What is the New Bottom Line?

Teresa A. Koncick

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WHAT IS THE NEW BOTTOM LINE?

Museum Governance and the Implications of the Sarbanes-Oxley Act of 2002

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ABSTRACT

Museums serve a singular role in society: they gather, preserve, and present collections of cultural, historical, scholarly, scientific, educational and aesthetic value for the benefit of the public. As collectors and caretakers of a considerable part of man’s cultural heritage, they hold their assets, in the form of collections, buildings, endowment and non-restricted funds, in trust for the public. Museums are expected to exercise a level of excellence not only in matters related to the conservation and presentation of the objects they hold but also in governance and management standards.

Approaches to museum governance must be reconsidered in light of upheavals in corporate governance and public expectations of accountability. The passage of the Sarbanes-Oxley Act of 2002 increased accountability standards for corporate boards and officers. There is no substantive regulation of museums, and nonprofits in general, as exists for public companies; however, recent legislative proposals by state attorneys general in California, Massachusetts and New York State relating to nonprofits would raise the standards of accountability to the public and increase governmental scrutiny of museum governance and operations. Moreover, the federal government is weighing in as a result of its concerns regarding nonprofit governance.

Museums should address their own standards in an effort to ensure that proper governance procedures are in place. Case studies of governance issues at two museums illustrate the need for greater self-examination and the positive results that can occur at those museums engaged in reviewing and enhancing their governance and management standards. This process can fundamentally strengthen public confidence in the museum as an institution.
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I. Introduction

A museum has been described as "an entity that emanates dense waves of power, value and authority. It is endowed with power by its treasures, and by its control of knowledge and information."¹ Most museums are nonprofit institutions organized for an educational or charitable objective, and, as such, operate for a public objective. As a consequence, museums have an overall duty to the public in carrying out their mission. To meet this obligation requires that museums are governed with the utmost of integrity; otherwise, public confidence in the institution could be seriously compromised. Moreover, reputational concerns must be taken seriously in order to satisfy a museum's key constituents – donors, members, visitors, taxpayers, and the public at large.

Museums have become a greater force in society and the nonprofit sector by virtue of increased activities, economic impact and attention. For example, visitors to art museums have increased from twenty-two million in 1962 to over one hundred million in 2000.² It has been documented in a study conducted by Americans for the Arts that the economic impact of nonprofit arts organizations (which include museums) is over $134 billion annually.³ As noted by the Director of the Metropolitan Museum of Art, Philippe de Montebello, "museums today are much larger physically, as well as in size of staff and budgets. By extension, they are far more complex and much harder to manage."⁴ Exhibitions have generated great public attention and, sometimes, controversy, none so

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notoriously as the one of Robert Mapplethorpe photographs portraying nude males at the Contemporary Arts Center in Cincinnati in 1990. Outrage over the exhibition resulted in criminal action against the Center’s Director for violating anti-obscenity laws.

Over the last two years, greater emphasis was placed on the adequacy of institutional governance across the for-profit and nonprofit sectors in this country by legislative bodies and the public. Why should this concern museums? Given the unique role museums play as nonprofit organizations, these developments underscore a need to evaluate how well they are governed. Important lessons can be gained from understanding the public’s need to have confidence in the governance of public companies, as illustrated in the impact of major corporate scandals and resulting legislative action.

The American Competitiveness and Corporate Accountability Act of 2002, commonly known as the Sarbanes-Oxley Act for its two Congressional sponsors, was signed into law on July 30, 2002, largely in response to a number of major corporate and accounting scandals involving public companies in the United States. In general, the Act establishes new or enhanced standards for corporate accountability and is intended to restore confidence in the corporate sector.

At least up to now, primary governmental regulation of museum operations has been under the purview of the state attorney general, whose legislative mandate is to oversee the solicitation of charitable funds and to safeguard the public interest in the way those funds are spent. Up to now, such responsibilities have not included a broad

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5 Pub. L. No. 107-204, 116 Stat. 745 (2002). Public companies represent those for-profit corporations that are registered with the Securities and Exchange Commission and offer investment shares in the company to the public.
mandate to regulate and oversee operations of nonprofit institutions. In addition to the state attorney general, the Internal Revenue Service has authority to regulate reporting of the financial activities of nonprofits through the provisions of the Internal Revenue Code exempting charitable entities from taxation.\(^6\)

The American Association of Museums is an organization that represents the interests of museums and develops and promotes professional standards. The AAM sponsors an accreditation and peer review program for museums in the United States. Participation is wholly voluntary, but for those institutions that choose to apply for accreditation, they will be subject to certain standards in order to qualify.\(^7\) The AAM cannot bring an action in court to enforce governance standards, but is able to revoke or deny accreditation.

The majority of the provisions of Sarbanes-Oxley do not specifically apply to nonprofit institutions. However, provisions concerning whistle-blower protection and the retention of financial documents are applicable to both for-profit and nonprofit entities. In response to the concerns raised by corporate accounting scandals in the for-profit sector, and governance issues raised at least three state attorneys general have proposed legislation that would impose “Sarbanes-Oxley” provisions on nonprofit organizations.\(^8\) This means that museums operating as nonprofit institutions in those states would, for the first time, be subject to a regulatory framework concerning oversight of their governance and financial operations. Furthermore, the Senate Finance Committee is reviewing the

\(^6\) I.R.C. Section 501(c)(3).
\(^7\) [http://www.aam-us.org](http://www.aam-us.org). Of nearly 16,000 museums in the United States, approximately 750 may be accredited at any one time. A museum will initially be accredited for five years, and after undergoing an additional review, will be accredited for a period of ten years.
\(^8\) Legislation has been proposed in California, Massachusetts and New York State. AILA-ABA Course materials, Legal Issues in Museum Administration, March 2004, New York at 179. To this date, no legislation has been enacted.
efficacy and usefulness of annual nonprofit reporting to the Internal Revenue Service in addition to questioning the adequacy of governance.

Efforts to strengthen governance have been made at such museums as The John and Mable Ringling Museum of Art in Sarasota, Florida and the Bruce Museum of Arts and Science in Greenwich, Connecticut. These museums have reviewed their governance standards and policies either in view of requirements dictated by Sarbanes-Oxley or in the interest of improved governance and management practices and adopted best practices in response.

In contrast, a number of museum officers, when informally questioned, were not aware of the applicability of Sarbanes-Oxley Act to nonprofit organizations and did not understand why they should address issues presented by the Act. Similarly, some museum officers were not aware of the recent proposals in California, Massachusetts and New York State that would apply Sarbanes-Oxley standards to nonprofits. There are recent examples of museums in which poor or questionable governance has had serious adverse consequences. The boards of directors of the Art Institute of Chicago and the Museum of Northern Arizona made decisions that ultimately led to adverse financial consequences and, in the case of the Museum of Northern Arizona, loss of AAM accreditation.

Given the increased attention to the adequacy of governance of nonprofit institutions, it is timely for museums to assess their own governance standards and practices, and how boards oversee management in their financial reporting obligations.

Museums traditionally have not been at the forefront of major initiatives in evaluating and improving their own governance. Museum boards have usually been
comprised of major donors, who have been expected to provide leadership in donating funds rather than recognizing the important role that they play in oversight. Board members themselves may be part of the problem with regard to laxity in governance standards. According to Marie Malaro, an attorney and author of works relating to museum governance, there is a need for greater attention in this area. She writes, "If there is to be a strengthening of the nonprofit section [sic], however, it must come about through thousands of small good actions by those who govern our many nonprofit organizations. Board members have special opportunities to bring about change, but to do so they must understand their core responsibilities and appreciate the importance of consistent and thoughtful interpretation of those responsibilities."9

Museums have a tremendous public responsibility. Most hold collections of value in public trust. Shouldn't museums, and for that matter, the public be concerned about the fact that the board of the Art Institute of Chicago decided to sink more than half of their endowment in risky hedge fund investments managed by persons with ties to the Institute's primary outside investment advisor to the finance committee members? And what about the board of the Museum of Northern Arizona improperly selling objects from the collection and using the proceeds for operating expenses, as opposed to following museum-wide standards in deaccessioning as promulgated by the American Association of Museums?

The enactment of Sarbanes-Oxley, the proposals by state attorneys general, and the recent Senate Finance Committee hearings suggest that it is timely and advisable for museum boards to conduct a creditable self-evaluation so that they can represent that they

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are fulfilling properly their fiduciary duties in caring for property that really is held in the public trust. Nonprofit board consultants are recommending that boards should evaluate their function and effectiveness.\textsuperscript{10} Some museum boards have heeded this call, and are actively engaged in reviewing their governance roles. Museums should take seriously the reverberations stemming from the enactment of Sarbanes-Oxley, proposed state mandates for nonprofits and recent federal attention to the state of nonprofit regulation to ensure effective governance before the government proactively mandates greater regulation of the nonprofit sector. If not, museums may seriously undermine the public confidence in their existence, and may be faced with greater regulatory intrusion into their operations.

