

COMMENT

Student Derivative Lawsuits

On October 10, 2005, the American University Board of Trustees announced that it had removed University President Benjamin Ladner.¹ The board had suspended Ladner in August, several months after receiving an anonymous tip that he had been charging most of his personal expenses to the University for years.² Despite his extensive misconduct,³ the Board allowed Ladner to resign and collect a \$3.7 million severance package.⁴ Why did the Board of Trustees take so long to remove a president found to have flagrantly misused University funds, and then send him off with a golden parachute? The shocking answer appears to be that few of the trustees actually knew what the terms of Ladner's employment contract permitted, and thus most were unsure whether Ladner had even acted improperly.⁵

In this Comment, I argue that states could help avert financial scandals like the one at American University by adopting rules less protective of university boards. Specifically, I propose that states subject all nonprofit university boards to the same fiduciary standards as corporate boards and empower enrolled students to oversee their university boards. Part I addresses the current law concerning university oversight. Part II briefly discusses the responsibilities of

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1. See Memorandum from Cornelius Kerwin, Acting President, Am. Univ., to Campus Community (Oct. 19, 2005), <http://www.american.edu/president/statements/101005.html>.
 2. Michael Janofsky, *American U. Dismisses Its President over Spending*, N.Y. TIMES, Oct. 11, 2005, at A14.
 3. The Board determined that Ladner should reimburse American for \$125,000 of expenses, and that he should have to report an additional \$308,000 of income to the IRS. *Id.*
 4. See Michael Janofsky, *College Chief at American Agrees To Quit for Millions*, N.Y. TIMES, Oct. 26, 2005, at A20. Had the board terminated Ladner outright, he would not have been entitled to any severance package. *Id.*
 5. See Janofsky, *supra* note 2 (“[M]any trustees admitted that they knew no details of Mr. Ladner’s 1997 contract.”).

corporate directors, with an eye toward how the American University trustees' behavior would be analyzed in the corporate context. After concluding that the American University trustees might well be found to have violated their fiduciary duties under corporate standards, I describe my proposal regarding enforcement of corporate oversight standards on university boards in Part III.

I. THE LAW GOVERNING UNIVERSITY BOARDS

Universities can be organized under a variety of different forms, and the oversight regime imposed on universities largely depends on the form of organization chosen. I focus on one common organizational form for nonprofit universities⁶: the nonprofit corporation.⁷

Forty-eight states have a statute specifically designed to address formation and governance of nonprofit corporations.⁸ Like a corporation, nonprofits formed under those statutes have boards charged with managing the organizations' affairs.⁹ Unlike for-profit corporations, nonprofits may—but are not required to—have “members,” who elect the board.¹⁰ Insofar as the members choose the board, they are analogous to shareholders of a corporation. But unlike shareholders of a corporation, members do not have an equity stake.

Most jurisdictions subject directors of nonprofit corporations to the same fiduciary standards that apply to directors of for-profit corporations. The District Court for the District of Columbia reached this result in the much-

6. About twenty percent of university students attend nonprofit institutions. See MARION R. FREMONT-SMITH, *GOVERNING NONPROFIT ORGANIZATIONS: FEDERAL AND STATE LAW AND REGULATION* 10 (2004). These nonprofits compete with for-profit institutions and universities formed under state constitutions, which largely operate under boards of regents. The meetings of these boards are often open to the public, obviating the proposal I put forth in this Comment. As such, I limit my discussion to nonprofit universities.

7. The other common form is the charitable trust. Courts have generally held that substantially the same (stringent) principles apply to charitable trusts as apply to private trusts. See RESTATEMENT (SECOND) OF TRUSTS § 379 (1959). While my proposal could—with some tweaks—also be applied to universities organized as charitable trusts, I focus on the nonprofit corporate form in this Comment.

8. This count is accurate as of January 1, 2003. Twenty-three of these states employ the Revised Model Nonprofit Corporation Act or a modified version of it. See FREMONT-SMITH, *supra* note 6, at 152.

