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HIGHER EDUCATION PRACTICE

ALERT

CORPORATE GOVERNANCE IMPOSED
THE STEVENS INSTITUTE OF TECHNOLOGY CASE

By Kevin B. Scott

In September 2009, the Attorney General of New Jersey filed an action against The Stevens Institute of Technology in New Jersey alleging a host of claims, including financial mismanagement, excessive spending, misuse of charitable funds and breach of fiduciary duty. The complaint followed a three-year investigation by the Attorney General's Office into the school's financial practices and highlights several areas where college and university officials may want to focus.

Among other things, the Attorney General alleged that the salary and benefits of Stevens' president were excessive and that the president received low-interest loans as well as other benefits alleged to be excessive. The complaint alleged that the president, along with the board chairman, kept the full board in the dark about their "spending and borrowing practices and financial mismanagement." One committee of the board allegedly "buried" an independent consultant's analysis concluding the president's compensation was excessive and another committee failed to adequately disclose the internal control letters of the school's original independent auditors. According to the Attorney General, the original auditors 'fired' the school as a client due to the high risk the school posed to the accounting company. The school's new accountants also allegedly repeatedly warned about internal control weaknesses.

On January 15, 2010, Stevens entered into a consent decree with the Attorney General and agreed to sweeping changes to its corporate governance. Stevens also announced that its president was stepping down on July 1, 2010. Stevens did not admit to any liability or unlawful conduct in the consent decree.

The corporate controls agreed to by Stevens in the consent decree were extensive. The decree covers the organization, compensation, power and duties of the board and all of the major board committees. It requires some committees to hire independent consultants and mandates that Stevens hire an in-house counsel. It also requires Stevens to retain the services of a former New Jersey Supreme Court judge for at least 24 months as special counsel to monitor and report to the board on the school's compliance with the consent decree.

While the particular facts of the Stevens case may be somewhat unique, the trap that apparently ensnared its board members and administration is not. By its very nature, the governing structure of colleges, universities and other nonprofits makes them susceptible to the type of abuse and neglect alleged in the Stevens case. Most significant nonprofits have very large boards that meet, at most, three times a year for two or three hours. There is always tension between what should be brought before the full board and what should be handled by management. In fact, board agendas are normally very carefully scripted by the administration and the board

chair. The tight agendas and somewhat formal proceedings do not lend themselves to questions or scrutiny. This can often lead to a benign conspiracy of sorts where top administration officials and a few key board members are the only ones with access to all of the information. This small group, in turn, decides the scope and content of information to be disclosed to the full board. Most of the time, these efforts are performed in good faith and produce positive results. However, this type of insular process can also evolve into a "we know what's best" attitude that can alienate board members and lead to decisions being unduly influenced by personal relationships and other inappropriate factors.

Each board member owes a fiduciary duty to the institution, which cannot be properly discharged by a mere passive acceptance of what is presented to him or her. The challenge, from management's perspective, is to present the important issues when there is so much information to convey in such a short amount of time.

For all involved, it helps to take a step back and look at the big picture. While much of what goes on in board meetings is important in terms of the direction of the institution, certain issues deserve particular attention due to their sensitive nature. To see what the Internal Revenue Service (IRS) thinks is important, one need look no further than Part VI of the newly designed Form 990, which is the Informational Return required to be filed with the IRS by most charities. Part VI of Form 990 involves questions on corporate governance, conflicts of interest and whistleblower policies. A few examples follow.

Compensation

Compensation has received much attention lately, especially from the IRS. Since 2000, the IRS has had the ability to impose excise taxes on institutions and trustees who engage in "excess benefit transactions," the most common example of which is excessive compensation of a "disqualified person." This is generally anyone who can influence the institution and would normally include the president, executive director, vice presidents, board members as well as those individuals' family members.

The IRS allows, however, the institution to establish a rebuttable presumption that the compensation was reasonable by demonstrating the compensation package was:

(1) Approved by the board or committee who were free from any conflict of interest;

(2) Based upon appropriate comparable data (such as the industry salary survey); and

(3) Documented in writing.

Comparable compensation means comparable to similarly situated institutions. As the Attorney General of New Jersey made clear, the fact the compensation of the Stevens' president was only slightly higher than the president of The Massachusetts Institute of Technology is not helpful when MIT's operating expenses were approximately $2.3 billion as compared to $158 million for Stevens. Compensation surveys, broken down by size, enrollment and other factors, are becoming increasingly available.

All board members should know the details of the compensation packages of the executives and how that compensation was reached. If the compensation is approved by a committee, each board member is entitled to ask for a copy of the comparable data and the other documentation pursuant to the IRS regulations. If something does not look right, it may not be right. In the Stevens case, there was allegedly a compensation expert who questioned the president's compensation, but the expert's report never saw the light of day — at least, not until the New Jersey Attorney General became involved.

Conflicts of Interest

Conflict issues are difficult for several reasons. First, it is not always clear whether a conflict exists. An obvious example is where there is a transaction between a board member and the institution. But what about a transaction between a business associate of the board member and the institution? Is that a conflict or should it be treated as one? The question comes down to whether management would feel constrained in evaluating or dealing with the business associate knowing his or her relationship with the board member.

If there is a conflict, most state nonprofit laws (and most conflict policies) do not prohibit the transaction so long as it was voted on by trustees without a conflict of interest and/or the terms are fair. The IRS procedures discussed above can also be used to establish a rebuttable presumption for IRS purposes. However, no matter how much diligence and vetting is done, if a problem occurs with a transaction that has a conflict, it will look much worse than the same transaction without a conflict. There

is simply no way to scrub a conflicted matter enough to avoid doubt and second-guessing if a problem later arises. That is why some institutions simply prohibit any transaction with interested parties. Ultimately, resolving conflicts comes down to disclosure, optics and judgment.

How does the institution find out about conflicts in the first place? The starting point is a comprehensive conflict of interest policy pursuant to which each officer, trustee and others of influence declare, on an annual basis (or sooner if a conflict arises), any conflict or potential conflict. Whether an institution has such a policy is just one of the many questions the IRS asks in the revised Form 990.

Board Committees

Many institutions perform most of the board work through the use of a variety of committees such as an executive committee, compensation committee, audit committee, etc. While the existence of a healthy committee system can provide an efficient way for all board members to participate in some aspect of the operations, it is subject to abuse, especially where there is one dominant committee or where the committee chairs are part of an insular group. An executive committee is especially susceptible to this type of arrangement and in some cases acts as a mini-board with little or no accountability to the full board. This may have been at issue in the Stevens case, because one of the requirements of the consent decree was the executive committee serve only as an advisory group with no power or authority to act on behalf of the full board.

As a general matter, the executive committee should only act in between board meetings or for other matters of emergency. The committee should not act as a substitute for the full board. As to the other committees, it is important to have a diversity of members in leadership positions of those committees so that all of the power is not concentrated with a few individuals. Most board members are used to having leadership positions and they are good at it — it is an ideal way to get valuable board members involved in a meaningful way with the institution.

Scrutiny of nonprofits by the IRS, attorneys general, donors and other constituents is likely to continue. Having thoughtful procedures and policies in place, applied in a common sense manner, can go a long way to attracting talented board members and protecting the legacy of the institution.

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