E-Briefings

Volume 15, No. 3, May 2018

Board Lessons from Recent Non-Profit Scandals

By Michael W. Peregrine, McDermott Will & Emery LLP

As the saying goes, "To predict the next crisis, study the last one." For as it is in business and in politics, so it is often with corporate governance. And over the last two years, a number of controversies have arisen in the non-profit sector that, individually and collectively, serve as an important oversight resource for boards and executive leadership.

The affected companies reflect a broad cross section of the non-profit sector: a university fundraising foundation, a veterans' support organization, a disease-associated charity, and a children's medical organization. The allegations against management included fraud, financial malfeasance, waste of assets, and self-dealing. The allegations against boards ranged from conflict of interest, to passivity, to excessive deference to the CEO.

Each controversy involved unrelenting media scrutiny with associated costs in terms of expenses and ongoing damage to the reputation of the organizations and affected individuals. In each case, corrective efforts have been adopted by leadership, but the impact of the damage lingers. Indeed, for some of the organizations and implicated individuals, there is continuing legal exposure.

Yet it is important to note that in each of these examples there has been no determination by a state or federal court that the organization or any implicated fiduciary thereof violated applicable law. For that reason we have not, for purposes of this article, identified corporations or individuals by name (although all are a matter of public record).

A Snapshot of Recent Non-Profit Controversies

The University Foundation. This is an organization formed to solicit funds for a major university and to control the university's endowment. The allegations against the foundation's board included the failure to exercise oversight of the organization's finances, approving property acquisitions without identifying a source of funding, authorizing excessive executive compensation, and allowing the inappropriate depletion of endowment assets.

Foundation executives were alleged to have exceeded their authority (i.e., acting without board approval), failed to adequately provide the board with necessary information, and to have presented the board with inaccurate and misleading information (among other concerns).

These allegations have been the subject of state attorney general and state auditor review, a specially commissioned forensic audit, and (reportedly) IRS inquiry as well. Recently the individual who served as CEO of both the university and the foundation was sued by the university for various allegations of malfeasance.

The Veterans' Support Organization. The allegations here included extravagant staff spending (including on travel, administrative efforts, and fundraising), inadequate governance and administrative policies, misuse of donor funds, misleading advertising relating to spending for long-term support programs for veterans, and insufficient board oversight of executive actions.

The allegations were the subject of employee whistleblower complaints, were covered extensively by the national news media, and became the subject of a year-long investigation by the Senate Judiciary and Finance Committees. The charity made multiple changes in practices, policies, and executive leadership as part of the investigation and was subsequently recognized for these efforts by charity rating agencies and Senator Charles Grassley.

The Disease Charity. This situation reportedly arose from a fundraiser for the charity, for which Harvey Weinstein provided two items for auction. Allegedly, the contribution was conditioned on an agreement that the charity would transfer $600,000 of auction proceeds to a non-profit theater that had done a trial run of a musical produced by Mr. Weinstein. According to news reports, the theater had agreed to reimburse Mr. Weinstein for previous production costs and a charitable contribution if he could offset them with payments from third parties. (Theoretically at least, that could prompt private benefit concerns, among other issues.)

The board dispute over the arrangement led to two separate outside counsel investigations with conflicting results, and a resulting intra-board dispute that subsequently prompted a review by the New York Attorney General.[1] Also, according to *The New York Times*, the transactions between the charity and Mr. Weinstein became, in late 2017, the subject of a criminal investigation by the U.S. Attorney's Office for the Southern District of New York.[2]

The Children's Charity. This controversy arose from the charity's bankruptcy filing, which followed an arbitration award against the charity, which it was unable to pay. The nature of the filing, together with complaints from the other party to the arbitration (alleging that the charity's CEO had a long history of engaging in fraud and financial impropriety), prompted the bankruptcy court to appoint an examiner to review the charity's financial statements.

The examiner's five-month investigation concluded that the charity's CEO had engaged in a series of fraudulent transactions, including diverting over $50 million in donations for his personal compensation and the compensation of other individuals within the organization, using false and misleading charitable solicitation materials, financial mismanagement, improper reporting practices, and making false and misleading statements about charity operations in public filings.

The examiner also considered the conduct of the charity's board and concluded that a cause of action existed for the charity, as "debtor in bankruptcy," to pursue certain directors based on inattentive oversight (while noting that the likelihood of prevailing on such claims was uncertain; i.e., whether the alleged inattentiveness rose to the level of "gross negligence").

Key Board Takeaways

Charitable status and "good works" are not prophylactics for board and management malfeasance. As boards look to reduce the risk of controversy and/or scandal at their hospitals and health systems, they should reflect on the following questions:

1. Is the board too reliant on the CEO and other senior executive officers, and does it, in a constructive manner, challenge their ideas and viewpoints?
2. Does the board have an efficient risk reporting system to ensure important information is promptly reported to the board and key committees?
3. Is the board adept at identifying "red flags" of legal/compliance risk?
4. Does the board make every effort to demand further information about serious legal, compliance, and financial issues that come to its attention?

Lessons Learned

These scandals reflect several themes that are worthy of note by non-profit boards.

Perhaps the overarching lesson is that ***it can happen, and frequently does***. "The government" will indeed investigate perceived abuses in charity governance, no matter how meritorious the charity's mission may seem. Note also that the range of governmental agencies that might exercise jurisdiction to investigate a non-profit is large, and the cost of responding to such an investigation (to both the charity and its leaders) is potentially huge.

[1] Jason Guerrasio, "Harvey Weinstein and Kenneth Cole Reportedly Covered Up a Suspicious Deal Involving a Charity," *Business Insider*, October 19, 2017.
[2] Megan Twohey, "Tumult After AIDS Fund-Raiser Supports Harvey Weinstein Production," *The New York Times*, September 23, 2017.

More fundamental lessons relate to the level of engagement of the board, and the extent of its oversight of senior management. In order to reduce the risk of controversy and/or scandal, directors should:

1. Avoid being overly dependent upon, and overly passive with respect to, senior executive officers (especially the CEO).
2. Insist on a risk reporting system that assures the board and its key committees that information that could "keep management awake at night" is promptly reported.
3. Ensure the board's role in the effective oversight of the organization's business and operations, and in facilitating communication between the board and senior management.
4. Be capable of identifying "red flags" of legal/compliance risk when they arise in information that comes to the board's attention, no matter the source.
5. Make robust inquiry and demand for further information about serious legal, compliance, and financial issues that come to the board's attention.

Non-profit boards can benefit from an understanding of the facts and circumstances that were at the core of the several leading charity scandals of the past two years. The involved non-profits reflected a cross section of the charitable sector. Basic themes running through these scandals included inattentive board oversight of the financial activities of management, and a failure to identify "red flags" of possibly improper conduct. These scandals are a useful reminder that neither the organization's charitable status, nor the "good works" it conducts, serve as prophylactics for board and management malfeasance.

The Governance Institute thanks Michael W. Peregrine, a Partner at McDermott Will & Emery, for contributing this article. Mr. Peregrine advises corporations, officers, and directors on matters relating to corporate governance, fiduciary duties, and officer–director liability. He thanks his associates, Ryan Marcus and MaryKathryn Hurd, for their assistance in preparing this article. The views expressed herein do not necessarily reflect the views of McDermott Will & Emery or its clients. He can be reached at mperegrine@mwe.com.

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