A Lesson from Corporate Boardrooms:

Practice Good Governance or Face External

BY T. GRANT CALLERY

TAKEAWAYS

1 Higher education governance can expect to feel the same external pressure to be more accountable that was felt in the corporate world after recent scandals.

2 College and university governing board members, like members of corporate boards, are bound by two fundamental duties: the duty of care and the duty of loyalty. Many nonprofits are also governed by a third obligation, the duty of obedience.

3 To remain ahead of the curve and not become subject to increased public scrutiny and government regulation, boards should move in the direction of "gold standard" governance, reviewing and updating their processes, educating board members, and ensuring that they are acting in good faith consistent with their fiduciary duties.

OVER THE PAST FEW DECADES—AND ESPECIALLY IN THE past three or four years—governance practices at colleges and universities have often fallen short of the mark. During the same time period, the governance structure of the corporate world has been significantly strengthened. A key distinction between the two areas of board behavior is the existence of various external forcing mechanisms in the corporate arena that are not found in higher education. Yet with increasing public scrutiny of higher education governance and demands for greater accountability, colleges and universities can reasonably expect that similar external forces will eventually pressure them to "get with the program" of 21st-century governance norms.

ARTHUR GIRON

Forces

On numerous occasions, governance-related issues have damaged the reputations of otherwise respected colleges and universities. Adelphi University, part of the New York State University system, was tainted in the mid-1990s by allegations of excessive presidential compensation and misappropriation of university funds. Following a review, the New York State Board of Regents found instances of self-dealing on the part of the Adelphi board and removed a number of its members.

Spring forward 10 years, and a similar set of circumstances involving executive compensation arose at American University in Washington, D.C. The board terminated the president after an investigation revealed his alleged lavish spending habits. Moreover, because the university held a congressionally approved charter, the events also resulted in congressional hearings.

In the past two years, other attention-grabbing instances of governance problems at major universities have occurred. One at Penn State involved the oversight of potentially criminal activities among the university's football coaching staff; another at the University of Virginia concerned a botched attempt to dismiss the president. As AGB President Rick Legon noted in *Trusteeship* (September/October 2012), members of the UVA board, "who care passionately about the institution, lost sight of that larger playing field, allowing governance to misfire and putting the university's reputation at risk. The governance failures at UVA attracted national attention and raised a number of questions, not the least of which was whether the historic governance model of our colleges and universities merited support." In the case of Penn State, an investigative report by former FBI director Louis Freeh concluded that the Penn State board's "overconfidence ... and its failure to conduct oversight and responsible inquiry... hindered the board's ability to deal properly with the most profound crisis ever confronted by the university."

These are just the most widely reported instances of governance failures in the college and university setting; there are certainly others. But they amply demonstrate the serious risk to a higher education institution if care and attention are not paid to ensuring good governance.

Defining Fiduciary Obligations

What then are a board member's obligations to an institution? During our orientation processes, all of us who serve on boards are (or should be) imbued with the understanding that, as members of the board, we become fiduciaries to the institution. But as stated in an oft-quoted U.S. Supreme Court decision by Justice Felix Frankfurter, "To say that a man is a fiduciary only begins analysis; it gives direction to further inquiry. To whom is he a fiduciary? What obligations does he owe as a fiduciary? In what respect has he failed to discharge these obligations? And what are the consequences of his deviation from duty?"

In American corporate law, state statutes and judicial interpretation of those statutes generally determine the obligations of directors. State legislatures have followed two basic models in enacting laws governing corporations. The first is the unitary model followed by Delaware, the chosen state of incorporation for a large number of American for-profit corporations. The Delaware statute does not distinguish between for-profit and nonprofit corporations, but rather between their structure as stock or non-stock corporations. Under that model, all corporations have either shareholders or members (who, to a large degree, have status similar to shareholders with respect to their rights under the law).

The second model distinguishes between for-profit and nonprofit corporations and allows the nonprofits to operate without either shareholders or members and to be governed by self-perpetuating boards. Those states, such as New York, set out differing obligations and, perhaps more important, oversight models for the two types of corporations. It is under the nonprofit portions of the statutes that most private colleges and universities are incorporated.

