

Chapter III

ENDOWMENT MANAGEMENT AND TRUSTEE DUTIES

Overview

Recent disclosures surrounding the United Way of America and the various business arrangements of its president caused reduced gift giving to the organization. A president of a major university gained notoriety when he was questioned about the stock he received at the time of the sale of the university's investment. Staff, faculty, and alumni questioned legal fees paid to a law firm operated by a college trustee who also involved another board member in legal work. Boards are raising questions about construction contracts awarded to companies owned by or in which members possess a substantial interest.

Application

DUTIES OF CARE AND LOYALTY

Challenges to such self-dealing and mismanagement are governed by a standard of care applied to the twin trustee obligations:

duty of care and duty of loyalty. A duty of care requires trustees to exercise reasonable judgment on actions taken by the board and to provide oversight of the college. The duty of loyalty requires trustees to place their allegiance to the college first and thereby refrain from entering into unfair, undisclosed conflict situations or self-dealing ventures.

Colleges are major businesses in their communities and some college endowments are in excess of a billion dollars. Efforts to maximize endowment dollars have led institutions to invest in unchartered areas such as emerging technology and entrepreneurial businesses. College and university trustees accordingly are presented opportunities: to engage in self-dealing; to take advantage of “insider” information; and to get so close to the chief executive that the trustees no longer really govern the institution. These activities seriously jeopardize the reputation of colleges and their trustees.

Standard of Care

The standard of care has developed through case law and legislative actions. For nonprofit corporations, the trend is the adoption of a standard--similar to that of a profit corporation--requiring directors to exercise ordinary and reasonable care and to exhibit honesty and good faith in the discharge of their duties. Nonetheless, because of the lack of legislation in some states and the paucity of judicial decisions, some uncertainty remains.

In a landmark decision in 1974, Judge Gerhard Gesell exhaustively reviewed the responsibility of trustees of charitable institutions and fashioned useful guidelines. (*Stern v. Lucy Webb Hayes National Training School, 1974*)

At issue was the performance of the trustees at Sibley Memorial Hospital, established by the Lucy Webb Hayes National Training School for Deaconesses and Missionaries, a charitable institution incorporated in Washington, D.C. The plaintiffs, hospital users, challenged various aspects of the hospital’s fiscal management, and named as defendants, among others, specified members of the hospital board of trustees.

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According to the hospital's bylaws, revised in 1960, the board of trustees was to meet twice a year. In the interim period, an executive committee was to represent the board and to provide guidance necessary to supervise the day-to-day operations of the hospital. Finance and investment committees were charged with specific budget and investment management responsibility.

Two trustees, who also served as hospital administrator and treasurer, dominated the board. The executive committee routinely accepted the recommendations of the two trustees and ratified their actions. The finance and investment committees failed to meet or to transact any business until 1971, although they had been established in 1960.

The plaintiffs alleged that the trustees had conspired to enrich themselves and certain banking institutions with which the trustees were affiliated by placing hospital funds in low-or-non-interest bearing accounts. The plaintiffs further alleged that the trustees breached the fiduciary duties of care and loyalty in the management of the hospital's funds by mismanagement, nonmanagement, and self-dealing.

With the exception of the hospital administrator and the treasurer, the trustees were not involved in the management of the hospital. In fact, the board treated as a mere formality its responsibility to review annual audits. Similarly treated was the executive committee's responsibility in approving the opening of new accounts in banking institutions. All of the trustees testified that they had accepted the recommendations of the treasurer as a matter of course and rarely had they read the details of the audits.

Having found the conspiracy allegation groundless, the court reasoned that the trend is to apply corporate rather than trust principles in determining the liability of trustees of a charitable corporation. The court applied corporate principles to the three areas in which a breach of duty was alleged: mismanagement, nonmanagement, and self-dealing.

Mismanagement

What standards of care should be applied in a finding of

mismanagement? Said the court: “A trustee is uniformly held to a high standard of care and will be held liable for simple negligence, while a director must often have committed ‘gross negligence’ or otherwise be guilty of more than mere mistakes of judgment.”