\textsuperscript{10} BoardSource and Independent Sector are two organizations dedicated to representing and advocating on behalf of nonprofit entities. Both have strongly recommended that nonprofits undertake reviews of governance standards in light of the Sarbanes-Oxley Act.
I. Trustees and the Public Trust: Traditional Approaches to Museum Governance

Museums have traditionally been viewed as cultural, ethnological, scholarly and scientific institutions, acquiring, preserving and protecting collections for aesthetic and research purposes, and exhibiting and interpreting these collections for the public. Almost above reproach, museums during the late nineteenth and much of the twentieth century were seen as ivory towers of pronounced and unchallenged respectability and virtue. The governing bodies of these institutions, the board of trustees or directors, were once comprised primarily of men of wealth who contributed money and personal collections to the museum. Their generosity entitled them to hold a vaunted seat on the board. Museums were viewed as private entities, for the most part, as much of their support derived from private sources. This state of affairs, at least in the United States, existed up to the latter part of the twentieth century.

Traditionally, boards may have actively determined the growth and direction of the museum’s collection, provided donations of funds and objects, and determined the selection of the museum director. However, for many years accountability to the public at large was not emphasized as a distinguishing duty of board members of eleemosynary corporations. As early as 1847, Yale Professor Leonard Bacon expressed concern about the lack of accountability. He felt that the power achieved by paid executives and board factions had made voluntary associations self-serving. Bacon argued that a true working board, in which each member retained a sense of individual responsibility, should ensure
the accountability to the public of such organizations. In fact, who was really there to question how a museum was governed if not the public? Without any continuing governmental regulation or intervention, there were no means for assessing accountability to the public.

In actuality, trustees are entrusted with distinct and important fiduciary duties under articulated common law principles dating back to the nineteenth century, whereby trustees are held responsible for property that must be administered for the benefit of others. This bestows a significant level of responsibility on the trustee, including the duties of care, obedience and loyalty to the beneficiaries of the trust, i.e., the public.

Judge Benjamin Cardozo of the New York Court of Appeals described these standards of conduct in 1928 in a case involving the duty of loyalty. He stated, “Many forms of conduct permissible in a workaday world for those acting at arm’s length, are forbidden to those bound by fiduciary ties. A trustee is held to something stricter than the morals of the market place. Not honesty alone, but the punctilio of an honor the most sensitive, is then the standard of behavior.” Therefore, even when museum boards functioned without statutory regulation of any kind, board members were, and still are, subject to these enumerated common law principles of the duties of care, obedience and loyalty governing their conduct and accountability.

Why is the public trust so important? Aside from obvious reasons involving the public’s right to care about property held for their benefit, the evolution of nonprofit

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12 Common law “comprises the body of those principles and rules of action, relating to the government and security of persons and property, which derive their authority solely from usages and customs of immemorial antiquity, or from the judgments and decrees of the courts recognizing, affirming, and enforcing such usages and customs.” Black’s Law Dictionary 250 (5th Ed. 1979)
status has conveyed upon nonprofits a special and privileged status in society, as opposed to those entities formed as public or private for-profits corporations that are not entitled to exemption from taxation.\(^{14}\) Charitable entities were thought to be entitled to tax-exempt status by virtue of the fact that they exist for a distinctly public purpose. Following this proposition, the public is the primary beneficiary of the organization's purpose and operations.\(^{15}\) However, this sector has long been self-regulated, and there has been continual debate over whether legal and regulatory changes are necessary in order to ensure that nonprofits are indeed accountable.\(^{16}\)

To some observers, affirmative action is necessary. Carl Bakal, in his book, *Charity USA*, suggests, "To regulate our only unregulated major industry – indeed a shocking dereliction! – what is needed is a newly created, independent, nonpolitical federal agency comparable to the Securities and Exchange Commission, which would oversee charities and take action against abuses."\(^{17}\) In Bakal’s theory, museums should be required to provide public disclosure with respect to results from operations, accounting and management practices, and investment policies.

Bakal may be somewhat disingenuous in asserting that the nonprofit sector is our only unregulated major industry, but he has a fair point to make about the laxity in regulation. Some states that have enacted the Revised Model Nonprofit Corporation Act (RMNC), which consists of a body of rules adopted by the American Bar Association and codifies fiduciary duties of directors. While the RMNC provides a regulatory framework

\(^{14}\) Since for-profit companies generally operate to earn a profit, they are not considered to be serving a true public benefit to the same degree as nonprofit charitable and cultural institutions.

\(^{15}\) Scott on Trusts Section 379 (3d ed. 1967)

\(^{16}\) Hall, p. 25.

for the discharge of fiduciary duties, it provides a less restrictive standard against which
the actions of directors can be held.\textsuperscript{18} Nor does the RMNC allow third parties to bring
actions against nonprofit entities in the event there is a perceived dereliction of these
duties.

The enforcement of nonprofit board duties has been invested with the state’s
attorney general, either through the common law concept of \textit{parens patriae}, or through
specific statutory provisions. The attorney general represents the general public, who is
the real beneficiary of the museum’s collection, and therefore has standing to enforce
museum trustees’ duties of care, loyalty and obedience through litigation.\textsuperscript{19} A few cases
can be cited where states attorneys general have alleged lax financial management or
self-dealing.\textsuperscript{20} However, this oversight admittedly has been considered to be uniformly
weak, and the “much-touted fiduciary duties of museum trustees are rarely enforced.”\textsuperscript{21}

The American Association of Museums is an organization that provides museums
guidance on ethical responsibilities. AAM offers an accreditation program, which is
contingent upon certain factors, including the adoption by the museum of a code of ethics
for boards and employees. However, there are no established sanctions for ethical

\textsuperscript{18} Revised Model Nonprofit Corp. Act Sections 8.30, 8.31 (1987). The RMNC does not incorporate the
duty of obedience and provides that a director who acts in good faith can be protected from liability.
\textsuperscript{19} Stephen K. Urice. \textit{External Constraints on Museum Authority}. American Law Institute – American Bar
Association (ALI-ABA), \textit{Course of Studies Materials: Legal Problems of Museum Administration}
\textsuperscript{20} Id.
\textsuperscript{21} In State of Washington ex rel. Slade Gorton v. Leppaluoto, Superior Court, State of Washington,
Klickitat County, No. 11781 (April 5, 1977), it was alleged that poor financial management by the trustees
Silverstein, Circuit Court, Cook County, Ill., County Department, Chancery Division, No. 76 Ch 6446
(October 28, 1976), the attorney general charged that museum trustees were engaged in self-dealing,
including receiving excessive salaries.
violations. Stephen E. Weil, a well-versed observer of museum governance, commented as follows,

Something must be done about the continuing failure of the museum community to incorporate sanctions of any kind into its own self-prescribed codes of conduct … The question remains as to how seriously the public can regard the museum community’s various ethical provisions … when the museum community itself is unwilling to take collective action against those who violate its use.22

In Weil’s view, voluntary self-regulation may not be taken seriously enough to withstand public scrutiny.

Has reliance upon traditional governance standards, with its emphasis on voluntary compliance with ethical standards and attorney general oversight, with minimal governmental regulation, been effective? The answer is somewhat ambiguous. There have not been many widely publicized cases of egregious governance practices or mismanagement at museums, or nonprofits for that matter. Evelyn Brody writes in the Indiana Law Journal, “Unfortunately, we are unable to judge the level of charity oversight because few cases involving nonprofit fiduciary issues have reached the courts – often as much because of the concerns of charity fiduciaries as those of the attorney general.” 23

In fact, a review of cases involving museum trustee fiduciary responsibilities is revealing: in many of these cases, the trustees themselves have petitioned the court to

approve a proposed transaction or decision that could impact the museum and its collection.\textsuperscript{24}

In a controversial action concerning the fate of the Barnes collection, the trustees sought permission from the Court to alter the Trust Indenture to allow the Foundation to move the collection to Philadelphia, even though this move would clearly negate the intentions of Dr. Barnes as outlined in the Indenture.\textsuperscript{25} All matters relating to the Barnes Foundation remain before the Orphans' Court, and as of this writing no decision has been made with regard to the request for relief to amend the Trust Indenture.

It would be misleading to assert that no court actions have been taken by state attorneys general against museum trustees. In fact, there have been instances where state attorneys general have brought actions alleging failures by museum trustees to properly discharge their duties, although there are not many.\textsuperscript{26} For example, the controversy over the Barnes Foundation and its art collection has been the subject of an action taken by the Pennsylvania State Attorney General challenging the nonprofit status of the Foundation.