Irrespective of the corporate model under which an institution is incorporated, the basic obligations of corporate board members and nonprofit trustees like those at colleges and universities are similar. (As will be discussed later in this article, however, the manner of incorporation can significantly impact the remedies that might be available to interested parties who may feel aggrieved by the actions of the institution and its board.)

The discussion of board obligations in this article is derived from the corporate law applicable to for-profit corporations, and therefore is most directly applicable to private colleges and universities. The same standards, however, also appear to be generally applied in the public university context, either by the charter creating the institution, by statute, or by regulation. As an example, in its "Statement on the Governance Role of a Trustee or Board Member," the New York State Board of Regents applies the same basic obligations of public university trustees as state corporate law imposes. The Freeh Report cited previously also articulated such duties and made clear that Pennsylvania law governing nonprofit boards imposes similar requirements.

One of the most basic premises of American corporate law is that the business of an incorporated entity is to be managed by, or under the direction of, its board of directors. That does not mean that directors are to be engaged in the everyday management of the institution, but rather that they bear ultimate responsibility for ensuring proper management. In carrying out this responsibility,

two fundamental duties are imposed on all corporate directors: **the duty of care** and **the duty of loyalty**.

In general, **the duty of care** requires a director to act in a reasonable and diligent manner in carrying out his or her functions as a board member. **The duty of loyalty** requires that directors act in the best interests of the corporation and not be tainted by any personal motive when carrying out their board responsibilities. Some courts, in interpreting and articulating directors' obligations, particularly in the context of nonprofits, also impose what is known as **the duty of obedience**, which means that a director must act in a manner that is faithful to the purposes and mission of the corporation. Many courts consider the duty of obedience to be subsumed within the duty of loyalty.

These duties have been developed and shaped through judicial interpretations of the various state corporation statutes. (See box on page 29 for specific examples of what board members should do to satisfy these basic fiduciary duties.) And, broadly speaking, boards of nonprofits, such as colleges and universities, are expected to meet the same fiduciary obligations as their corporate counterparts.

No External Forcing Mechanisms ... Yet

How, then, do higher education boards differ from corporate boards in ways that make them more likely to experience governance failures? I would submit that one of the principal distinctions is the lack of what can be considered "forcing mechanisms," such as those that exist in the for-profit world. Without those mechanisms, boards of colleges and universities, as entities incorporated without either shareholders or members, can become lax in following state-of-the-art governance practices.

Shareholder-based corporations have always had to deal with such forcing mechanisms, including various forms of litigation. Publicly traded companies also risk incurring enforcement action by the U.S. Securities and Exchange Commission (SEC) or other regulatory authorities having jurisdiction over them. Beyond those traditional remedies, when matters have gone significantly awry—such as the corporate scandals of the early 2000s, including those involving Enron, WorldCom, and Arthur Andersen—external forces such as congressional intervention have also been brought to bear.

Those scandals led to the Sarbanes-Oxley legislation, which imposed significant requirements on all public companies and, to a lesser degree, on nonpublic companies. Similarly, after the financial crisis of 2008, the Dodd-Frank legislation, passed in 2010, greatly increased regulations on corporations in the financial sector. Some would argue that Sarbanes-Oxley and Dodd-Frank, like many legislative solutions, went too far, and their "fixes" imposed costs and burdens on corporate America that could have been better addressed with less drastic measures. But once the egregious behavior of corporations like Enron made headlines, the outcome and the extreme nature of the remedies proposed were largely predetermined, and no chance for modest reforms truly existed.

Until now, the nonprofit world has not traditionally had remedies such as litigation or regulatory intervention available, and there has been no crisis generating a legislative response along the lines of Sarbanes-Oxley. The traditional enforcement mechanisms for nonprofit corporations have been in the hands of the state attorneys general who typically have enforcement rights under nonprofit statutes. To some degree, the Internal Revenue Service (IRS) and, in certain instances, state licensure authorities also have oversight responsibilities.