9. REVISED MODEL NONPROFIT CORP. ACT § 8.01 (1987).

10. *Id.* § 6.03; see also *id.* §§ 6.01-22.

discussed *Sibley Hospital* case,¹¹ as did the Georgia Supreme Court in *Corporation of Mercer University v. Smith* in deciding whether the trustees of a university satisfied their fiduciary duties in deciding to close a college.¹² In both those cases, courts adopted the corporate rule in order to protect the board from the higher standards imposed on trustees.¹³ Within the next few years, New York and California codified the corporate fiduciary standard for nonprofit directors, and the Revised Model Nonprofit Corporation Act followed suit.¹⁴

The corporate standard is a protective one for directors because courts follow the business judgment rule, which largely shields directors from personal liability in making discretionary business decisions.¹⁵ The rule can be overcome, however, if a plaintiff shows that a director (1) acted in bad faith, (2) thought that the decision was contrary to the corporation's best interest, (3) was compromised by a conflict of interest, or (4) did not have enough information to make the decision in question.¹⁶ Under Delaware case law, this final requirement for business judgment protection imposes a duty on the board to set up a system of monitoring to provide it accurate and timely information about the corporation.¹⁷

Nonprofit corporations differ from their for-profit counterparts, however, in that fewer parties are allowed to police charitable boards. While the shareholders of for-profit companies have standing to sue for breaches of

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11. *Stern v. Lucy Webb Hayes Nat'l Training Sch. for Deaconesses & Missionaries*, 381 F. Supp. 1003 (D.D.C. 1974).
 12. 371 S.E.2d 858, 860-61 (Ga. 1988) (“[The] formalities of trust law are inappropriate to the administration of colleges and universities which, in this era, operate as businesses.”).
 13. *See, e.g., Stern*, 381 F. Supp. at 1013 (holding that the trustees of a charitable organization “should only be held to the less stringent corporate standard of care”); *Smith*, 371 S.E.2d at 861 (“[T]hose 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.”).
 14. *FREMONT-SMITH*, *supra* note 6, at 202.
 15. *See, e.g., Shlensky v. Wrigley*, 237 N.E.2d 776, 780 (Ill. App. Ct. 1968).
 16. *See* MODEL BUS. CORP. ACT § 8.31 (1984).
 17. *See In re Caremark Int'l Inc. Derivative Litig.*, 698 A.2d 959, 969 (Del. Ch. 1969). This duty has been supplemented by the Sarbanes-Oxley Act, which requires boards to produce annual reports disclosing internal control structures. *See* Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, § 404(a)(1), 116 Stat. 745, 789. While Sarbanes-Oxley generally does not apply to institutions of higher education, outside consultants and lawyers for boards of trustees have begun to advise that wholesale adoption of its requirements is now a “best practice.” Alexander E. Dreier, *Sarbanes-Oxley and College Accountability*, CHRON. HIGHER EDUC., July 8, 2005, at B10.

fiduciary duty, the stakeholders in nonprofit corporations generally do not.¹⁸ In fact, the state attorney general is normally the only person with standing to sue nonprofit directors for breaches of duty.¹⁹ But, as James Fishman has reported, “[s]taffing problems and a relative lack of interest in monitoring nonprofits make attorney general oversight more theoretical than deterrent.”²⁰ Indeed, only thirteen state attorneys general oversee full-time charity divisions.²¹

While certain states have granted standing to members, officers, or directors of nonprofit corporations,²² these measures have done little to increase effective policing. Members still have little incentive to sue—both because of the collective action problem and because they lack any direct monetary stake—and directors have strong disincentives against suing each other.²³ While Fishman has found that the strict standing requirements “occasionally have been relaxed in matters of public importance that relate to charities or where the plaintiffs have a special interest,” the strict standing requirements remain the rule.²⁴

II. APPLYING CORPORATE LAW PRINCIPLES TO THE UNIVERSITY

The Ladner incident and other high-profile nonprofit governance scandals demonstrate that the combination of strict standing requirements with lenient substantive fiduciary duties may allow boards of universities organized as nonprofit corporations to operate with too little judicial oversight. This Part examines how the logic of corporate law applies to universities, with an eye toward the American University trustees.