\textsuperscript{24}{For example, in the case, In the Matter of the Estate of William K. Vanderbilt, IV 109 Misc. 2d 914 (Surrogate’s Court, Suffolk County 1981), the trustees of the Vanderbilt Museum petitioned the court to compel the county to account for the administration of an endowment fund created for the benefit of the museum. With regard to the trustees' standing to sue, the court held that the trustees had the direct right to sue to protect the rights of the beneficiaries of the trust. 190 Misc. at 923.}

\textsuperscript{25}{See Memorandum Opinion and Order Sur Second Amended Petition to Amend Charter and Bylaws (Orphans’ Court, Montgomery County, Penn. No. 58,788, January 29, 2004).}

\textsuperscript{26}{For example, the controversy over the fate of the Barnes Foundation and its art collection is rooted in actions taken by the Pennsylvania State Attorney General and petitions filed in the Orphans' Court by the trustees. The State Attorney General challenged the nonprofit status of the Foundation when it discovered that the collection was not open to the public. In another case, the Attorney General took affirmative action against a museum board. In Ledlowitz v. Museum of the American Indian Heye Foundation, the trustees and director were charged with mismanagement. Among the charges was the failure by the trustees and officers of the Museum to maintain a record of all collection objects. The case was ultimately settled with the agreement to remove the director and several trustees, and a mandate to complete an inventory of the collection.}
The Attorney General alleged that since the trustees had not opened the collection to the public, the Foundation was not entitled to nonprofit exemptions.\(^{27}\)

In the absence of any meaningful and ongoing enforcement, traditional approaches to governance may no longer suffice in today’s volatile environment. It is now time for boards to engage in a review of how they govern and whether the museum is managed effectively. One commentator noted,

Nonprofit boards are not known for their capacity to change the way they operate. With the organizations they govern isolated from both electoral politics and market forces — and with the boards themselves held to varying standards of accountability — trustees could become ossified in their thinking … the result is that nonprofit boards tend to steer a steady course, content with the status quo, until the iceberg is in plain view.\(^{28}\)

The proverbial “iceberg” is an underlying or previously undisclosed problem or decision whose consequences have a significant negative impact upon the institution. It cannot be assumed that icebergs are always foreseeable. However, laxity in governance, as in navigation, can result in an adverse impact on public confidence. Two cases in point, that will be addressed subsequently, underscore the issues that can arise when boards do not foresee the consequences of their actions. If museum boards do not govern effectively, consistent with their fiduciary duties, and management fails to carry out board directives, public confidence can be eroded with regard to the stature of and respect accorded to a museum.

III. Sarbanes-Oxley and the New Corporate Dynamic

A. Enron and Its Aftermath

The collapse and bankruptcy of Enron Corporation, which had been the seventh-largest corporation in the United States, was a shocking and unexpected event. It was in fact part of a pattern in which a number of major and highly-regarded public companies and their auditors relied upon convoluted and fraudulent accounting devices to inflate earnings. The scope and scale of the corporate transgressions exceed anything the U.S. has witnessed since the years preceding the Great Depression. Senator Paul Sarbanes, July 30, 2003

Enron Corporation, one of the largest public companies in the United States, became a symbol of corporate greed and excess, and fomented the need for proactive legislative action after its spectacular collapse in 2001. In addition to Enron, other well-known companies such as WorldCom and Tyco International were victims of poor governance. The toll taken on investors and the stock market in general as a result of the abject failure of a number of public companies to report accounting irregularities was not only startling and significant, but also raised serious questions regarding the efficacy of corporate governance and transparency of public companies which have a significant impact on the economy in this country. Proverbial questions relating to "who was minding the store?" prompted great debate over the adequacy of corporate governance and oversight among investors, legislators, regulators and the public in general.

The American Competitiveness and Corporate Accountability Act of 2002, most commonly known as the Sarbanes-Oxley Act ("Sarbanes-Oxley" or "Act"), was signed

into law on July 30, 2002.\textsuperscript{30} The Act was intended to restore public confidence in the corporate sector by focusing attention on the role of directors of for-profit companies in governing financial transactions and auditing procedures, with the ultimate goal of preventing future financial misfeasance. Public outcry from several major and devastating corporate accounting scandals, most notably the fall of both Enron and WorldCom, prompted Congressional action.\textsuperscript{31}

The Act represented an immediate reaction to numerous accounting scandals involving “cooked books” and failures to disclose material discrepancies in company financial statements and fraudulent activities. The magnitude of these scandals was so great that trillions of dollars in the market value of these companies suddenly evaporated. Investors lost money and many employees lost jobs and their pension funds. Senator Sarbanes remarked that the collapse and subsequent bankruptcy of Enron Corporation, up to then the seventh largest corporation in the United States, was “in fact part of a pattern in which a number of major and highly regarded public companies and their auditors relied upon convoluted and fraudulent accounting devices to inflate earnings.”\textsuperscript{32}

To understand the events that prompted this serious response, it is useful to review briefly the events surrounding the bankruptcy of Enron that caused such turmoil. No other scandal in recent history captured as much public attention as the demise of Enron and contributed to the questioning of corporate ethics and governance.

\textsuperscript{30} The legislation was co-sponsored by Senator Paul Sarbanes (D. MD) and Representative Michael Oxley (R. OH).

\textsuperscript{31} WorldCom announced in June 2002 that it had overstated income by $3.8 billion. Jesse Drucker and Henry Sender, WorldCom Accounting Debacle Shows How Easy Fraud Can Be, Wall St. J. (Online ed.), June 27, 2002.

Enron began as a pipeline company based in Houston, Texas, in 1985. Over time, it grew to become a giant middleman in the trading of commodities contracts and also a builder of power plants overseas. Enron was primarily engaged in transactions involving commodity futures contracts in the energy sector. This type of contract enables buyers to buy a specified amount of a commodity at a specified price at a particular date in the future, and assumes that the underlying commodities can be delivered in the future.\textsuperscript{33}

Soon, however, Enron’s contract volume grew to be too large to actually deliver the commodities underlying the contracts, and major losses began to accumulate.

Enron financial officers, in collusion with their outside auditors, Arthur Andersen, masked the losses by assigning them to private investment limited partnerships organized off-shore and conveniently off the books of the company, in reliance on aggressive and questionable accounting practices. As a result, Enron overstated income for more than four years.\textsuperscript{34} The losses eventually amounted to a stunning $618 million for one quarter alone. This disclosure, in October 2001, took the market and apparently the Enron board by surprise. Moreover, directions to destroy financial records and other documents related to the accounting methods employed were given by Arthur Andersen audit partners and Enron management. The eventual result was the largest bankruptcy in the United States ever recorded. The bankruptcy petition listed $13.15 billion in debt, which did not include off-balance sheet debt estimated to be as much as $27 billion.\textsuperscript{35} Not only did investors lose money, but also Enron’s chief regulating agency, the U.S. Securities


and Exchange Commission, lost respect for its failure to identify the accounting discrepancies in reviewing Enron regulatory filings.

Questions were immediately raised about what the Enron board knew about the fraudulent accounting practices. Issues were also brought up concerning possible conflicts of interest in Enron’s dealings with its offshore partnerships and whether the board was aware of such conflicts. It turns out that the board, comprised of a number of corporate executives and lawyers, knew too little, and much too late. The business community, regulators, Congress and the public were stunned that a company could manufacture false positive earnings for years without meaningful scrutiny. What level of board oversight existed? Were board members aware that aggressive accounting methods were being employed? Why were senior managers able to withhold such information from the board?

B. Sarbanes-Oxley Mandated Governance Rules

The main provisions of the Act affect all publicly traded companies in the United States and regulate board responsibilities to ensure auditor independence. The Act creates a new Public Company Accounting Oversight Board empowered to promulgate and enforce standards for audits of public companies. It also calls for regulations that apply to both for-profit and nonprofit entities relating to document retention and whistle-blower protection. The Act is directed at the standards of conduct of both the board of directors and senior management of public companies. In this regard, it also creates an expectation that boards will step up their oversight of management practices and
decisions. Failure to do so can result in censure or limitations on activities by order of the Securities and Exchange Commission.\(^{36}\)

The key provisions of the Act and their relevance to nonprofits and museums in particular, is discussed in greater detail below.

1. Audit Committees.

Due to the failure of the Enron board to identify any accounting irregularities, Congress determined that audit committees of boards of directors should be more proactive. The Act requires that each member of a company's audit committee be a member of the board of directors and be independent. To be "independent," one must not be a member of the management structure and cannot receive compensation from the company other than for board service. Audit committees are also expected to have at least one member who is a "financial expert."\(^{37}\)

A financial expert is defined as a person who has, through education and experience as a public accountant, auditor or a principal financial officer, an understanding of generally accepted accounting principles and financial statements, or experience in the preparation or auditing of financial statements of generally comparable companies and has an understanding of audit committee functions.\(^{38}\) An effective audit committee presumably would have the ability to question management and auditors on financial report and accounting matters. If no financial expert serves on the audit

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\(^{36}\) Pub. L. No. 107-402 Section 107(d).
\(^{37}\) Pub. L. No. 107-204 Section 407.
\(^{38}\) Pub. L. No. 107-204 Section 407(b).
committee, the company is expected to disclose why that is the case. If the board has no audit committee, the entire board is charged with these executing these responsibilities.  

Audit committees are generally responsible for overseeing the accounting and financial reporting processes of a company and hiring, setting compensation, and overseeing the outside auditor's activities. Many institutions separate finance and audit committee functions of the board, as the finance committee is charged with reviewing overall financial operations. The audit committee is charged with recommending to the board the selection of the accounting firm to review financial records and to prepare the annual audit. Under the Act, the audit committee is also expected to set procedures for handling complaints received by the company concerning internal accounting controls, and auditing matters, and to ensure the confidential anonymous submission by employees of the company with regard to concerns about questionable accounting or auditing matters.  

