

*Using the Sandusky Scandal as a Case Study: Due Diligence Requirements of Corporate Board Members in Profit and Non-Profit Organizations.*

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Reading Pennsylvania

I. Introduction and Context:

Penn State has been subject to a series of governance shocks over the last years. It is now an excellent laboratory for the ways in which large and complex institutions respond to stress. The effects of these stresses on university faculty, as an autonomous unit of governance, are among the most interesting. The role of the faculty at a university suggests the ways in which changes in the cultures of governance and in the forms of administration in collaborative governance structures, that is changes in the internal governance culture of an institution, can put substantial stress on the viability of formal systems. In the university, in particular, the reluctance to change formal structures even as the realities of governance culture changes preserves the appearance of a governance role even as it is effectively reduced.<sup>2</sup>

On November 5, 2011 Jerry Sandusky retired Penn State football defensive coordinator and at one time briefly heir to Joe Paterno was charged with assaulting eight boys over a 15 year period.<sup>3</sup> The base of his operations was a charity he had helped found—the Second Mile, established to help at risk children. Sandusky was subsequently tried and convicted. He is currently appealing. In what would later prove to be a disastrous decision, then President Graham Spanier issued an initial response to the arrests: “Spanier calling the allegations against Sandusky “troubling” and adding Curley and Schultz had his unconditional support. He predicted they will be exonerated. “I have known and worked daily with Tim and Gary for more than 16 years,” Spanier said. “I have complete confidence in how they handled the allegations about a former university employee.””<sup>4</sup> The parties continue to dispute the President’s authority to have made that statement and the extent to which the board was consulted beforehand.

Initially swept up in the scandal were Tim Curley, then Athletic Director at Penn State, and Gary Schultz, Penn State’s Vice President for Finance and Business. Both were arrested for perjury. But they were not the only officials to be caught up in the scandal. Four days after the Sandusky, Curly and Schultz arrest, the board of Trustees summarily terminated Penn State’s long time President

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<sup>2</sup> Larry Catá Bacjker, Regulatory Incoherence and the University, Law at the End of the Day, January 29, 2013. Available <http://lcbackerblog.blogspot.com/2013/01/regulatory-incoherence-and-university.html>.

<sup>3</sup> See Genaro C. Armas and Mark Scoforo, Jerry Sandusky Arrested, HuffPost Sports, Nov. 5, 2011, available [http://www.huffingtonpost.com/2011/11/05/jerry-sandusky-tim-curley-arrested-penn-state\\_n\\_1077771.html](http://www.huffingtonpost.com/2011/11/05/jerry-sandusky-tim-curley-arrested-penn-state_n_1077771.html).

<sup>4</sup> Id.

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Graham Spanier and even longer time coach Joe Paterno. ““The university is much larger than its athletic teams,” board vice chair John Surma said during a news conference. “The Penn State board of trustees tonight decided it is in the best interest of the university to have a change in leadership to deal with the difficult issues that we are facing.””<sup>5</sup> The students rioted that night.<sup>6</sup> And the board announced that it would launch an investigation of everyone involved.<sup>7</sup> and opinions about the way the board handled the affair split sharply, something that has not been resolved to this date.

With the terminations of Messrs. Spanier and Paterno, the university became embroiled in a number of legal and administrative investigations and actions from which it has yet to extricate itself and incurred well over \$100 million in costs, expenses, fees and the like, with the likelihood of additional substantial payments in the near future. It gave free hand to its investigative agent, Louis Freeh, whose report was exceptionally damning and remains highly controversial,<sup>8</sup> producing a counter report commissioned by the Paterno family.<sup>9</sup> It has been subject to extraordinary sanctions from the NCAA, review of its academic accreditation by Middle States and investigations by state and federal governments. Its board has been the subject of substantial criticism and it has undertaken a review of its organization and operation, which is likely to produce some changes.

The scandal continues to raise a number of questions about the extent of the responsibilities of boards of trustees and about conduct expectations especially in an era where it has been customary to be substantially deferential to university presidents and their administrative apparatus.<sup>10</sup> What I would like to focus on today is the role of the University board of trustees—especially the legal framework within which conduct standards are elaborated—in the context of

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<sup>5</sup> Joe Paterno, Graham Spanier Removed, ESPN Nov. 10, 2011. Available [http://espn.go.com/college-football/story/\\_/id/7214380/joe-paterno-president-graham-spanier-penn-state](http://espn.go.com/college-football/story/_/id/7214380/joe-paterno-president-graham-spanier-penn-state).

<sup>6</sup> Id.

<sup>7</sup> “After meeting Tuesday, Penn State's board of trustees said it would appoint a committee to investigate the “circumstances” that resulted in the indictment of Sandusky, and of athletic director Tim Curley and school vice president Gary Schultz, who are accused in an alleged cover-up.” Id.

<sup>8</sup> Larry Catá Backer, Penn State Prepared for the Release of the Freeh Group Report The Faculty Voice, July 10, 2012. Available <http://lcbpsusenate.blogspot.com/2012/07/penn-state-prepared-for-release-of.html>;

<sup>9</sup> “A report commissioned by the family and released Sunday by a group including former U.S. Attorney General Dick Thornburgh contended that the findings last year of former Federal Bureau of Investigation Director [Louis Freeh](#) were factually wrong, speculative and “fundamentally flawed.”” Kris Maher, Paterno Family Fires Back at Freeh Report, Wall Street Journal, February 10, 2013. Available <http://online.wsj.com/article/SB10001424127887324880504578295832979670680.html>.