Judge Gesell agreed that since board members of most large charitable corporations fell within the corporate rather than the trust model, they should be held to the less-stringent corporate standard of care: “More specifically, directors of charitable corporations are required to exercise ordinary and reasonable care in the performance of their duties, exhibiting honesty and good faith.”

Nonmanagement

Regarding the issues of delegation of authority and supervision, the court held:

Once again, the rule for charitable corporations is closer to the traditional corporate rule: directors should at least be permitted to delegate investment decisions to a committee of board members, so long as all directors assume the responsibility for supervising such committees by periodically scrutinizing their work.

A director should acquire information required to supervise investment policy and should attend meetings for consideration of policy. Further, a director “whose failure to supervise permits negligent mismanagement by others to go unchecked has committed an independent wrong against the corporation....”

Self-Dealing

In response to the allegation of self-dealing, the court noted that trustees were held to a higher standard than were directors of corporations:

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Trustees may be found guilty of a breach of trust even for mere negligence in the maintenance of accounts in banks with which they are associated...while corporate directors are generally only required to show 'entire fairness' to the corporation and 'full disclosure' of the potential conflict of interest to the Board.

The less-stringent corporate rule is applicable to the charitable corporation.

Corrective Action

Although the plaintiff sought a wide range of remedies, including removal of certain trustees and damages, the court's concern was primarily corrective. The court took note of the fact that in the period following the filing of the suit, the board had undertaken remedial measures.

To prevent a recurrence of the situation, the court established specific steps and duties to be followed by the hospital, its auditors, treasurer, and board of trustees. The court required the board to develop written investment policies and to review the hospital investments; board members must fully disclose their affiliations and maintain a current disclosure statement; the auditors must report on the investment firms with which the hospital conducted business and report these transactions to the board; and finally, trustees must read the judge's opinion.

TRUSTEE REMOVAL

An extraordinary decision by a Pennsylvania court to reverse a decision by the Wilson College Board of Trustees to close the women's college raised anew the issue of the standard of care to which a trustee is held responsible in managing an institution. (*Zehner v. Alexander*, 1979)

Judges are often reluctant to substitute their judgment in areas that are proper matters of academic and administrative discretion. Yet the judge in this case found that in closing the college the trustees had “acted precipitously without sufficient or valid information and consequently irresponsibly.” The court decision was not without its detractors. It was a flagrant example of “judicial overkill,” editorialized a highly respected education magazine.

In the Wilson College case, the petitioners were not seeking recovery of losses, but were seeking 1) reversal of the decision by the board of trustees to close the college; 2) removal of all trustees; 3) appointment of new trustees; and 4) continuing supervision of the college by the court. The petitioners included three alumnae, a member of the board of trustees, a faculty member, and five students. The plaintiffs sued each member of the board of trustees and the president of the college, hired in 1975, who served as an ex-officio member of the board.

Although certain aspects of the case are governed by Pennsylvania law and judicial procedure, the decision is instructive for colleges chartered in other states. The Pennsylvania Nonprofit Corporation Law provides that trustees must act with good faith and with the highest fidelity. Moreover, the statute, as interpreted by the courts, required court approval before any property committed to charitable purposes could be diverted from the original purpose for which the property was donated. Another section of the statute provided for the removal of directors for fraudulent or dishonest acts, gross abuse of authority or discretion or for any other proper cause.

After an exhaustive review of the five-year history of enrollment, management and financial difficulties of the college, the judge found that the trustees had been misled by the president, had permitted mismanagement of the institution especially in the critical admissions program, and had failed to bring their expertise to the board. The judge’s critical assessment of the college admission program appears to be intruding into internal decisions of the administration and not addressing decisions of the board.

Removal of Certain Trustees

The court found that the trustees had exceeded their authority by taking actions to close the college. Boards do have the authority to make decisions to close institutions, but under Pennsylvania statutes, boards are required to seek court approval first. In a *cy pres* proceeding—applicable in other states as well as Pennsylvania—the court must be convinced that it is either impractical or impossible to fulfill the purpose of the institution. The trustees were advised by their legal counsel that court approval of closure was not required in February and, hence, did not actually file for court approval until May.