Many museum boards have established committees to oversee the financial operations of the museum. The basic committee structure should be delineated in the museum's by-laws, where each standing committee is listed and its function described. As recommended in Museum Trusteeship, a publication of the American Association of Museums that outlines the duties of museum board members,

A standing committee for finance, budget and investment matters is a necessity for most boards, although larger institutions usually have a separate committee for each function. Institutions with substantial funds may elect a separate investment committee to monitor the performance of investment managers and in general review the institution's stewardship of funds entrusted to it ...  

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39 Pub. L. No. 10-204 Section 205.  
40 Pub. L. No. 107-204, Section 301.
Audit is another financial concern of the board, and many organizations separate fiscal and audit functions. Following the standards set forth by Sarbanes-Oxley, museums, especially those that have larger endowments and conduct an annual audit, should establish an audit committee. There are important reasons to ensure that the audit committee is comprised of independent persons who are not managers of the museum. The audit function involves the ability to question freely, and if “insiders” serve on the committee, the climate for true questioning may be dampened. The members of the audit committee should include at least one member who is capable of understanding financial reports and annual audits. Moreover, an ideal audit committee would have responsibility for independently reviewing the investment management decisions and policies made by the finance committee or any outside investment advisor.

Boards must review and understand their institution’s financial statements, evaluate the competency of outside auditors and make sound financial decisions. This is as true at a museum as it is for any public company. In this regard, the audit committee can assist the board in fulfilling their fiduciary obligations and guide the board in making appropriate and informed decisions. For those smaller museums, where an annual audit would be financially burdensome, outside review of financial statements by a professional accountant may be warranted. However, any decision not to conduct an annual audit should be reviewed annually by the board, in the event that a change in circumstances may require an audit of the museum’s finances.

2. Codes of Ethics

41 Museum Trusteeship at 49.
The Act mandates that rules be issued to require companies to disclose whether or not they have adopted a code of ethics for senior financial officers, including its principal financial officer and comptroller or principal accounting officer. A code of ethics can be described as a set of standards reasonably necessary to promote honest and ethical conduct, including the handling of actual or apparent conflicts of interest. The code should make clear the expected responsibilities and behavior of financial officers when confronted with potential conflicts or other ethical issues.

At the recommendation of the American Association of Museums, most museums in the United States have adopted a code of ethics that is applicable to both the board and the museums’ employees. The adoption of codes of ethics is also a requirement for AAM accreditation, and is described in the AAM’s Professional Standards for Museum Accreditation. However, not all museums have made that choice, and their boards and employees are susceptible to apparent or real conflicts of interest, permitting interested party transactions to be approved without proper consideration, or resulting in poor governance practices.

3. Responsibilities of Auditors

Pursuant to the provisions of Sarbanes-Oxley, the lead partner of the auditing firm must rotate off the audit every five years in order to ensure auditor independence. One way to accomplish this is to replace the audit firm every five years. This provision is also intended to prevent the type of long-term collusion that existed between Enron management and the Arthur Andersen audit team. The audit firm is prohibited from providing non-audit

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42 Pub. L. No. 107-204, Section 406(a).
43 Pub. L. No. 107-204, Section 406(b).
45 Pub. L. No. 107-204 Section 203.
consulting services, such as systems design, legal advice or internal audit outsourcing services, in order to preserve the independence of the audit firm in preparing the annual audit. The audit firm must report to the audit committee of the board all “critical accounting policies and practices to be used” and “all alternative treatments of financial information within generally accepted accounting principles.”

Most museums that conduct annual audits have come to understand that an audit is an expensive undertaking. It also places a great strain on resources, as museum staff must prepare financial reports and compile documents for auditors to review, and make themselves available to explain reports and answer questions. Changing auditors every five years would also place a great burden on many museums in that the museum would be forced to introduce a new firm, with new accountants, to the organization. The proverbial “learning curve” involved will cost the museum time and resources, both of which are ordinarily scarce in museums.

However, museums would be well served by following the standards set forth in the Act that prohibit their auditing firms from supplying non-audit services. The continued independence of a museum’s auditing firm is important for the goodwill of the museum. It also prevents any apparent or actual conflict of interest between the auditing firm and the museum. However, certain services may not pose a conflict between auditor and client, such as the preparation of the museum’s Internal Revenue Service Form 990 and might result in economies of scale and cost-savings to the museum.

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46 Pub. L. No. 107-204 Section 201.
47 Pub. L. No. 107-204 section 204.
48 Form 990 is the annual information form filed by tax-exempt organizations with the IRS. Financial information, revenue from unrelated business activities, and grant information is included in this form.
It is good practice for the auditing firm to explain critical accounting policies and any alternatives employed to the audit committee, or if none exists, to the board. This form of dialogue can lead to better review and recommendations for improving internal controls and procedures with regard to financial reporting, and should involve any discussions the audit firm has held with management so that the audit committee is informed of any key issues.

4. Certified Financial Statements

The Sarbanes-Oxley Act requires senior management of companies to take responsibility for all financial statements. The chief executive officer and the chief financial officer must certify the appropriateness of the financial statements and the disclosures contained in any reports, and that “the financial statements fairly present, in all material respects, the operations and financial condition of the issuer.”

The rationale behind this requirement is to ensure that senior management know and understand the financial statements. Recently, former Enron Chief Executive Officer Kenneth Lay claimed that he had no knowledge of discrepancies in the financial statements, and he continued to reassure the public that Enron was a viable company up to the October 2001 disclosure that the company had suffered a huge third quarter loss. However, such ignorance is no longer an adequate excuse under Sarbanes-Oxley, and it is a lesson for all managers in both the for-profit and nonprofit sectors.

While managers of museums may not always be as financially savvy as those in the corporate world, it is still their responsibility to understand the financial operations of the museum, or to employ an effective and experienced financial officer to assist in these

49 Pub. L. 107-204 Section 302.
duties. Without this ability, it is difficult to assure the board members that the museum is in sound financial condition and is being operated with strong financial controls in place.

There is no requirement, yet, for nonprofit executive and financial officers to certify the financial statements. However, proposed legislation in California, Massachusetts and New York State would require such verification. Under these proposals, the chief executive officer or the chief financial officer of a smaller nonprofit organization would be required to verify: 1) that they have reviewed the organization’s annual financial report to the board and, 2) that based on their knowledge, the report fairly presents the financial condition and operational results of the organization.50

For larger nonprofit organizations, the officers must verify the financial report based upon their own knowledge and state that the report does not omit any material fact or contain any untrue statement relevant to full financial disclosure.51 If enacted, these provisions would be far-reaching in their implications for museum management. It would mean that an executive director of a museum could be held liable for any misstatements of a material fact in such financial reports of the museum as the Form 990 filed annually with the Internal Revenue Service.

Internal Revenue Service rules and regulations require nonprofit tax-exempt organizations to file an annual information report on Form 990.52 The primary purpose of the report is to document continuing eligibility for tax-exempt status and to provide detailed financial and program information. Additionally, current law requires

51 Id. at 183.
tax-exempt organizations to make their Form 990 filings available to the public upon request.\textsuperscript{53}

It is recommended that management and the board each understand the financial disclosures contained in the audit and the Form 990. A cursory review of several Forms 990 through research on the GuideStar website reveals that many are seemingly prepared in a haphazard and slipshod fashion.\textsuperscript{54} Some may be typewritten using older typewriters and it is often difficult to read the entries. Assuming the information is accurate for the sake of argument, one might question how well the board can understand the disclosures if they are unintelligible or sloppily written. It also is important that the Form 990 is filed in a timely manner and that the board is so informed. The board has the ultimate fiduciary responsibility for all financial reports, and should be reviewing and approving the Form 990.

5. Disclosure

Sarbanes-Oxley requires certain disclosures, including information on internal control mechanisms, changes in financial condition, material off-balance sheet transactions and arrangements with third parties that could have a material impact on the financial condition, capital resources or significant components of revenues or expenses.\textsuperscript{55} The purpose of these provisions is to enhance the reliability and quality of financial reports. Unlike public companies, museums are not required to file annual and quarterly reports with detailed disclosures concerning operations, management discussion

\textsuperscript{53} The IRS announced in February 2004, that new electronic filing processes will be available for Form 990/990EZ, www.irs.gov/article.

\textsuperscript{54} GuideStar is an online information resource that provides detailed information on charitable organizations in the United States, including access to IRS Forms 990. See, http://www.guidestar.org.

\textsuperscript{55} Pub. L. No. 107-204 Section 401.
and analysis, and financial results. Financial analysis on many museums, prepared by GuideStar analysts, can also be located on the GuideStar website.56

Museums are not required to make these disclosures in any mandated format. The Form 990 does not require the degree of disclosure mandated by Sarbanes-Oxley. It is primarily a financial information statement. However, it is important to inform the board of any issues with regard to material transactions and financial reporting in the Form 990 so that the board can fulfill its fiduciary duty and will not encounter any “surprises.” Moreover, there is no reason why audited financial statements should not be accessible for review by the public, as is the case for public companies. If museums hold objects in trust for the public, the public arguably is entitled to understand the underlying financial stability of the museum.

