UNIVERSITY GOVERNANCE AFTER PENN STATE

In November of 2011, the grand jury indictment of former Penn State football coach Jerry Sandusky on charges of child sex abuse ignited the most prominent university scandal in recent memory. Former federal judge and FBI Director Louis Freeh conducted a full-scale investigation of the incident after allegations surfaced of a university-wide cover up. Freeh's final report laid much of the blame at the feet of the board of trustees, finding that the board had "failed to exercise its oversight and reasonable inquiry responsibilities."

As a crisis of university governance, Penn State should serve as the proverbial wake up call for university boards of trustees. Traditionally, university trustee positions have been filled with political friends of the governor and big donors to the university. As a result, the boards of many universities have more closely resembled booster clubs than boards of directors, with many trustees lacking prior corporate governance experience. But increasingly universities are billion dollar institutions with athletic programs producing large television contracts, "star athletes" and the piercing glare of the media. With this additional attention comes increased scrutiny of the board's fiduciary role. From the scandal at Penn State to controversies at Rutgers, Florida A&M, USC, Ohio State, the University of Illinois, and other institutions, boards of trustees are being increasingly called to answer when a scandal erupts.

While running a business is very different from running a large public university that is subject to public records laws and public opinion, university trustees can nonetheless draw on best practices from the corporate world to prevent these kinds of scandals from happening in the first place. A university board—just like any corporate board—has to be focused on its product and its reputation. In this context the product is the student and academic achievement. Unlike corporate boards, universities don't have shareholders and consequently are not focused on increasing shareholder value. However, universities do have stakeholders whose investment in the institution will determine its continued success. A combination of public and private investors expect a strong return on investment. In 2009, for example, the New Jersey Attorney General brought suit against the board of trustees of the Stevens Institute of Technology alleging various fiduciary breaches by the board, including misuse of assets, failure to monitor, and awarding excessive compensation to the university president. The parties ultimately settled, with Stevens agreeing to implement large scale governance changes.

As a prior university trustee for two universities, I know that often times board meetings are just something the staff want to get through. Meetings are filled with voluminous reports in university speak and the agenda is tight, often leaving little room for substantive discussions. According to the Freeh Report, for example, Penn State trustees reported that their meetings felt "scripted" and that they were simply "rubber stamping" major decisions already made by the president and a small group of trustees. Moreover, the board did not have committees on risk, audit, governance, or academic affairs prior to the Sandusky debacle. This provided the basis for the Report's finding that the Board had "failed to exercise its oversight and reasonable inquiry responsibilities" and had not created a "'Tone at the Top' environment wherein Sandusky and other senior University officials believed they were accountable to it." The Report concluded that the Board had breached the fiduciary duty of due care imposed under Pennsylvania state law by

failing to exercise these oversight responsibilities. Interestingly, the Report cites a landmark corporate law decision, *In re Caremark International Derivative Litigation*, 698 A.2d 959 (Del. Ch. 1996) as articulating the standard of care that the trustees failed to meet. Under this standard, "a sustained or systematic failure of the board to exercise oversight—such as an utter failure to attempt to assure a reasonable information and reporting system exists—will establish the lack of good faith that is a necessary condition to [director] liability." *Caremark*, 698 A.2d at 971.

Why is this important for university governance? More then half the states, including Pennsylvania, have adopted the American Bar Association's Model Nonprofit Corporations Act, which imposes the same duties of loyalty, due care and good faith on nonprofit trustees as their for-profit counterparts. Consequently, Judge Freeh's determination of a complete lack of oversight and fiduciary duty could have personal liability implications for any trustee facing a lawsuit arising out of the scandal.

So how can trustees best protect themselves and their university? Fortunately, the business judgment rule is alive and well. The business judgment rule presumes that in making a business decision the directors of a corporation acted on an informed basis, in good faith and in the honest belief that the action taken was in the best interests of the company. Absent an abuse of discretion, the courts will respect that judgment. University trustees should remember three key things to ensure that their decisions enjoy the protection of the business judgment rule:

1. **Accountability.** The right "tone at the top" ensures accountability. The board supervises the president, not the other way around. The tone from the board needs to set clear expectations for the president, drive the agenda and create, in consultation with the president, measurable action plans. One glaring issue that emerged from the Freeh Report was the extent to which the president felt comfortable keeping information from the board. The tone, according to the Report, was that what was most important was the reputation of the football program, a kind of "football first" mentality that made the program and its coach untouchable. Consequently when red flags were raised no one felt compelled to take information to the board. The right tone recognizes that the ultimate power for university governance is the board.

2. **Information.** Good information *systems* lead to good decisions. Nearly every major university scandal of the past twenty years has followed the same pattern: A scandal occurs, an investigation reveals a lack of compliance and oversight systems, and the university overhauls its monitoring systems after the fact. University boards should be proactive in instituting these types of information systems *before* problems have a chance to develop. The business judgment rule focuses on process: Do the trustees have good information reporting systems in place to allow the board to make informed decisions? Is the board focused on the right things—academic standards, compliance, balance sheet goals and business performance? *Caremark* is still the standard. Trustees will not be held liable if they can demonstrate good corporate monitoring systems, with opportunity for informed decision making by the board, and demonstrated board oversight of those systems.

3. **Leadership.** Trustees are fiduciaries, not boosters. While taking a strong interest in the success of a university's athletic and academic programs can be beneficial, trustees should remember that they are fiduciaries first and foremost, with a legal obligation to act on an informed basis, in good faith and in the honest belief that the actions they take are in the best interests of the university. In every university scandal, the question arises of what the board knew or should have known. To avoid allegations of inattentiveness, boards should focus on documenting process, with identification of important issues the board is monitoring and the level of discussion and direction that the board engages in. Those areas where there is heightened risk should have regular reports to the board with the opportunity for substantive feedback from board members. Board action should not just be an executive committee function or a "rubber stamp" of the administration's decisions. If the board uses a consent agenda, the minutes should reflect an opportunity for any member to remove an item from the consent agenda for further discussion. Board members should come to meetings having read the materials. Members should take and maintain copious notes. The agenda should leave time for discussing important topics.

One more thing, board members should put the smart phones down and direct their full attention to the board meeting. A colleague I once served with on a corporate board said "if you wouldn't take out a newspaper and read it during the meeting, don't take out your phone."

With the rapid expansion of institutions of higher education and increased scrutiny of university leadership, good university governance is more important now than ever before. By understanding the legal landscape and borrowing best practices from corporate governance, university boards can minimize risk and better arm themselves to navigate the challenges ahead.

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