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The Potential Impact of Sarbanes-Oxley on the Health Care Industry

The reach of the Sarbanes-Oxley Act has potentially become much broader. In a move that could greatly impact many in the New York health care industry, Attorney General Eliot Spitzer recently introduced legislation aimed at extending many of the act's requirements to not-for-profit corporations.

Sarbanes-Oxley, which is now applicable only to public companies, sets new standards designed to quell the fears of investors by improving the quality of public disclosures and preventing fraud.

For-profit companies have already significantly modified their operations to comply with the act. And New York's not-for-profits may soon have to take similar measures.

When President George W. Bush signed Sarbanes-Oxley into law last summer, a number of questions were raised by New York state not-for-profits regarding whether it would indirectly affect their organizations' governance and financial practices. Some of these questions have now been addressed as part of the New York State Attorney General's Corporate Fraud Prevention Initiative of 2003. The initiative consists of bills covering six areas including, but not limited to, amending the New York State Not-for-Profit Corporation Law (the N-PCL) in order to provide greater protec-



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tion against fraud and wrongdoing by senior executives of not-for-profit corporations.

Background

Some of Sarbanes-Oxley's key requirements include senior officer certifications as to the completeness and accuracy of a for-profit corporation's financial and non-financial disclosures. It also requires senior management to attest to the effectiveness of the corporation's internal controls and imposes severe criminal penalties for filing false certifications.

In addition to criminal penalties, the act expands securities plaintiffs' rights with regard to civil penalties. The increased civil penalties include an expanded statute of limitations for securities fraud claims, and further protection through amendment of federal bankruptcy laws to declare that the corporation may not discharge any settlement in bankruptcy arising from a securities-related transaction.

For-profit corporations are also required to appoint audit committees to oversee the work of any public accounting firm employed by the corporation. The audit

committees' duties consist of establishing auditing standards, investigating and disciplining such public accounting firms whenever necessary. In addition, the audit committee must establish procedures for the confidential, anonymous submission by employees of concerns regarding questionable accounting, auditing or other financial matters.

Members of the audit committee are required to be "independent" members of the board of directors. An independent director may receive compensation only for serving as a member of the board and cannot have any material relationship with the company. Furthermore, the audit committee must be comprised of at least one member who is designated as a "financial expert." The financial expert's role is to help monitor the work of outside auditors, evaluate the adequacy of the company's internal controls and assess the completeness of the company's financial statements and other disclosures.

Proposed Reforms

Early last month, Mr. Spitzer emphasized to the Legislature that recent scandals "clearly demonstrate the need for significant legislative reforms to protect New York residents from similar [not-for-profit] corporate abuses in the future."¹

His initiative will "apply many of the federal Sarbanes-Oxley standards to New York businesses,"² thereby profoundly affecting the nearly 40,000 registered New York state not-for-profit corporations. It is important to

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note that Mr. Spitzer's proposed legislation is not confined to New York not-for-profit corporations, but also addresses their for-profit counterparts throughout the state. Nevertheless, the passage of such legislation would impose significant new restrictions on not-for-profit entities, including not-for-profit health care organizations, and on how they do business in New York.

The most potentially significant bill in the proposed legislation, amends the N-PCL by incorporating important aspects of Sarbanes-Oxley as well as integrating other safeguards. Following is a summary of the key substantive amendments that have been proposed.

Annual Report Requirements

The first section of the bill proposes to amend N-PCL §519, Annual Report of Directors, by adding two new paragraphs requiring the president and the treasurer to sign the annual report and thereby certify that: (i) each has reviewed the annual report, and (ii) based on his or her knowledge such annual report does not contain any false or misleading statements.

For any not-for-profit corporation with revenues in excess of \$250,000 in any fiscal year, the president and the treasurer must also attest to the accuracy of the financial statements included in the annual report and will be held responsible for maintaining and ensuring the effectiveness of the corporation's internal controls. Any significant deficiencies or material changes in the design or operations of internal controls and any fraud, whether or not material, are to be disclosed to the corporation's auditors and the audit committee.

This provision of the bill is potentially quite burdensome to not-for-profit health care organizations. Most health care organizations in New York are classified under the N-PCL as Type B corporations. Such entities are already subject to considerable oversight through, for example, the existing requirements under the New York State Insurance, Public Health and Mental Hygiene laws and regulations. Consequently, in addition to a

not-for-profit health care corporation's existing obligations, it will now need to comply with a more stringent reporting standard and coordinate with both internal and external auditors to effectuate stricter disclosure and certification requirements.

Filing Reports

The bill amends N-PCL §520, Reports of Corporation, to include more stringent provisions with respect to filing reports including: (i) such reports must be complete and accurate, and (ii) persistent failure to file complete and accurate reports will be considered a breach of not only the directors', but the officers', duty to the corporation. Any violation of these new requirements may result not only in a suit

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by the attorney general at an action or special proceeding for judicial dissolution, but also in removal of such director or officer.

Audit Committee

Section 712 of the N-PCL, Executive Committee and Other Committees, currently provides for the designation of an executive committee, and any other committee if permitted by the certificate of incorporation or the bylaws of the organization. The bill mandates the designation of an executive committee and an "audit committee" consisting of three or more directors for any corporation which receives gross revenues in excess of \$250,000 in any fiscal year.