6. Whistle-Blower Protection

The Sarbanes-Oxley Act provides greater protection to whistle-blowers who provide information concerning possible illegal activities or fraud to a federal agency, Congress or persons with supervisory authority over the employee. The value of this protection is to encourage those with any knowledge of possible wrongdoing to raise issues without suffering adverse consequences, such as the loss of employment or demotion. In most circumstances, the employer may not retaliate against the employee for this conduct. It is important to emphasize that this provision applies to both for-profit and nonprofit organizations.57

Museums should adopt specific written guidelines and procedures to address and provide a venue for employee complaints. If the claims are unfounded, the museum

57 Pub. L. No. 107-204 Section 806.
cannot punish the employee.\textsuperscript{58} Violations of this protective status conveyed upon whistle-blowers could result in liability. There should be a mechanism in place, either through the human services department or management by which an employee can bring forth matters of concern without retaliation, such as the loss of employment, demotion or other form of reprimand. In addition, to the extent that there are serious problems raised, they should be addressed in a timely manner.

7. Destruction of Documents

Due to the widespread destruction of documents by Arthur Andersen of Enron documents, and the resulting obstruction of justice by destroying evidence, the Act provides that auditors must maintain all audit or review work papers for a period of five years. There are criminal penalties for failure to follow this provision.\textsuperscript{59} Additionally, the Act imposes criminal penalties for the knowing destruction or altering of documents or records with the intent to impede, obstruct or influence investigations or court proceedings.\textsuperscript{60}

These provisions do apply to nonprofit organizations. Therefore, document retention and destruction policies should be adopted by museums in order to prevent intentional destruction and to limit accidental removal. This policy should not only address physical records but electronic files as well. Certainly, if there is any formal litigation or investigation occurring, management must inform employees that no records relating to the particular matter should be destroyed or altered in any way. Otherwise,

\textsuperscript{58} It is unclear how this provision will be enforced against nonprofit organizations.
\textsuperscript{59} Pub. L. No. 107-204 Section 802.
\textsuperscript{60} Id.
under the statute, the museum's management, and by extension, the board could be subject to criminal penalties for obstruction of justice or censure.

The New York State proposal does not address all areas of board conduct, and does focus more on the actions of senior management of nonprofits, especially with regard to financial reporting. Yet, this legislation presents an educational opportunity for boards to understand what requirements may be looming in the future, and strengthen the need for proper review of the performance and capabilities of senior management.
IV. Governmental Responses to the Sarbanes-Oxley Act

The passage of Sarbanes-Oxley did not go unnoticed by state officials charged with oversight of charitable institutions. At least three state attorneys general realized the intrinsic value of strengthening regulation of the oversight of financial operations for all nonprofit institutions. Perhaps they were influenced by a number of well-publicized "scandals" in recent years involving the spending patterns and executive compensation of certain nonprofits. Several of these prompted inquiries by state and federal legislators, who began exploring proposals to fundamentally change the way in which nonprofits operate and provide adequate disclosure to the federal government and the public at-large. These developments are worth reviewing because they signal a new era in nonprofit regulation and oversight — one that could result in greater strains on limited resources for many museums in this country.

A. The New York Not-For-Profit Reform Bill

After the passage of Sarbanes-Oxley, New York State Attorney General Eliot Spitzer announced proposed legislation that would make Sarbanes-Oxley-type concepts applicable to New York nonprofit organizations. Subsequently, the State Attorneys General of California and Massachusetts proposed similar legislation. Each of the proposals is intended to strengthen protections against financial fraud and abuse in the nonprofit sector and to extend the reach of the Attorney General in enforcing governance standards and fiduciary duties.

61 The compensation of Richard A. Grasso, former Chairman and Chief Executive Officer of the New York Stock Exchange, a nonprofit organization, received a compensation package worth almost $140 million, which led to a lawsuit by the New York State Attorney General for excessive compensation in 2003. A more recent example involves the Statue of Liberty-Ellis Island Foundation. The Senate Finance Committee began investigating the payment of more than $300,000 annually to the foundation’s president in 2004.
When announcing the proposed reforms, Spitzer stated, "[W]hile some beneficial changes were instituted by the federal Sarbanes-Oxley Act, those protections apply only to companies listed on the major stock exchanges, and do not apply to the thousands of companies that New Yorkers do business with every day, or to not-for-profit entities that have custody of billions of dollars in charitable funds." The New York legislation is more comprehensive than the California and Massachusetts proposals, and will be addressed in greater detail below.

1. Audit Committees and Whistle-Blower Protection

The New York legislation parallels Sarbanes-Oxley by requiring nonprofits to establish audit committees of three or more board members if they have audited financial statements of at least $1,000,000 in revenues or at least $3,000,000 in assets. If the articles of incorporation or by-laws prohibit an audit committee, the entire board is responsible to carry out the functions of an audit committee. The audit committee members may not be compensated for any services rendered to the museum other than for board service.

Additionally, the audit committee is charged with establishing procedures to address complaints made with regard to auditing, accounting and internal control matters, and the confidential and anonymous submission by employees of concerns about these matters. This would place the audit committee in a particularly significant role requiring direct oversight of management.

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As discussed above, larger museums should consider seriously the importance of establishing audit committees. Not all museums are able financially to conduct expensive annual audits. However, consideration should be given to ensuring that annual financial statements are prepared so that the board is provided with sufficient information to fulfill their fiduciary duties. Moreover, there is also merit to the idea of adopting procedures to enable employees to raise problems outside of the management structure without retribution. Every institution can be subject to wrongdoing on the part of employees, and often only other employees will be aware of transgressions. Recently, an employee at the Whitney Museum of American Art reported to management that his supervisor was stealing admission fees.\textsuperscript{64}

2. Executive Committee

The New York legislation calls for the creation of an executive committee of three or more members where the board has more than 25 members. This provision “has the worthy objective of trying to concentrate responsibility in the hands of a more manageable group by having that group be the executive committee.”\textsuperscript{65} With an executive committee, boards and management have an added tool in their governance arsenal and with it the concomitant ability to react quickly to problems and issues. Many boards meet regularly only a few times each year. An executive committee can represent the full board in addressing issues that may arise between full board meetings.

\textsuperscript{64} The head of Visitor Services at the Whitney was accused by a fellow employee of voiding admission tickets and pocketing cash. It was subsequently discovered that both employees stole over $800,000 from this scheme. See Press Release, District Attorney of New York County, July 29, 2004 (http://www.dany.gov).

\textsuperscript{65} Small, supra at 181. Executive committees are common in for-profit companies. Management may require quick action by the board when material events warrant decisions and possible disclosure. The executive committee allows management to avoid convening a full board meeting.
3. **Conflicts of Interest**

The proposed law would enable the Attorney General to oppose potential conflict-of-interest transactions. These transactions also include the payment of compensation to interested parties. The underlying purpose of this provision is to discourage boards from "rubber-stamping" insider transactions without adequate scrutiny. The new law would require boards to take affirmative steps to review proposed transactions through adequate disclosure, investigation and analysis of comparable goods or services, and ensuring that the transaction would be considered "fair and reasonable."\(^{66}\)

Insider transactions can run the gamut from a board member offering professional services at below-market prices or for no compensation, to the recommendation of a service firm with ties (whether personal or professional) to the board member. While nonprofit board members are expected to contribute to the organization, any contributions, or recommendations of service providers, should be analyzed with even greater scrutiny than a completely independent transaction. Conflicts, whether apparent or real, can negatively impact the organization’s image and reputation. Moreover, nonprofits may be subject to possible criminal or civil charges should this law be enacted. Museums are not immune from these potential problems. One way to address this issue is to adopt and enforce the AAM Code of Ethics for Museums.

4. **Oversight and Verification of Financial Data and Controls**

To prevent fraud and self-dealing transactions, the legislation would require verification or certification of annual financial statements by senior officers of the nonprofit organization. This reform would place new responsibilities on the management of

\(^{66}\) S.4836A, Not-For-Profit Reform Bill, Section 519 (NY 2003).
nonprofits, and is intended to hold charities accountable for the donations received from the public. In this regard, the New York proposal parallels the requirements of Sarbanes-Oxley that certification be made that financial statements fairly present the financial condition and results of the entity.  

The attention paid to financial controls is a recurrent theme in Sarbanes-Oxley, the proposed state legislation in California, Massachusetts and New York State, and, as will be discussed later, proposals by the Senate Finance Committee. Boards of nonprofits and museums are liable for the accurate reporting of financial results and adequate financial controls. It is difficult to be absolved from fiscal negligence, whether in the form of legal jeopardy or possible revocation of AAM accreditation. For smaller organizations, the consequences could be more tragic and final, including the inability to operate as a going-concern. Therefore, attention must be given by boards to the museum’s financial management and operations, as well as how effectively senior managers at the museum handle financial matters.