The remedies available in the arsenals of those overseers generally are draconian in nature and include revocation of the nonprofit charter, cancellation or suspension of a license to conduct a certain type of business (e.g. to provide educational services), or withdrawal of an organization's tax-exempt status. But based on a dearth of resources in the states, a lack of focus by the IRS, and the extreme nature of the remedies available, such remedies have thus far been used sparingly.

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Coming Soon: More Regulation and Litigation?

Winds of change, however, may be blowing. A number of state attorneys general are becoming more aggressive—and publicity-seeking—by bringing actions in areas such as privacy breaches and securities-law violations where they had traditionally been relatively inactive. Should the highly visible instances of failed governance that I related at the beginning of this article continue, they could generate interest on the part of state attorneys general, either individually or collectively.

In addition, the IRS has evidenced an increased interest in tax-exempt organizations and their governance, as reflected in statements it has made and its adoption of the new Form 990 in 2008. On its Web site in the section dealing with 501(c)(3) organizations, the IRS says: "Good governance is important to increase the likelihood that organizations will comply with the tax law, protect their charitable assets and, thereby, best serve their charitable beneficiaries. Accordingly, charities should consider governance practices and related topics to assure sound operations and compliance with the tax law."

Those of us serving on private college and university boards who have reviewed our institution's Form 990 have seen that the form is now more of a public disclosure document than a traditional tax return. Significant portions of it require subjective and narrative descriptions of the operations of the institution, much like the periodic disclosure documents required of public companies. With the advent of public, Web-based portals such as Guidestar, the transparency of the operations of the tax-exempt sector has been enhanced. And the greater availability of such information will make it even easier for people to compare the practices of various entities.

In a "post-Madoff" world of whistleblowers, state authorities will very likely be brought into on a more frequent basis what might be characterized as governance issues—such as the investigation conducted in 2012 by the Attorney General of New Hampshire relating to alleged mismanagement of the Dartmouth College endowment. Authorities also are going to be increasingly less likely to dismiss, out of hand, complaints purported to be from whistleblowers, given the public thrashing that certain regulators have recently taken for missing "red flags" that were before them.

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In addition, some classes of interested parties may seek to augment the authority of the state attorneys general through privately initiated litigation. The issue here generally relates to the concept of standing which, simply stated, involves which class or classes of parties have the ability to bring a legal action against an institution or its board for the alleged breach of one or more fiduciary duties. The traditional view has been that, under the state nonprofit statutes where authority has been delegated to attorneys general, those remedies are generally viewed as exclusive; potentially aggrieved parties must rely on those authorities for redress of any grievances against the institution. However, a number of academic articles over the past decade or so have suggested that a combination of factors, including the lack of resources in state attorneys general offices and a general reluctance of those offices to enforce laws against respected institutions, militate toward at least a limited right of action to an appropriate subset of interested parties. In the context of higher education institutions, those could include students, donors, or alumni.

Generally, such an action, if allowed, would take the form of what is known as "derivative" or "relator" litigation, where the beneficiary of the suit, if successful, would be the corporation itself. Or, in the case of a relator suit, the plaintiffs would act on behalf of the attorney general to enforce obligations as the attorney general would. In this type of litigation, if applied to colleges, the beneficiary would be the institution and the remedy would help it rather than the party bringing suit. Moreover, the remedy would generally be governance reform, rather than money damages. The advantage of such litigation to the institution is that the plaintiffs generally receive no "pot of gold" at a successful conclusion, which tends to act as a disincentive to non-meritorious suits. (Legal fees are a different issue.)

In 1999, Professor Harvey Goldschmid of Columbia Law School, who has since served both as a commissioner and as general counsel at the SEC, wrote an article in the *Journal of Corporation Law* where he posited what he characterized as several paradoxes relating to nonprofit governance. Among those was the fact that, while nonprofit boards operate under the same legal standards as their for-profit peers, "the law plays little role, other than aspirational, in assuring the accountability of the nonprofit sector." In his article, Goldschmid proposed a number of reforms, including that "room should cautiously be opened for donor, member, and beneficiary derivative actions." In conclusion, he asked, "Can we continue to justify or afford—and will the public continue to tolerate—the relative ineffectiveness of nonprofit corporate governance and the virtual absence of accountability constraints?"