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18. James J. Fishman, *Improving Charitable Accountability*, 62 MD. L. REV. 218, 223 (2003)
 19. Neither the conceptual nor the practical justifications for limiting standing to sue nonprofit directors to the attorney general is particularly compelling. The conceptual justification for this policy is that the “beneficiaries” of a charity are actually nothing more than intermediaries through which a public objective is achieved. See *Hooker v. Edes Home*, 579 A.2d 608, 612 (D.C. 1990) (holding that the plaintiff has standing notwithstanding the fact that “the private beneficiary is the ‘conduit’ through which the broader community benefits flow”). The practical justification is that the beneficiaries of a charity constitute a quickly changing group of people; if every member of the group were given standing, the charity would be subject to an unnecessarily large amount of litigation. See Fishman, *supra* note 18, at 258.
 20. Fishman, *supra* note 18, at 262.
 21. *Id.*
 22. See, e.g., REVISED MODEL NONPROFIT CORP. ACT § 6.30 (1987).
 23. See Denise Ping Lee, *The Business Judgment Rule: Should It Protect Nonprofit Directors?*, 103 COLUM. L. REV. 925, 934 (2003).
 24. Fishman, *supra* note 18, at 253.

It is a fundamental tenet of corporate law that the corporation is run by, or under the direction of, the board,²⁵ which is largely shielded from liability by the business judgment rule. While the board is given broad authority and latitude, shareholders are in certain limited circumstances empowered to police boards of directors using shareholder derivative suits. Shareholder derivative suits developed as a mechanism by which principals (shareholders) could force their agents (the board members) to act in their best interests when the agents otherwise might not.²⁶ In order to balance shareholders' desire that the corporation pursue its legal claims with the requirement that the directorate must run the corporation, Delaware courts have required a stringent set of conditions to obtain in order to survive a board's motion to dismiss.²⁷

Before arguing that corporate law principles ought to apply more broadly to university boards, it is worth noting how corporate law's goals bear on universities. Corporate law responds to the firmly held belief that boards of companies are centers of wealth-creation that courts should be hesitant to meddle with.²⁸ The rationale for protecting board decisions with the business judgment rule is strong in the university context even though the decisions made by university boards are not concerned entirely with wealth-maximization.²⁹ To the extent that courts defer to directors' judgment because they fear that meddling in directors' decisions would lead to less wealth production, courts ought also fear that meddling with university boards would lead to an inferior charitable product. The logic behind the business judgment rule is that courts should defer to private actors who are better decisionmakers. Just as allowing corporate directors to exercise their business judgment recognizes that directors are more skilled than courts at maximizing returns to equity, deferring to university boards recognizes that those boards are especially well suited to providing university services to the community.

If corporate standards were applied wholesale to university boards, American University's board might well be liable for a breach of the duty of care if sued derivatively, despite the protections of the business judgment rule.

25. See MODEL BUS. CORP. ACT § 8.01(B) (2002); cf. REVISED MODEL NONPROFIT CORP. ACT § 8.01(b) (1987) (requiring all corporate powers of the nonprofit to be exercised by the board).

26. See *Aronson v. Lewis*, 473 A.2d 805, 811 (Del. 1984) ("The derivative action developed in equity to enable shareholders to sue in the corporation's name where those in control of the company refused to assert a claim belonging to it.").

27. For the complicated burden-shifting scheme now in place in Delaware, see *id.* at 811-17.

28. See Charles Hansen, *The ALI Corporate Governance Project: Of the Duty of Due Care and the Business Judgment Rule*, 41 BUS. LAW. 1237, 1239-40 (1986).

29. *But see Lee, supra*, note 23.