B. Senate Finance Committee Proposal

The Act also has prompted a similar analysis of the nonprofit sector by the Senate. Approximately two years after the passage of Sarbanes-Oxley, a Congressional roundtable was held to discuss proposed legislation to address governance issue and abuses in the nonprofit sector. In Spring 2004, the Senate Finance Committee issued a Staff Discussion Draft ("Draft") and called for comments relating to proposals contained therein for reforms and best practices that focus upon strengthening nonprofit governance. The proposal calls for major changes in governance standards and annual reporting requirements with which

\[67\] ld.
many museums and smaller nonprofit entities would find it difficult to comply. This difficulty will arise from financial burdens and additional resource requirements attendant to compliance with the imposition of new standards and requirements.

While not addressing specific steps that should be taken, it is worthwhile to discuss significant proposals contained in the Draft that would have a direct impact on the operations of many museums. 68

1. Improvement of Form 990 and Financial Disclosures

In a report to the Senate Finance Committee, the General Accounting Office (now known as the Government Accountability Office) identified problems with the accuracy and completeness in the Forms 990 it reviewed. 69 Charitable organizations may follow different standards for filing the Form 990, and the actual standards are difficult to discern. The Draft is, in part, a response to these problems, and states, “Because of the significant role played by the Form 990 in public and governmental oversight of tax-exempt organizations, some reforms are necessary to ensure accurate, complete, timely, consistent, and informative reporting by exempt organizations.” 70

The proposal would further require the chief executive officer of the tax-exempt organization to sign a declaration in the Form 990, under penalty of perjury, that there are procedures in place to produce an accurate and complete Form 990 in all material

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68 The proposal contains other recommendations with regard to charitable fundraising and foundations, which are not addressed in this paper.
70 Senate Finance Committee Staff Discussion Draft, 2004 at 7.
respects. Penalties for failure to file a complete and accurate form would be increased, and the tax-exempt status removed if no form is filed in two consecutive years.\textsuperscript{71}

2. Electronic Filing

In order to promote greater transparency in the financial operations and results of nonprofit entities, the Senate staff proposal recommends that the Internal Revenue Service require all tax-exempt organization informational filings to be made in an electronic format. This would parallel the SEC requirements that public companies file annual and quarterly reports in electronic format so that they are readily accessible to the public over the internet. Accordingly, the public would have greater access than before to review the regulatory filings of tax-exempt organizations.


The Draft calls for the IRS to promulgate standards for filing a Form 990. Without these standards, many similarly situated organizations produce very different information reports.\textsuperscript{72} The lack of consistency can be confusing to the public, and organizations may or may not include a discussion and analysis of operations in narrative form, although there is now no requirement to do so.

4. Independent Audits or Reviews.

A major change in current reporting methods would involve a mandated independent review of the information report. Form 990 would now be subject to a review by an independent auditor for conformity to established Form 990 filing standards. The auditor’s report would be a public document. For larger organizations

\textsuperscript{71} Id. At 9.
\textsuperscript{72} Id. The GAO Report also noted great disparities in the timeliness of filings, the level of disclosure and the quality of presentation.
(defined as having more than $250,000 in gross receipts), an independent audit of the organization’s exposure to the unrelated business tax would be required. New auditors must be used every five years. If the gross receipts are under $250,000 but over $100,000, the financial statements must be reviewed by a certified public accountant.

5. **Disclosure of Performance Goals, Activities, and Expenses in Form 990 and in Financial Statements.**

Tax-exempt organizations with over $250,000 in gross receipts would be required to include in the Form 990 a detailed description of the organization’s annual performance goals and measurements as established by its board of directors for the past year and goals for the upcoming year. This would enable donors to assess the organization’s ability to set and meet goals and to decide whether or not to donate on that basis. All materials changes in activities, operations or structure also must be disclosed. The meetings of the board would have to be reported, and all expenses delineated.\(^7\)

6. **Disclosure of Investments**

All tax-exempt organizations would be required to make publicly available, upon request, their investments. Smaller organizations would not be subject to the same requirement.\(^8\)

7. **Public Availability of Documents**

The Senate Staff Discussion draft states,

Public oversight is critical to ensuring that an exempt organization continues to operate in accordance with its tax-exempt status. For charitable organizations, public oversight provides donors with vital information for determining which organizations have the programs and practices that will ensure that contributions will be spent as intended. Oversight is facilitated under present law by mandated

\(^7\) Id. at 10.

\(^8\) Id.
public disclosure of information returns and applications for tax-exempt status, but more can be done.\textsuperscript{75}

Therefore, it is recommended that exempt organizations make disclosure of the following:

- Financial statements
- Application for tax-exemption
- IRS tax-exemption determination letter
- Financial statements for the last 5 years
- Audits
- Form 990-T
- Gifts over $10,000

8. Encouragement of Strong Governance Practices

The Draft contains numerous recommendations that would require minimum standards for the operation of the nonprofit organizations, including establishing the following:

- Organizational, management and procedural policies;
- Board review of program objectives and performance measures;
- Board review and approval of auditing and accounting principles and practices used in preparing the organization's financial statements and selection of the independent auditor;
- Board review and approval of the organization's budget and financial objectives, as well as significant investments, joint ventures, and business transactions;
- Board oversight over the conduct of the business and evaluation of whether it is properly managed;
- Board adoption of a conflicts of interest policy;
- Board adoption and oversight of a compliance program to address regulatory and liability concerns;
- Board adoption of procedures to address complaints and prevent retaliation against whistle-blowers.\textsuperscript{76}

\textsuperscript{75} Id.
\textsuperscript{76} Id. at 12-13.
9. **Prudent Investor Rules**

Under the proposal, the prudent investor rule would be applicable to the investment activities of charitable organizations under a new federal standard.\(^77\)

Other proposals would authorize the Internal Revenue Service to remove trustees found to have violated self-dealing rules or conflict of interest rules. Individuals would be able to file complaints against nonprofit organizations with the IRS. The IRS would also develop an accreditation program nationwide, through the states, whereby tax-exempt entities would be required to apply for accreditation and continue to qualify for accreditation.\(^78\)

Yet again, we are confronted with an affirmative and rude awakening to the fact that serious consideration is now being given to overturning the status quo and imposing greater regulation on the nonprofit sector. The Senate Finance Committee proposal, if enacted into law, would mark a “sea change” in the level of regulation imposed upon nonprofit organizations. While there is some overlap with Sarbanes-Oxley-type provisions, under this regulatory scheme, nonprofits would have to take affirmative action in other areas, including improving Form 990 disclosure and the development of a wide range of new policies and procedures. The Form 990 would assume the importance of a prospectus, the mandated disclosure document form for public companies.

All of the proposals discussed are far-reaching and will strain the resources of most smaller and medium-sized museums. To implement the new regulations, museums would have to seek counsel from lawyers, accountants and consultants in order to establish internal compliance controls.

\(^77\) *Id.* at 15. See, Harvard v. Amory, infra at 33.  
\(^78\) *Id.*
V. The Troublesome Effects of Questionable Governance

Actions taken by two museums tell a story about the effects of questionable governance practices and indicate that there is a need for a self-evaluation process to improve the level of oversight by boards and management.

The Art Institute of Chicago Invests its Endowment

For most museums, the endowment is an important source of funding for programs, and at times, operations. Endowments must be managed carefully, as funding sources often depend upon the maintenance of a certain level of endowment funds, and a healthy endowment may be the stabilizing financial factor in uncertain times. An AAM publication sets forth the guiding principles concerning museum endowments:

Close supervision of the management of institutional endowments is a traditional task of trustees, frequently assigned as the special responsibility of one or more finance or investment committees. It is the duty of trustees to manage all the financial assets of their trust so that maximum gain is realized within the bounds of what is considered a prudent investment.\(^7^9\)

Moreover, “Trustees are responsible for ensuring that all the museum’s financial resources, including the cash needed for day-to-day operations, are put to the most efficient and profitable use.”\(^8^0\)

In an early case involving the duties of trustees to oversee investments, Harvard v. Amory, the court articulated the “prudent person” standard. The court stated, “All that can be required of a trustee to invest, is, that he shall conduct himself faithfully and exercise a sound discretion. He is to observe how men of prudence, discretion and intelligence manage their own affairs, not in regard to speculation, but in regard to the


\(^8^0\) Id.
permanent disposition of their funds, considering the probable income, as well as the probable safety of the capital to be invested.\textsuperscript{81}

It is therefore interesting that one of the leading museums in this country, the Art Institute of Chicago, invested over half of its endowment in risky, relatively unregulated hedge funds. No doubt inspired by the heady bull markets of the 1990s and the promise of steep investment returns, the Institute took a great risk with a sizable amount of their endowment funds.