The requirements for audit committee

members parallel those in Sarbanes-Oxley. This is a significant proposed amendment which closely resembles the act's requirements; however unlike the act, the bill does not require that one of the audit committee members be a "financial expert." This specific new provision will require such not-for-profit healthcare corporations to, among other things, either appoint or restructure an audit committee and ensure that officers or directors with any potential conflict of interest are not included as members of the committee.

Contracts and Transactions

Another significant alteration in the not-for-profit landscape will be in the area of Interested Directors and Officers, which is currently addressed in §715 of the N-PCL.

The bill proposes to repeal and replace existing §715 with a number of new requirements, including requiring the board, prior to approval of a contract or transaction involving an interested director or officer, to obtain and rely upon appropriate comparability data, and after approval, to adequately document the basis for such approval.

If the interested or approving director or officer fails to meet his or her obligations with respect to the contract or transaction, the power granted to the corporation to modify or void such contract or transaction is extended to the attorney general.

Also, the corporation or the attorney general may seek restitution for breach as described in §4958 of the Internal Revenue Code, regardless of whether or not the IRS pursues its remedies.³

Not-for-profit health care organizations frequently deal with contracts or transactions by and between corporate decision-makers and their corporation. The fairness of the contract or transaction, and perhaps more importantly, adequate disclosures to directors or members has always been very significant. Not-for-profit health care organizations should be aware that this new version of N-PCL §715 shifts the "fairness" burden even more onto the board, by requiring, in essence, due diligence through its mandate

that the board obtain comparability data prior to approving a contract or transaction.

Indemnification

With respect to indemnification, the bill repeals existing §721 of the N-PCL, Nonexclusivity of Statutory Provisions for Indemnification of Directors and Officers. In its place, the new language requires that any provision made by a New York not-for-profit corporation to indemnify its officers or directors must comply with the new Article 7, regardless of what is contained in its certificate of incorporation, bylaws or any resolution.

Therefore, in order for directors and officers of not-for-profit health care organizations to exercise their business judgment without fear of personal liability under the new provisions, they must ensure strict compliance with the new Article 7 exclusively, and not rely on the corporation's certificate of incorporation, bylaws or resolutions.

The bill amends N-PCL §722, Authorization for Indemnification of Directors and Officers, to generally cover expenses and court costs, and to limit its scope to the settlement of civil actions. The existing law provides that the termination or settlement of a civil or criminal action does not, by itself, create a presumption that a director or officer did not act in good faith.

The amendment removes this benefit with respect to the termination of a criminal action. As a result, not-for-profit health care organizations should be aware that this amendment, in effect, may create a presumption that a director or officer did not act in good faith if a criminal judgment or other finding is entered against him or her.

Section 724 of the N-PCL addresses Indemnification of Directors and Officers By a Court. Perhaps the most interesting change in the attorney general's bill requires that Type B and C corporations not only provide notice to the corporation if a defending director or officer is denied indemnification, but also to the attorney general. This additional notice requirement augments existing attorney

general oversight of not-for-profit health-care organizations.

Other Bills

Although not contained in the bill, not-for-profit health care corporations should also be aware of two other proposed bills included in the initiative that increase criminal penalties and protections for whistleblowers.

For example, one bill amends the Penal Law to increase penalties for the destruction of evidence, which now includes tampering with computer information, and creates the crime of "obstruction of a government

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investigation." The bill also makes an entity guilty of criminal contempt for refusal to produce documents requested by government subpoena.

Another bill amends the Labor Law and the Civil Service Law to enhance the rights of both public and private employees. For example, Labor Law §740 is amended to protect private employees from retaliation for disclosures to any "public body of illegal business activities, regardless of whether those acts are a danger to public safety. Employees are also no longer required to notify their employer before making a disclosure to a public body in certain instances. The Civil Service Law is amended to add protections for public employees that correlate to those provided for private employees.

Steps to Take

The proposed bills have just recently been submitted to the Legislature, and it is likely

that there will be many changes before they are finally promulgated. With this in mind, there are still a few preliminary steps that New York not-for-profit health care organizations can take to prepare themselves for the forthcoming legislation and protect themselves from liability while safeguarding the confidences of its members, donors, and directors:

- Review the structure and effectiveness of the board of directors and of senior management. This may include such simple steps as ensuring that members are aware of their roles and responsibilities with respect to management activities.

- Consider the development of an audit committee and make corresponding amendments to the corporate bylaws. Regardless of compliance with the bill, it is a prudent business practice for not-for-profit health care organizations to have an adequate system in place that includes independent oversight of the corporation's public accounting firms. Such oversight may include making determinations regarding auditor compensation; a review of all "audit" and "non-audit" services; increased oversight of company financial statements; and a review of the audit and financial controls currently in place.

- It is especially important for large not-for-profit health care organizations with gross revenues in excess of \$250,000 to begin evaluating their internal controls to ensure their current effectiveness.

- Review all executive compensation plans and practices for compliance with applicable current law, addressing loans to directors and officers, and taking into account the bylaws of the corporation.

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(1) Attorney General's Legislative Program Bill # 02-03.

(2) Office of New York State Attorney General Eliot Spitzer, Press Release Jan. 24, 2003.

(3) Generally, section 4958 of the Internal Revenue Code of 1986 imposes excise taxes on "excess benefit transactions" by 501(c)(3) and 501(c)(4) organizations

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