Other legal commentators have since raised the same question in different ways in, among other journals, the *American University Law Review* (following that institution's compensation scandal and suggesting standing for students) and the *Vanderbilt Law Review*. Although such theories have not taken hold in any significant way, court precedent has recognized standing under what is known as the "special interest doctrine" for groups such as former patients seeking redress of governance issues at a nonprofit hospital in the District of Columbia.

If a groundswell of discontent with the accountability of the board members of higher education institutions were to develop—along with a concern relating to the lack of resources in the offices of state attorneys general—those theories could gain traction and lead to inroads for either derivative or relator rights of action by the proper class of interested parties. Once that process began, it would be difficult to prognosticate whether courts could impose proper limitations or whether the door would then be open to vexatious litigation that would cost educational institutions scarce funds even if they ultimately prove successful in their defenses.

"Gold-Standard Governance" Required

The world of higher education institutions is changing. In many if not most institutions, governance principles have not kept pace with the growing complexity of issues confronting college and university governing boards. Moreover, the number of governance failures appears to have escalated in the past few years, and news-media coverage of those failures and increased transparency in the operations of educational and other nonprofit institutions have increased public awareness of those failures. Such developments put boards at risk that new and nontraditional forces will be brought to bear on governance processes—through some or all of the means I've discussed in this article—if it appears that boards are ignoring their responsibilities.

How, then, should a board wanting to be ahead of the curve ensure that its processes are able to withstand public scrutiny? The following suggestions are reasonable starting points:

- Undertake a review of your institution's charter documents and bylaws to ensure that they are up-to-date and comport with the manner in which it is currently functioning;
- Review and update, where necessary, the financial controls that your board has in place, including those relating to presidential and other executive compensation and expenses. Every college or university need not implement Sarbanes-Oxley-type controls, but they should be consistent with the financial complexity of your institution;
- Review the committee structure of the board and put in place one that effectively addresses the major components of your institution's operations;
- Ensure that board members are given proper education and training about the operations of the institution and sufficient information upon which to make informed and reasonable decisions so as to properly exercise the board's duty of care; and
- Implement appropriate conflict-of-interest policies and other procedures to properly document that board members are acting in good faith consistent with their duty of loyalty.

Each college or university must craft its program to fit the needs and complexities of its own operations. And there is no guarantee that some unforeseen disaster will not result in overreactions by attorneys general, the courts, or legislatures. Yet a visible move in the direction of "gold standard" governance will certainly help all of us who serve as board members to be masters of our own fates—rather than be subjected to external mandates that may not fit our institutions at all and may carry a far higher cost than necessary. ■

The Duty of Care, the Duty of Loyalty: What Are a Board Member's Obligations?

Examples of approaches a director must take to satisfy **the duty of care** include:

- A reasonable, diligent, and informed manner of performing his or her duties;
- Exercise of the reasonable inquiry, skill, and diligence of an ordinarily prudent person in a similar position;
- Diligence in preparation for and participation in board deliberations;
- Care in seeking appropriate information to make informed decisions; and
- In exercising these duties, reasonable reliance on management for information absent indications that such reliance might be misplaced.

Similarly, the following are components of a director's adherence to his or her **duty of loyalty**:

- Actions in good faith and in the best interests of the corporation;
- Absence of personal interest in the decisions made;
- Actions in the best interests of the entity as a whole and not of any constituent group of which he or she might be a member;
- Avoidance of taking advantage of business opportunities based on knowledge gained from board service; and
- A duty of confidentiality.

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T'SHIP LINKS: "Fiduciary Behavior: What's the Responsible Trustee to Do (and Not Do)?" March/April 2013. Robert M. O'Neil, "Updating Board Bylaws—and Beyond." March/April 2013. "When Governance Goes Awry: What Are the Takeaways?" September/October 2012. Richard Novak, "State Policies and Practices to Improve Board Governance." September/October 2012.

OTHER RESOURCES: "AGB Board of Directors' Statement on Conflict of Interest with Guidelines on Compelling Benefit" (2013). "AGB Statement on Board Responsibility for Institutional Governance" (2010). "AGB Statement on Board Accountability" (2007).