h. Executive and Director Compensation:** Executives (and directors if appropriate) should be compensated fairly and in a manner that reflects their contribution to the organization. Such compensation should not include loans, but may include incentives that correspond to success or failure in meeting performance goals.
- i. Monitoring Compliance and Investigating Complaints:** An organization should have procedures for receiving, investigating, and taking appropriate action regarding fraud or noncompliance with law or organization policy, and should protect "whistleblowers" against retaliation.
- j. Document Destruction and Retention:** An organization should have document retention policies that comply with applicable laws and are implemented in a manner that does not result in the destruction of documents that may be relevant to an actual or anticipated legal proceeding or governmental investigation. Section 802 of the Sarbanes-Oxley Act imposes criminal penalties on nonprofit organizations, as well as public companies, that obstruct justice by destroying documents that are, or anticipated to become, subject to an official federal proceeding or federal agency investigation.

Many of these principles now intersect with, and to some extent overlap with, the IRS Form 990 policies and procedures disclosures described below.

2. IRS Encourages Good Governance Policies

The IRS is encouraging improved nonprofit governance in three ways. First, it has adopted a checklist to help IRS examiners determine whether an organization's governance practices affect its tax compliance, which is available here: http://www.irs.gov/pub/irs-tege/governance_check_sheet.pdf. Second, the IRS is training its employees on how nonprofit governance affects determinations and rulings. Third, the IRS will look for ways to correlate responses to the questions on Form 990 about governance in Part VI of the form with other Form 990 information in possible compliance initiatives. For example, the IRS might consider whether an organization has adopted procedures for setting compensation of senior employees when reviewing the compensation reported in Form 990. More information

and resources regarding the IRS and good governance are available at:
http://www.irs.gov/pub/irs-tege/governance_practices.pdf.

3. Good Governance for Nonprofit Organizations under Massachusetts Law

Directors and officers of nonprofit corporations in Massachusetts are held to the same general fiduciary duties as those required of their for-profit counterparts. These fiduciary duties ensure that the interests of the organization are paramount.

The basic standard of care applicable to such officers and directors generally requires “complete good faith plus the exercise of reasonable intelligence.” In practice, corporate officers and directors must serve the organization in good faith and in a manner that they reasonably believe to be in the corporation’s best interests. This includes the prudent management of the organization’s funds. Directors and officers may not use their position or the organization as a means by which to further their own personal interests at the expense of the organization. The Non-Profit Organizations/Public Charities Division of the Massachusetts Office of the Attorney General (the “Division”) enforces the Attorney General’s statutory mandate to oversee the “due application” of funds held and administered by charities in Massachusetts. The Division has taken positions on certain governance practices that, while not binding, provide some indication of the Division’s views should it pursue an enforcement action.

First, the Division has published guidelines for board members of charitable organizations that are intended as “recommendations in key areas of stewardship” (available at <http://www.mass.gov/ago/docs/nonprofit/guide-for-board-members.pdf>). These guidelines contain recommended actions board members should undertake as good stewards of a public charity. Under Massachusetts law, there is no statutory definition of a charity, but the Attorney General notes that as a general matter, a nonprofit organization having a primarily charitable purpose, that benefits an indefinite class or number of people, and that is exempt under section 501(c)(3) of the Internal Revenue Code of 1986, as amended, is considered a charity by the Attorney General, and therefore subject to its oversight. Note that “charity” and “charitable purpose” include educational and other activities.

Second, the Division has investigated and issued statements about executive and board compensation and about conflicts of interest. In 2009, the Division announced an initiative to more closely examine executive compensation at nonprofit hospitals and nonprofit health insurance companies, the scope of which was ultimately broadened to charitable organizations in other industries. In assessing whether compensation paid to an executive is excessive, the Division looks for evidence that the organization’s board of directors engaged in a deliberative and reasoned decision-making process. The Division wants to see that the

board of directors considered several factors and negotiated with the executive before establishing the compensation amount.

Following this investigation, in order to assure comprehensive reporting of all aspects of compensation in charitable organizations, the Division indicated a desire to require annual disclosure of all senior executive employment agreements.

The Division's compensation initiative also included a review of the practice of compensating independent directors for their service to charitable organizations. In this regard, the Division stated that public charities that compensate independent directors should do so only if they have a sound and convincing rationale.

Legislation was introduced (but not enacted) in 2012 and 2013 that would have required Massachusetts-based public charities to apply for approval from the Division in order to provide compensation to independent directors and trustees for their service in those roles. For these purposes, a "Massachusetts based public charity" includes public charities established under the laws of Massachusetts and those established outside of Massachusetts if they primarily conduct business in Massachusetts.

In light of these developments, nonprofit charitable organizations are well-advised to consider the Division's guidance and consult nonprofit counsel when establishing executive, director, and trustee compensation.

4. Resources

- Governance and Related Topics – 501(c)(3) Organizations (Internal Revenue Service), http://www.irs.gov/pub/irs-tege/governance_practices.pdf.
- Guide for Board Members of Charitable Organizations (Office of Attorney General, Commonwealth of Massachusetts, July 2007), <http://www.mass.gov/ago/docs/nonprofit/guide-for-board-members.pdf>.
- Guide to Nonprofit Corporate Governance in the Wake of Sarbanes-Oxley (American Bar Association, Section of Business Law, 2005).
- Guidebook for Directors of Nonprofit Corporations (American Bar Association Section of Business Law, 2d ed. 2002).
- Jacobs, Jerald A., Association Law Handbook (ASAE & The Center for Association Leadership, 4th ed. 2007).
- Principles for Good Governance and Ethical Practice: A Guide for Charities and Foundations (Independent Sector, Panel on the Nonprofit Sector, October 2007) http://www.nonprofitpanel.org/Report/principles/Principles_Guide.pdf.
- Spotlight on Executive Compensation (Foley Hoag LLP, May 2010) http://www.foleyhoag.com/NewsCenter/Publications/Alerts/Nonprofit/Nonprofit_Alert-052610.aspx.

