LLB&L Client Alert

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Did Attorney General Establish New Standards for Nonprofit Governance?

Stevens Institute of Technology Settlement Agreement

In September 2009, the New Jersey Attorney General sued the Stevens Institute of Technology ("Stevens"), its president and chairman of the Board of Trustees alleging multiple acts of misconduct, breach of fiduciary duties and negligence on the part of the president and chairman of the Board and Trustees. These allegations included excessive compensation, an illegal loan to the president, violation of donor restrictions, negligent internal controls and accounting practices, an illegal pledge of the endowment as collateral, expenditures in excess of Board approved spending rates, use of gifts and bequests to pay operating expenses, and many other egregious practices. The Attorney General alleged that the Board's failure to perform its oversight function was due in part to poor governance practices. The school settled this case in January 2010, at great expense and agreed to adopt many changes to its governance practices, committee structure, charter, bylaws, and operating practices.

Among the governance changes agreed to were:

Power of the Board and Executive Committee

The Executive Committee was stripped of its power to act or approve any matter on behalf of the Board or Stevens and will be advisory only. No member of the Executive Committee may chair or co-chair any committee.

The entire Board has the exclusive power or is obligated to:

- Approve the contract and annual compensation of the president;
- Approve the salary of the five other employees with the highest annual compensation;
- Review all financial results at each Board meeting;
- Approve the annual budget, any change to the spending rates of the general endowment and any amendments to the Investment Policy of the endowment;
- Review the annual IRS Form 990 submission;
- Meet with the external auditor annually, review the internal control letters of the external auditor, any material weaknesses and significant control deficiencies identified by the external auditor;
- Review the performance and asset allocation of the endowment annually;
- Establish an orientation and education program for new Trustees;
- Prepare annual assessments of committees and Board performance;
- Elect Chairperson, Vice-Chairpersons, committee members, committee chairs, new Trustees and Emeritus Trustees based on the recommendation of the Nominating and Governance Committee; and
- Meet in executive session at each Board meeting.

Committees

There were a number of changes to committee governance including:

- All committees must include at least four Trustees and two faculty members;
- Committee members' terms are limited to four years. A rotation shall be accomplished by one Trustee leaving the committee each year and one faculty member leaving the committee every two years. Initial terms

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may be adjusted in order to establish the annual rotation;

- Committee chairs' terms are limited to terms of four years, except when the chair is a non-Trustee professional;
- Committee chairs may be re-elected two years after the end of a term;
- Committee members may rejoin a committee after two years;
- Subject to Board approval, committees must prepare and adopt charters detailing responsibilities, meeting requirements, duties, membership, and other issues consistent with the settlement agreement;
- Committees must complete self-evaluation reviews at least every two years;
- Committees must prepare complete, detailed and accurate minutes for each committee meeting and all sub-committees and submit them to the entire Board at its next meeting or within the time required under New Jersey law; and
- In the event of any unresolved dispute between a majority of Trustees on a committee and a Trustee who was engaged or compensated to serve on that committee due to his or her expertise, the dispute shall be submitted to the entire Board for a vote.

The settlement also provides for specific tasks to be set forth in the charters of the Audit Committee, Human Resources and Compensation Committee, Nominating and Governance Committee and Investment Committee.

Term Limits

Any Trustee reaching the age of 72 and who has served 12 years becomes a nonvoting "Trustee Emeritus." The Chairman and Vice-Chairman of the Board are limited to a maximum 15-year term. A Trustee can serve again in either position after a two-year break.

Consultants

The Board is also required to hire a nationally recognized board governance consultant to recommend other changes appropriate to achieve best practices. Stevens had retained a special counsel and was required to continue to retain him for at least 24 months to ensure compliance with the settlement agreement, and provide periodic reports to the Board on Stevens' compliance with the settlement agreement. The Audit Committee is required to hire an Audit Committee consultant, with appropriate financial expertise, to serve as chair of the Audit Committee and to review and oversee the Committee's and Office of Finance's processes and procedures. The Compensation and Human Resources Committee is required to hire an independent compensation consultant to advise the Board on establishing a peer group and compensation policy, including performance metrics for the president and top five officers. The Investment Committee is also required to hire a non-trustee professional advisor to assist in proper asset allocation target and investment policy and to evaluate outside portfolio managers' performance.

Transparency

Stevens is required to post its consolidated financial statements, credit rating agencies' reports, Form 990s, annual budgets, endowment investment portfolio's performance, periodic reports of the special counsel on compliance with the settlement agreement and key governance documents on its website.

Other

- Stevens' bylaws must provide that the president shall not be a voting member of the Board but may participate in Board and committee meetings;
- No executive committee member (including the Chair and Vice-Chairman) may serve as chair of any committee or sub-committee (other than the Executive Committee);
- Stevens must hire an in-house counsel with duties comparable to those at other institutions; and
- The Board must approve both a Donors Bill of Rights (which must be posted on the website and include the pledges included in the Donors' Bill of Rights of the Council for Advancement and Support of Education) and a Gift Acceptance Policy.

Analysis

Although the lack of Board oversight at Stevens certainly justifies many of the practices required in the settlement, some of these changes raise issues as to whether they are best practices recognized in for profit and nonprofit Board rooms. The Executive Committee is emasculated because it is advisory only, and when emergencies arise between Board meetings, there can be problems organizing a full Board vote quickly. Also, many executive committees are composed of chairs of the various committees, but in Stevens' case, chairs of committees cannot serve on the Executive Committee.

Requiring two faculty members who are not trustees to serve on all committees (with at least four trustees) expands the influence of the faculty beyond that normally seen in private colleges. Although there are valid differences of opinions on whether the CEO of a non-

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profit should serve as a trustee, it may be difficult to recruit a president in the future that would accept this limitation.

By having a paid financial expert chair the Audit Committee, Stevens will not have a completely independent audit committee, which is a typical best practice. Over 70 percent of nonprofit boards included in the 2008 Nonprofit Governance Survey of the National Association of Corporate Directors had completely independent audit committees.

Attorney generals take their jobs policing nonprofit governance very seriously, and as shown in the Stevens case, wil not hesitate to flex their governance muscles. Nonprofits are well advised to extend their review of governance practices beyond those required by the recent changes in the IRS Form 990 to a much broader analysis.

About the Author

Kay W. McCurdy is a partner at Locke Lord. Ms. McCurdy co-chairs the Nonprofit Practice Group. She applies more than 30 years of experience to the general corporate and finance areas, focusing on representation of lending institutions and borrowers in a variety of transactions, mergers and acquisitions, executive compensation and corporate governance issues, securities offerings and nonprofit organizations.

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