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Significant New Corporate Governance Settlement

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Health lawyers should note the several valuable corporate governance lessons arising from the January 15, 2009 settlement of the civil complaint filed last September by New Jersey Attorney General Anne Millgram, alleging that nonprofit Stevens Institute of Technology, its President and its Board Chairman mismanaged the nonprofit's finances and endowment, and excessively compensated its President.

The *Stevens* controversy reflects (1) the willingness of state officials to challenge board action they perceive as placing charitable assets at risk; (2) the specific type of board conduct that may attract regulatory inquiry; and (3) the breadth of relief (including governance reforms) potentially available to state charity officials to correct problematic practices.

The *Stevens* case is directly relevant to nonprofit hospitals and health systems because it involved a sophisticated nonprofit corporation recognized as income tax exempt under IRC Sec. 501(c)(3). Furthermore, the Attorney General acted under the authority of statutes equally applicable to nonprofit healthcare corporations—the state nonprofit corporation act and the Uniform Management of Institutional Funds Act (UMIFA). Indeed, the Attorney General specifically intends that the new governance format is to serve as a model for other nonprofit organizations.

Case Background

The Attorney General's September complaint was the by-product of a three-year state investigation of the university's financial practices. The complaint was based upon multiple allegations of breach of multiple fiduciary duties and of the UMIFA duty by the President, Board Chair, and other "insider" board members. Specific allegations included:

- Regular misstatements of the nonprofit's financial reports;
- "Grossly negligent" internal control and accounting practices;
- Failure to correct related internal control weakness despite repeated warnings by the nonprofit's auditors;
- Violation of board-approved spending rates;
- Excessive borrowing practices beyond organizational authority;
- Invasion of restricted assets and collateralizing endowments;
- Use of gifts and bequests to satisfy operating expenses;
- Violating donor-imposed restrictions;
- Failure to monitor and diversify the organization's endowment portfolio; and
- Approving payment of excessive amounts of compensation to the university President.

The Settlement

By the January 15 "Consent Judgment," Stevens agrees to accept a series of "sweeping" governance changes affecting the composition and structure of its board and committee practices. Further, the President agreed to resign, but will remain compensated consistent with existing employment, consulting, and non-compete periods for set periods of time. Among the most notable of the governance reforms include the following:

- *Executive Committee.* The Executive Committee is to be reconstituted as solely an advisory body, with no power or authority to act on behalf or in the name of the board.
- *Full Board Powers.* The full board of directors is to be extended exclusive power and authority to take action on a wide variety of financial, operational, and compliance matters, including certain of those that normally would be exercised by committees with board designated powers.
- *Audit Committees.* The Audit Committee charter will be revised to provide it with more complete oversight of the nonprofit's financial affairs. The revised charter will charge the Committee with the responsibility (among other powers) for reviewing the Form 990 and for conducting an annual audit of all expenses of the President and of the other five most highly compensated Stevens employees. The Committee is to engage a professional with appropriate financial expertise to serve as both a trustee and as Committee chair.
- *Roles of Chair, Vice Chair.* Neither the Chair, Vice Chair, nor any member of the Executive Committee may serve as the Chair or Vice Chair of any committee or subcommittee (other than the Executive Committee). Further, the President may

not serve as a voting member of the board but may participate in board and committee meetings in a non-voting capacity.

- *Term Limits.* There is to be a maximum 15-year term for the Chairman and Vice Chairman of the board (with a two-year “stand down” provision). In addition, any trustee having served 12 years on the board and having reached the age of 72 will no longer be eligible to serve as a voting member of the board committee member. The terms of committee members and chairs will be limited to four years (with a two-year “stand down”).
- *Special Counsel.* A former New Jersey Supreme Court Chief Justice is to be retained as Special Counsel for a two-year period to insure Stevens’ implementation of the governance reforms, with specified rights and powers. Other consultants are to be retained to address governance, executive compensation, and finance controls.
- *Other Committee Matters.* New chairs are to be appointed for each of the Audit, Human Resources, Investment, and Nominating and Governance committees. The charters of these committees are to be revised to clarify their responsibilities.
- *Transparency.* All financial statements, credit rating agency reports, annual budgets, investment performance, and key governance documents are to be posted on the corporate website.
- *Loans.* The corporation will no longer extend loans to any officer nor will it act as a guarantor for loans to any officer. It will also assure that the President’s outstanding mortgage to the corporation will be satisfied in full within a certain time period.
- *Investment and Donor Matters.* In addition to revising the charter of the Investment Committee, the Board shall conduct a limited audit of certain restricted assets, and will adopt both a “Donor’s Bill of Rights” and “Gift Acceptance Policy.”

Lessons Learned

The Attorney General describes the new *Stevens* governance reforms as “best in class.” Without challenging that perspective, it is clear that the comprehensive consent judgment and the overall controversy offers several important governance lessons to nonprofit hospitals and health systems:

- Concentration of governance authority in a small group of board members/officers is problematic.
- Excessive authority exercised by the Executive Committee may inappropriately limit the rights and powers of the full governing board.
- Compliance with state laws regarding management of institutional funds (e.g., UMIFA or UPMIFA) should be a board priority.

- Audit Committees—and the full board—must demonstrate responsiveness to the Management Letter issued (and other concerns expressed) by the nonprofit’s independent auditor.
- The nominating committee should consider sensible term limits on board, committee, and chair positions that appropriately balance the value of institutional knowledge with the importance of turnover and fresh, independent perspectives.
- The concept of a state-appointed “special monitor” or “special counsel” of a nonprofit organization may prove an increasingly accepted option for state charity officials to assure compliance with mandated governance reforms by the nonprofit.

The Stevens Institute controversy is a reminder to nonprofit hospitals and health systems that state charity officials will take action when certain governance practices are perceived as placing charitable assets at risk. Taken together with the recently released Internal Revenue Service Examination Guidelines, they provide nonprofit counsel with practical guidance on what may constitute corporate governance “red flags” to regulators.

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