The court found that the board had erroneously begun to implement a decision to close—by formally announcing closure and by deciding to establish the Wilson College Foundation to aid the higher education of women—before seeking court approval. Moreover, the notice to close had substantially damaged the college's maintenance of the student body, the recruitment of the incoming class, and the college's ongoing academic and financial integrity. The court found further that the college was not bankrupt. For all of these reasons the court enjoined the closing of the college.

Although the judge found the trustees' action censurable, he did not grant the petitioners' request to remove all of the trustees. He did, however, order removal of two of the trustees, one of whom was President Waggoner. The judge does not draw a sharp distinction between President Waggoner's performance as president and her performance as trustee. The court has no authority to dismiss a college president—dismissal is a board prerogative. He apparently, however, supports his removal decision on the fact that she misled the board regarding the condition of the college and hence had failed to provide leadership in her role as trustee *ex-officio*.

In addition, he ordered the removal from the board, the president of Bryn Mawr College. As president of Bryn Mawr, a college which competed for students in the same geographical

area, she had, according to the judge, an irreconcilable conflict of interest. Secondly, as president of an eminent institution, she possessed an expertise which she should have brought to the board at Wilson College. The law requires, said the court, trustees to bring to the board “that expertise which can reasonably be expected considering their training, experience and background.” Thus she had failed to exercise her recognized expertise as a director.

Following the court’s decision to keep the college open, the parties negotiated a consent decree which provided for the resignation of a majority of the trustees and the selection of their replacements with the cooperation of the petitioners to the action. The decision was unreported, and following the consent decree, was not appealed. Wilson College is open today.

STANDARD OF CARE AND CORPORATE REORGANIZATION

In a more recent challenge to a corporate reorganization, a district attorney, three former trustees, a former professor and an organization consisting of alumni and donors challenged the decision of Mercer University to close Tift College. (*Corporation of Mercer v. Smith*, 1988) This decision by Mercer was made after Mercer and Tift merged in 1986, due to Tift’s serious financial problems triggered by a decline in enrollment, student attrition, and loss of outside contracts. Subsequently, the Mercer Board of Trustees voted to close Tift.

The lower court sustained the challenge by holding that the standard of care applied to the trustees’ closure decision was a trust standard and therefore, under Georgia law, Mercer could not close the college without the approval of the court. The lower court also found that Tift trustees had failed to exercise proper care in voting for the merger, under the higher standard applied to the duty of care of trustees.

On appeal, the Supreme Court of Georgia sustained Mercer and ruled that the appropriate standard of care applied to trustees

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of a college, i.e. a charitable institution, was the corporate standard and not the trust standard. As the court stated:

The formalities of trust law are inappropriate to the administration of colleges and universities which, in this era, operate as businesses. These institutions hold a wide variety of assets, and those persons responsible for the operation of the institutions need the administrative flexibility to make the many day to day decisions affecting the operation of the institution, including those decisions involving the acquisition and sale of assets.

Accordingly, the Georgia Supreme Court ruled that Mercer could close Tift College without court approval.

COLLECTIVE NEGLIGENCE

Several Mannes College of Music “dissenting trustees” and faculty members filed a petition in 1978 with the Board of Regents of the University of the State of New York to remove the trustees of the college. The Regents possess authority under New York law to remove trustees, for “misconduct, incapacity, neglect of duty,” or when the corporation has “failed or refuses to carry into effect its educational purposes.”

In essence, the petition stated that members of the Mannes College of Music board of trustees failed to consult with the faculty as required by faculty policies in connection with a potential merger of the institution; issued terminal contracts to faculty that caused a substantial alteration of the curriculum to the detriment of the college; failed to disclose critical financial information to the faculty; and, in general, failed to exercise their management responsibilities.

A committee of the Board of Regents concluded that while the conduct of the trustees did not reach the level of “misconduct, incapacity or neglect of duty,” in regard to the financial condition of

the institution or in the failure to consult with faculty, the trustees breached their duty since they had permitted important decisions to be made without their critical oversight. The report concludes:

This committee is led to the reluctant but unanimous and inescapable conclusion that the Mannes College board of trustees has, during the past year, demonstrated with respect to certain critical matters a collective neglect which is appalling.