If the board had put in place a system for delivering accurate and timely information about the university to the board—as they are required to do under Delaware law—the board might have uncovered the president’s irregular expense account habits months or years before they were notified by anonymous letter. Indeed, Acting Chairman of the Board Thomas Gottschalk and Chair-Elect Gary Abramson have essentially admitted that the board failed to implement a system by which the board would be advised of the corporation’s operations.³⁰

While commentators have offered a number of explanations and possible fixes for scandals like the one at American University,³¹ I believe that a particularly promising and simple solution to such failures of nonprofit oversight—in the university context, at least—is to enable effective enforcement of corporate law standards that have already been developed in other contexts. I propose giving standing to an on-campus constituency to sue the board derivatively on behalf of the university. Like shareholder derivative suits, this mechanism could provide effective supervision (or at least the threat of it) and perhaps prevent future scandals at the nation’s universities.

III. A PROPOSAL TO IMPROVE OVERSIGHT

I propose that states enact statutes granting current university students standing to sue their boards of trustees derivatively. Like business shareholders, students would be barred from bringing individual lawsuits, but

30. Memorandum from Tom Gottschalk, Acting Chair, Bd. of Trustees, and Gary Abramson, Chair-Elect, Bd. of Trustees, Am. Univ., to the Am. Univ. Community (Oct. 27, 2005), <http://www.american.edu/trustees/statements/10272005.html> (“[T]he board’s own processes over the years did not allow us to have a clear understanding of what contracts were in place, their provisions, and the various forms of compensation which the president was receiving. . . . Had we been more vigilant and had more robust processes, the situation we have had to confront might never have occurred.”). On the other hand, it appears that the board did satisfy its fiduciary duty of care in deciding to provide Ladner a golden parachute. The letter describes the board’s decisionmaking process on the severance package as well reasoned, informed by the views of attorneys, and designed to minimize costs to the university. As such, under the business judgment rule, the board members would not be personally liable for the payment.

31. Some commentators have emphasized the underlying differences between for-profit and nonprofit corporations, and concluded that those differences make corporate standards an inadequate solution to the problem of nonprofit oversight. See, e.g., Thomas L. Greaney & Kathleen M. Boozang, *Mission, Margin, and Trust in the Nonprofit Health Care Enterprise*, 5 YALE J. HEALTH POL’Y L. & ETHICS 1 (2005). Others have taken these scandals to mean that stricter standards are needed. See, e.g., Lee, *supra* note 23 (arguing that the business judgment rule ought to be abandoned for nonprofit directors).

they could force a suit in the university's name when faced with inaction by the university's board.

A natural worry might be that students would bring an overwhelming number of suits against their universities, and that an onslaught of litigation might distract boards, impose high costs, and drain universities of critical resources. To address the analogous problem in the for-profit context, Delaware courts have required a stringent set of conditions to obtain before a shareholder derivative suit may survive the board's motion to dismiss.³² States should explicitly adopt the Delaware requirements by statute. The Delaware derivative standing requirements for business corporations would be more than sufficient to guard against the fear that universities would be overwhelmed by student lawsuits.³³

Another worry might be the information problem facing students, who are not necessarily informed of the bases for the actions of their university's board. In order to provide students with the information they need to act effectively in this context, students would have to be provided the same rights to inspect the records of the university as the members of a nonprofit corporation are granted under the Revised Model Nonprofit Corporation Act.³⁴ Under the Model Act, members may have access to these documents if they describe with particularity the purpose for which they wish to inspect the records, and the records are directly connected to that purpose.³⁵ This provision would potentially give the students power to inspect and copy the minutes of all board meetings, records of director activity outside of a meeting, accounting records, and financial statements.³⁶ At the same time, the narrow access written into the Model Act should ensure that students could not peruse board records gratuitously.

Although current students are not the sole beneficiaries of universities,³⁷ they are the stakeholders most predictably affected by board misconduct.