Hedge funds are pooled investments that "often take large risks on speculative strategies, including program trading, selling short, swaps and arbitrage."\textsuperscript{82} Hedging strategies are utilized in order to maximize gains and limit losses. In plain English, this covers the gamut of risky investment strategies, often involving commodities and index trading and bets upon how the markets will perform in the future.\textsuperscript{83}

Most museums with large endowments retain the services of an independent professional investment advisor to propose and implement an investment program. These professionals may be broker-dealers, investment advisers or banks. Ultimately, the board is responsible, under the duty of care, for the supervision of the management of institutional endowments and ensuring that the museum's financial resources are put to the most efficient and profitable use whether under their own management of that of an outside investment management firm. This responsibility is generally entrusted to the finance committee of the board, which recommends the selection of investment managers

\textsuperscript{81} 26 Mass. 461 (1830).
\textsuperscript{82} Dictionary of Finance and Investment Terms at 228.
\textsuperscript{83} Significantly, on July 14, 2004, the Securities and Exchange Commission voted to propose new rules requiring hedge fund advisers to register with the SEC in order to improve compliance controls and disclosures to prospective and current investors regarding investment policies, practices and fund operations. Hedge funds would then be subject to greater SEC regulation and be required to demonstrate compliance and internal controls and procedures. SEC Rel. 2004-95, July 14, 2004.
to the full board. The committee is also expected to review and approve any investment program for the museum.\textsuperscript{84}

In September 2001, the finance committee of the board of trustees of the Art Institute of Chicago evaluated and approved a proposal by its outside investment manager, Kennedy Capital Advisors, to invest more than $43 million of the Institute's endowment in a hedge fund managed by Integral Investment Management. At that time, this amount represented 6.6% of the Institute's $650 million endowment as then valued. By the end of 2001, the Institute lost $20 million from this initial investment, almost 50% of its original stake in the Integral hedge fund. It was only after this loss that the museum learned that its investment was used to fund an internet start-up company operated by a principal of Integral, and not in a traditional hedge fund.

Significantly, Integral paid the Institute's advisor, Kennedy Capital Advisors, 25% of the management fee paid by the Institute, and 3% of the profits earned. In this arrangement, it is important to note that management fees continue to be paid by the investor whether or not the investment is making money. In December 2001, the Institute filed suit against Integral, alleging fraud. It was also reported that the Federal Bureau of Investigation and the Securities and Exchange Commission began investigations of Integral.\textsuperscript{85}

Unfortunately, the Institute's trustees ultimately invested almost 50% of the endowment, or $396.5 million, in hedge funds as of June 30, 2002. The investment returns were less than spectacular given the market downturn that occurred in the latter

\textsuperscript{84} See generally, Museum Trusteeship, pp. 25-27.

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part of 2001 in the post-September 11 environment when investor confidence reached a new low. It is interesting to note that the Institute’s finance committee consisted of a number of experienced businessmen and wealthy investors and entrepreneurs. The Institute claimed that the principals of Integral Investment Management made promises that the monies would be invested conservatively and that there would be no losses, but instead the money was put into highly risky investments such as distressed credit card debt. In January 2002, the Institute fired Kennedy Capital after disclosing huge losses resulting from investments made on Kennedy’s recommendation.

However, one would have to question the board’s business acumen and duty of care in concentrating such a high percentage in endowment assets in non-conservative, highly risky investments, despite the oral promises made by the hedge fund manager to the contrary. One would have to question how the board’s duty of care can substantiated by the reliance on oral representations.

In any event, an external audit was conducted in the Art Institute’s hedge fund investments, but the results have not been made public. The SEC’s complaint against the principals of Integral did allege that false representations were made to the Institute’s auditor concerning transaction results and included erroneous valuations of the Institute’s investment. In June 2004, the SEC announced it was bringing legal action against the two principals of Integral Investment Management, alleging fraud and overstatement of assets under management.

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In the case of the Art Institute of Chicago, an effective audit committee should have been entrusted to review its investment management policies and practices, especially when the audited financial statements reflected significant losses. The committee should have provided additional oversight over what appears to be very questionable investment decisions and over-reliance upon oral promises of potential returns and protection against loss. At the very least, the board and museum management should have questioned more carefully and routinely the decisions being made with respect to the investment of the museum’s endowment monies. Sarbanes-Oxley emphasizes the importance of the audit committee because its very function is critical to the sound financial governance of an entity or institution. Museums should take heed from the lessons of Enron and the Art Institute and review how effectively their committees are working.

Conflicts of interest that have a direct impact on a museum may not be readily apparent. In the case of the Art Institute of Chicago, its own investment advisor was reaping significant benefits from the museum’s stake in risky hedge funds. It is unclear whether this was disclosed to the board; however, this arrangement posed a conflict of interest in that the advisor was benefiting from the risks assumed by the Institute in this investment. These benefits were in the form of a sizeable (25%) percentage of the management fees being paid, whether or not the investment itself was generating profits. Former SEC Commissioner Bevis Longstreth argued that one consideration in prudent investing by a nonprofit organization is, “If delegates are involved, the reasonableness of the terms and conditions of such delegation, taking into account the

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compensation structure, monitoring mechanisms, and provisions for termination.” The reasonableness of the compensation paid to Kennedy Capital is certainly open to question and does indeed raise a conflict between the “independent” advice given to the Institute’s finance committee, and Kennedy’s lucrative fee agreement with Integral.

With regard to the Art Institute of Chicago, financial data on the GuideStar website shows that the museum suffered losses of $78,488,325 from investments between July 1, 2001 and June 30, 2002. No data is yet available for 2003.91 The most recent Form 990 lists hedge funds as investments, but does not explain the reason for the loss in investment returns.

The Museum of Northern Arizona Sells Collection Objects

The Museum of Northern Arizona is a seventy-five year old museum located in Flagstaff, Arizona. It “explores and explains the lands and peoples of the Colorado Plateau to encourage a broader understanding of its unique beauty and character.”92 In December 2003, the Accreditation Committee of the American Association of Museums withdrew the accreditation of the museum in response to allegations that the museum board improperly disposed of twenty-one items from the permanent collection in 2002 and that the funds from the sale were utilized for the purpose of stabilizing museum financial operations. The funds were not, in contradiction to AAM guidelines for deaccessioning, used to support or develop the collection.93

Deaccessioning is the procedure employed by museums to review and permanently remove objects from the museum's collection. Often, such determinations are subject to board review and approval. There is an inherent duty for museums to weigh carefully any decisions to deaccession. Marie Malaro states, "Museums contemplating deaccessioning should keep one thought in the forefront: A museum exists to serve its public, and to be truly effective, it must maintain the confidence of these beneficiaries." Museums generally use the proceeds from deaccessioning to acquire new collection objects. In Malaro's opinion, "Such a practice usually serves the best interests of the public because it lessens the temptation to drain collections in order to support expenses." 

The American Association of Museums addressed the use of proceeds from deaccessioning in its revised model Code of Ethics for museums. In a clearly worded provision, the Code states "disposal of collections through sale, trade or research activities is solely for the advancement of the museum's mission. Proceeds from the sale of nonliving collections are to be used consistent with the established standards of the museum's discipline, but in no event shall they be used for anything other than acquisition or direct care of objects." These ethical standards embody the duties of loyalty, are and obedience to the public and to the mission with regard to deaccession proceeds, although these standards do not have the force of law.

Resorting to deaccessioning may mean that the museum has no other recourse. In fact, as Malaro so aptly notes, "On the whole, the law has been more receptive to broader

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95 Id. P. 230.
use of deaccession proceeds ...because when cases of this nature are brought to the attention of [a state] attorney general or a court, the museum in question is usually in serious financial difficulty."97 It also may be the case that an affirmative deviation from the deaccession standards may signal other problems within the institution. Malaro observes, "When museums seek to deaccession for reasons other than collection improvement, the underlying problem is invariably a history of board failure to exercise prudence in fiscal management."98 In other words, deaccessioning should not be the answer to a museum's financial difficulties.

Therefore, if deaccessioning serves as a weak substitute for sound fiscal management, one would have to question the governance practices of the board in ensuring the financial stability of the museum, and whether weak management practices led to the acute financial instability.

If we examine the decisions made by the board at the Museum of Northern Arizona, either no code of ethics was in place that incorporated the deaccessioning procedures recommended by the AAM, or the board chose to ignore the code's provisions. Perhaps the collections management policy also was disregarded in order to pursue the sale of collections objects in order to avoid financial difficulties in the day-to-day operations of the museum. Boards of accredited museums must follow the ethical standards set forth in the code of ethics, or risk losing their accreditation, as indeed was the case with the Museum of Northern Arizona.

In this case, the withdrawal of AAM accreditation substituted for any regulatory action and underscored the fact that the directors had not acted with fiduciary principles

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97 Malaro, p. 232.
98 Id. at 233.
in mind. The board failed to properly oversee museum operations, despite acknowledged internal policies and procedures designed to prevent the deaccessioning of collection objects for purposes other than sustaining or building the collection. Why was there a shortage of funds to operate the museum? What was the board doing? Moreover, loss of AAM accreditation could have a chilling effect on future fundraising opportunities, if not on the museum’s reputation. This set of circumstances should never have presented itself if care had been taken to oversee the financial stability of the museum.

Several affirmative changes were made by the Museum in response to the loss of accreditation. The Museum’s board of trustees was subsequently replaced and a new board of directors was named. Amended by-laws were adopted that made clear that trustees must adhere to the Museum’s collections policy or be subject to removal from the board. In the interest of greater transparency, the museum’s by-laws, board meeting minutes, articles of incorporation and statement of values are available to the public through the museum’s website.