This board of trustees has permitted the acting president to take actions which have had the effect of completely eliminating a major department of the College and decimating a second department, thereby profoundly changing the character of the institution, with no formal authorization by the trustees, with no reasoned consideration by the trustees of the desirability of those changes in the basic curriculum, and with no consultation with the faculty.

The Regents committee recommended that the entire board of trustees, including the dissenting trustees, be removed from office. In May, 1979, the Board of Regents accepted the report of its hearing committee, removed the trustees, and appointed a new board.

STATE LAWS

State statutes generally establish specific standards for the duties of care and loyalty and for making investment decisions. For example, the Model Nonprofit Act provides that trustees must act “in good faith with the care an ordinarily prudent person in a like position would exercise under similar circumstances [and] in a manner the director reasonably believes to be in the best interests”

of the college. Further the statute provides that trustees are entitled to rely on designated experts such as auditors, legal counsel, and employees of the college if the director reasonably believes that the individual is “reliable and competent in the matters presented.”

Investment standards are established in the Uniform Management of Institutional Funds Act, a model act adopted in many states. It provides that investment decisions may be delegated and that in making investment decisions the board should “exercise ordinary business care and prudence under the facts and circumstances prevailing at the time of the action or decision.” The standards have been reproduced in Appendix 6.

State laws may also address the personal liability of trustees by providing exemption from liability under specified conditions. One such state law provides that directors and trustees of nonprofit corporations shall be immune from suit arising from the conduct of their affairs, however, such immunity from suit shall be removed when the conduct amounts to “willful, wanton, or gross negligence.”

POLICY DEVELOPMENT

Colleges must develop policies on conflicts of interest and self-dealing. Many college bylaws contain such policies, although they may not be adequately followed.

In developing an appropriate policy, a board of trustees should first check the state law in which the institution is incorporated or organized. Some states have a statutory definition of conflict of interest and what constitutes a transaction with an interested director or trustee. Case law should also be analyzed to ensure that the board policy meets both statutory and judicial requirements.

The basic principle is that a conflict must be disclosed. If the conflict is not disclosed, a transaction involving a conflict may not withstand legal attack.

A policy should define transactions that constitute a conflict. The policy should require disclosure of the precise nature of the board member’s or the family members’ interest in the transaction.

The policy should state the process by which such potential conflicts are reviewed. At a minimum, the policy should specify the manner of taking a vote when a potential conflict is present and how the vote is to be counted. For example, the policy could require that in any vote involving a conflict, the trustee involved should refrain from voting even though the trustee may be counted to determine if a quorum is present. The individual trustee, even if not required by the policy or bylaw, should make an effort to have the conflict noted in the minutes of the meeting. The minutes should also reflect the fact that the trustee refrained from voting.

The policy can range from a short statement to a detailed written document defining the various types of conflicts and requiring periodic completion of a conflicts questionnaire. The Association of Governing Boards has drafted a model bylaw for conflicts of interest, and has formulated a conflict policy and sample record form to be used by institutions.

Preventive Planning

The principle is clear that trustees must give full and reasoned consideration to questions of policy, must provide oversight and scrutiny to recommendations, and must develop a business-like relationship to the chief executive officer and to business transactions involving that person. Trustees are entitled to rely on recommendations that are reasonable, however, the trustee must make those assessments based on the trustee's particular skills and competence. Trustees must disclose potential conflict situations.

The most likely consequence of improper oversight or self-dealing is a challenge that could lead to removal of the trustees. There is, however, potential liability if the trustees do not act with good faith and reasonable judgment. Further, mismanagement and self-dealing allegations cause significant harm to board members and to the college or university.

A number of cases are triggered by the adamancy of college constituencies such as college faculty and alumni over their

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concerns about the management of the institution and reorganization decisions adopted by the trustees. Faculty may challenge board decisions when those decisions adversely affect them and when they believe the board has mismanaged the institution.

As with college and university trustees, directors of profit corporations are increasingly attuned to the need for “due diligence” and the requirement that “disinterested trustees” make significant corporate decisions. These actions help insulate corporate directors from liability and challenges.

The modern day college and university are community assets; they require quality governance by trustees who carefully and thoroughly carry out their duties of care and loyalty.

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