32. See *supra* note 27.

33. Another factor limiting the number of student-initiated derivative lawsuits is the fact that students would have to bear the costs of initiating those actions. Given that students would have to bear their own costs, they would have to be selective in the derivatives suits they chose to initiate.

34. Of course, students would also have access to the nonprofit's IRS Form 990, which is available for public inspection. See FREMONT-SMITH, *supra* note 6, at 66.

35. REVISED MODEL NONPROFIT CORP. ACT § 16.02(c) (1987).

36. See, e.g., *id.* §§ 16.01-.02.

37. See, e.g., American University Bylaws and Act of Incorporation (Nov. 2004), <http://www.american.edu/president/doc/Bylaws.pdf> ("The Purpose of the Corporation is to . . . promote education.").

While faculty, employees, or even the surrounding community may be harmed when the board breaches its duties,³⁸ these breaches always, at least indirectly, affect current students as well. Regardless of whether a student is on financial aid, studying on a fellowship, or paying full tuition, board decisions that needlessly cost the university money affect every student. When a university board wastes money, faculty hiring and research facilities suffer, and creature comforts, such as janitorial services, may be cut back. Both of these results have obvious impacts on students. Even if the result of wasting funds is fewer services to the community, students are affected in the form of more hostile community relations and reduced institutional prestige. In sum, because students are necessarily affected when the board breaches its duties, they have a good incentive to police the board effectively.

Further, students are well suited to police their university boards. Students provide a ready source of litigants, and even more so than shareholders, students are able to coordinate their efforts. University students tend to have spare time, live in close proximity, and be bound socially. They are organized into student councils and publish student newspapers. While students would experience the same collective action problem familiar to shareholder derivative suits, the close ties between students would reduce the barriers to suing: Since students are acquainted with the other people whom their legal action would benefit, there would be less of a tendency to free ride.

CONCLUSION

Courts have largely been allowed to pick and choose procedural and substantive standards to use in evaluating nonprofit boards. Perhaps out of sympathy for board members—who, after all, are engaged in one of the most respected forms of civic involvement—courts have given favorable treatment to nonprofit boards, both procedurally and substantively. As it now stands, courts' pairing of strict standing rules with traditional substantive standards of corporate law may result in too little oversight of universities organized as nonprofit corporations.

38. It would be natural to argue that other campus constituencies—such as faculty or donors—are also harmed by board misconduct, and could police the university board as effectively as students could. To the extent that that is true, my proposal would also work by substituting another campus constituency in place of students. Personally, I find the attributes of students to be particularly compelling from the standpoint of oversight; but I acknowledge that my proposal may be generalized to encompass other groups. A danger in giving standing to certain more permanent fixtures of the campus, such as tenured faculty members, is that such groups might threaten to sue in order to gain leverage in employment negotiations with the university.

Allowing student derivative lawsuits is not a radical idea.³⁹ It is merely an acknowledgement that, when people accept the substantial honor associated with a position on a university board, they also accept the fiduciary duties of any corporate director. These duties are not onerous; under corporate law, the business judgment rule protects directors in suits involving the duty of care in all situations but those in which the director has egregiously flaunted his responsibilities to shareholders.

The legal reforms I have suggested may change the makeup of certain university boards. One of the more immediate effects is that universities might have more trouble using board positions as a way to solicit donations from wealthy individuals. If potential board members knew that the position was not merely honorary, but also carried with it the duties and liabilities of corporate directorship, they might think twice before agreeing to serve. While development offices might bristle at the suggestions embodied in this Comment, these reforms would go some distance toward ensuring better university governance.

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39. Judge Cabranes has proposed giving standing to donors whose contributions have been misused. See José A. Cabranes, *How To Make Trustees Worthy of Their Constituents' Trust*, 49 CHRON. HIGHER EDUC., Oct. 18, 2002, at B20. And Professor Hansmann has proposed giving standing to all "patrons" of nonprofits. See Henry B. Hansmann, *Reforming Nonprofit Corporation Law*, 129 U. PA. L. REV. 497, 606-11 (1981).