The examples of the Art Institute of Chicago and the Museum of Northern Arizona only serve to highlight the fact that decisions made by museum boards of directors can have an adverse impact on museum operations and reputation. Whether it involves millions of dollars, or collection objects, the standards of care and the dedication to proper governance must be taken seriously. While one cannot state with certainty that the application of Sarbanes-Oxley provisions to museums would have prevented these actions described above, it can be argued that focus upon the adequacy of governance in general may have prevented the decision-making process at these two museums.
V. The New Bottom Line: Steps Taken By Museums to Strengthen Governance Standards

BoardSource, the nonprofit organization dedicated to building effective nonprofit boards, recommends that nonprofits heed the Sarbanes-Oxley “wake-up” call. A BoardSource publication states, “the Sarbanes-Oxley Act has caused a renewed realization that nonprofit organizations rely on – and must protect – the indispensable and unequivocal confidence and trust of our constituents. Self-regulation and proactive behavior will always prove more powerful than compulsory respect of laws.”

What follows is a discussion of two museums that have taken affirmative steps to assess and address governance issues. Both the Bruce Museum of Arts and Science and The John and Mable Ringling Museum of Art have focused on the importance of strong governance, fiscal responsibility and sound decision-making through training, procedural changes and implementation of policies designed to support and advance strong ethical standards.

The Bruce Museum of Arts and Science

The Bruce Museum of Arts and Science is located in Greenwich Connecticut. Its mission is to promote the understanding and appreciation of art and science and to enrich the lives of all people. Certainly, the Bruce Museum is not one of the largest or well-known museums in the country. It employs less than 50 persons. However, the Museum takes governance seriously, as I discovered through a number of communications with its

100 http://www.bruce museum.org
Business Director and Controller, Carol Collins. The governance practices address many of the standards set forth in Sarbanes-Oxley and the proposed New York State nonprofit legislation.

The Bruce Museum has an audit committee that at any one time will be comprised of three or four members of the board of directors. The head of the committee is selected based upon their knowledge of finance. Collins reports that this person is provided ample financial information throughout the year and "asks enough questions to obtain an overall feel of how the institution did for the year." The audit committee routinely meets with the auditor without management in attendance so that issues can be raised and discussed in a more open environment.

The audit firm does not provide non-audit services to the Museum. There has been no recent change in the selection of auditors, primarily because the cost involved in both time and dollars was found to be staggering. The relationship with the audit firm has always been an arm’s-length one, and it is the belief of management that changing auditors at this point, as required by Sarbanes-Oxley, would be detrimental to the firms that will perform professional services to smaller organization and that are well versed in nonprofit accounting practices.

The Controller, as the chief financial officer, certifies that the financial statements fairly present the financial condition and operations of the Museum, as required by Sarbanes-Oxley. The Executive Director and the Controller must also affirm that they

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101 In-person discussion, March 24, 2004; telephone conversation, July 7, 2004; and e-mail correspondence, July 2004. Ms. Collins has extensive experience in the corporate financial sector.
102 E-mail correspondence, July 27, 2004.
have not withheld any material information from the auditors. The Museum makes their financial statements available to the public upon request.

Written procedures are in place at the Museum to prevent conflicts of interest and self-dealing. The Museum has adopted a code of ethics, which is applicable to the Board, staff and volunteers. There are also internal controls in place regarding the specific personnel who are authorized to sign documents and checks and who is authorized to approve sizeable financial transactions. These controls are important in establishing a written audit trail and determining whether unauthorized personnel are approving transactions. The Controller also confers with board members if there is an expenditure that may require additional scrutiny and approval.

The Museum's personnel handbook provides guidelines with respect to whistle blowing and employee complaints. The section on "Grievance Procedures" states, "You are free at all reasonable times during work hours to discuss any job-related grievance with your supervisor and, should the grievance thereafter remain unresolved, with the Executive Director. Failing resolution at the Executive Director level, appeal may be made to the Executive Committee [of the board], which will review the issues in dispute and render its decision, which will be binding on all parties."\(^{103}\)

There is nothing specific with regard to whistle blowing in the handbook; however the Controller noted that the Museum takes seriously and addresses promptly any issues that are raised by employees.\(^{104}\) Management does not tolerate illegal behavior of any kind and employees found to be engaged in illegal conduct are subject to immediate dismissal.

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103 See The Bruce Museum of Arts and Science Employee Handbook, Section 5.
104 E-mail correspondence, July 27, 2004.
The John and Mable Ringling Museum of Art

The Ringling Museum of Art is located in Sarasota, Florida. It is the State Art Museum of Florida and has been a division of Florida State University since 2000. The affiliation with FSU is an important factor in the Museum's governance structure. As part of a state university, the Museum is subject to Florida statutes governing the retention of documents, employee grievance procedures and audit requirements. The University also provides valuable ancillary services in the form of legal counsel, financial oversight, human resources support, facilities planning and fundraising support.

In late 2003, the Chair-Elect of the Board of Directors, along with senior management, retained the services of a consultant from BoardSource to structure a training program for the directors. This full-day training seminar was intended to reinforce and raise the awareness of the board members of their fiduciary duties.

The importance of training cannot be over-emphasized. Malaro has noted, "If [board members] are to make prudent decisions, it stands to reason that they need more than generic principles; they need also an immediate overview of essential governance information relevant to organizations within their subdivision of the sector."  

At the training session the board was provided with an annual expectations statement that stressed the following goals for board members:

- Personal participation
  - Know the museum’s mission, purposes, goals, priorities
  - Follow trends in the nonprofit sector
- Attending board meetings
  - Make board and committee meetings a priority

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105 As the Associate Director of The Ringling Museum of Art as of this writing, I have personal knowledge of the matters discussed in this thesis relating to the Museum's governance and board training initiatives.
- Prepare for and participate in meetings

- Provide counsel to management as appropriate
  - Develop a relationship with senior staff in order to encourage and be in a position to offer guidance and support

- Avoid conflicts of interest
  - Provide service to the museum first
  - Maintain independence and objectivity
  - Be aware not only of actual conflicts, but potential conflicts of interest

- Promote the mission and goals of the museum

A discussion was held at the training seminar regarding the board’s role in working efficiently and effectively while maintaining its major role in governing the operations of the Museum. The success of the training was revealed when a number of board members acknowledged that this was their first collective review of the duties of the board.

The Museum now conducts an orientation training session for all new board members, which includes a discussion of board fiduciary responsibilities and the provisions of the Museum’s code of ethics. An experienced member of the board is assigned to “mentor” each new board member during their first year of service.

With regard to financial oversight, the Board established an audit committee in early 2004, which committee presently is chaired by an experienced CPA who is a partner with a local accounting firm. Other members of the committee have knowledge of financial matters, and are advised by the Chief Financial Officer and FSU legal counsel when necessary or appropriate. As required by Sarbanes-Oxley, the chief financial officer also certifies that financial statements fairly present the operations and financial condition of the Museum.
The Museum, as part of the state university system, is also subject to an annual audit by the State Auditor's Office. The State Auditor reviews such areas as the accounting practices, audit trail procedures, separation of duties between bookkeeping and audit, and the level of management and board involvement in the review of financial statements. The presence of this auditing function serves as an additional and valuable oversight mechanism, and provides the board with an independent source for any governance issues of importance.
VI. Conclusion

The "bottom line" is a phrase often used to describe the financial returns from business operations. However, a bottom line can represent more than a profit and loss statement. Stephen L. Hammerman, as Vice Chairman and General Counsel of Merrill Lynch & Co., the largest broker-dealer firm in the United States, stated on numerous occasions, "Nobody's bottom line is more important than the reputation of the firm."¹⁰⁷ For museums, same admonition holds true: the reputation of the museum is paramount.

The scrutiny by legislators, regulators, industry groups and the public with respect to the standards of accountability of nonprofit organizations cannot be denied, nor should it be casually ignored. Should a new regulatory scheme appear on the horizon, and it does not seem too far away, there would be a direct impact and additional strain on museum resources. The possibility of increased reporting and disclosure requirements make self-regulation and voluntary actions a more palatable alternative. However, it is incumbent upon museums to review their organizational behavior with a view toward improving governance and financial reporting. The board’s role is not solely ancillary to the part that senior management plays, and any review of governance must include an assessment of how management communicates to the board and their effectiveness. The director and chief financial officer of a museum must be held to as high a standard as the board to create a work environment that demands integrity and sound governance.

Boards often articulate the values of the institution both internally and to the public at large. It is within this context that boards of museums should conduct a self-

evaluation to determine their efficacy and ability to properly govern and be held accountable for the museum’s overall financial health, commitment to mission and stability. Otherwise, these obligations may be imposed involuntarily upon boards and museum management through legislative action, and increased and perhaps unwelcome regulatory oversight. Proactive, voluntary steps toward improvement and reform would have a salutary effect by increasing public and governmental confidence in a museum’s reputation. Herein lies the new bottom line.
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