<sup>10</sup> Board of Trustees Standing Order 9 for example, made clear that the Board would speak only to the University President with respect to any monitoring efforts inside the university. See Penn State Board of Trustees Standing Orders, available <http://www.psu.edu/trustees/pdf/standingorders.pdf>.

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scandals like the Sandusky scandal and its aftermath. In particular I will focus on the obligations of the board of trustees of a university with respect to its diligence and monitoring obligations. After this introduction Part II provides an overview of fiduciary duty applicable to enterprises and focus on non-profit enterprises. The legal framework is based in part on the excellent work of Judith Areen, *Governing Board Accountability: Competition, Regulation, and Accreditation*.<sup>11</sup> Part III then considers the university, focusing on the distinct models that have arisen for university governance. Part IV focuses on the diligence obligations of university trustees and considers recent cases, the legal framework and core issues. The presentation ends with a brief consideration of this framework in the context of the Sandusky scandal and the responses of the Penn State Board of Trustees from a legal perspective.

## II. Overview of Fiduciary Duty

### A. Substantive Standard:

1. Care. Understood as touching on both a diligence obligation and an obligation specific to transactions. There are two aspects:
  - a. personal obligations (to pay attention, be reasonably informed, take reasonable steps to participate, etc.) and
  - b. institutional obligations
2. Loyalty, understood both as avoiding conflicts of interest and making decisions solely in the best interests of the enterprise, even if that decision is personally detrimental. Also touches on doing the bidding of someone who dominates and controls the board member and who invokes that control to benefit herself.
3. Good faith, increasingly a species of breaches of duty of loyalty; intentional or reckless disregard of duty sufficient to avoid the duty of care exculpatory provisions of law.

### B. Liability Standard: tension between individual bad conduct and power of the board to commit the enterprise; while an individual can breach a duty only a tainted board decision will cause liability

1. Triggers slightly different for duty of care and duty of loyalty
2. Entire fairness
3. Board ratification
4. Shareholder ratification

### C. Business Judgment Rule

1. Substantive standard—judicial non interference
2. Procedural standard—framework for overcoming the presumption of non-interference and the shifting of burdens of production and proof to make a case for liability.

### D. Fiduciary obligation tending toward broader application to board members whether in a profit or non profit enterprise. The duty though still focused on individual conduct is increasingly understood to generate

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<sup>11</sup> 36 JOURNAL OF COLLEGE AND UNIVERSITY LAW 691-728 (2010).

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institutional obligations applicable to the board as a institution in its own right.

### III: Governing the University

Just as there are many models of aggregating capital for the purposes of engaging in profit making businesses, there are several methods of organizing the institution of the university. As is usual in the United States, there is little consensus on methods and much deviation at least at the margins. Two methods are less common in the United States.

Three types of organization:

A. Organization of the university under the control of its faculty—a method epitomized at places like Oxford University. The faculty serves as the governing board and principal constituency of the institution.

B. Organization of the university under the direct control of the state—method quite common in Europe. Government approval of curriculum, faculty appoints and the like.

1. State appoints all officers and managers.
2. Civil servants

C. Organization of university controlled by a governing board—the most common form of university organization in the U.S. In this case control in the hands of a “lay” (that is non faculty) group of people charged with the management of the university and the appointment of people to handle to day to day operating issues.

1. Big issue is who controls appointment of board members:
  - a. State
  - b. alumni (most common)
  - c. Others (hybrid; stakeholder, etc.)
2. Produces autonomy, with dotted line relationship to “shareholder” however identified.

Biggest internal issue: relationship between governing bodies (board and administration)—and their faculty.<sup>12</sup> The issue arises in part because faculty are not employees in the factory model sense of the term, and management is not hierarchical. The combination of substantial autonomy for course delivery combined with academic freedom standards designed to protect the production of knowledge from the arbitrary exercise of administrative whim transformed faculty in the early part of the 20<sup>th</sup> century from mere employee to a quasi-managerial, quasi autonomous contractor status, the later made more pronounced by the relentless development of expectations of faculty securing substantial

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<sup>12</sup> See Larry Catá Backer, *Between Faculty, Administration, Board, State, and Students: On the Relevance of a Faculty Senate in the Modern U.S. University* (February 10, 2013), CPE Working Paper Series, Available at SSRN: <http://ssrn.com/abstract=2032779>.

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grants to support their work. This has been confirmed by judicial opinion applying the National Labor Relations Act and embraced by incorporation of the AAUP standards.

A. AAUP arose as a consequence of disputes between elite faculties and administrators at the turn of the 20<sup>th</sup> century. “To protect American faculties from overreaching by governing boards, the Declaration adopted a broader form of academic freedom, one that rested on a new allocation of governance responsibilities within colleges and universities. This allocation has come to be known as “shared governance”<sup>13</sup>

B. A different kind of oversight under the rubric shared governance: “Although governing boards were acknowledged to be the “final institutional authority,” the Statement urged them to undertake appropriate self-limitation. An effective board, “while maintaining a general overview, entrusts the conduct of administration to the administrative officers--the president and deans--and the conduct of teaching and research to the faculty.”<sup>14</sup>

1. Courts have embraced this shared governance model in sketching out the framework of board and administrative oversight.<sup>15</sup>

a. “The “business” of a university is education, and its vitality ultimately must depend on academic policies that largely are formulated and generally are implemented by faculty governance decisions .... The university requires faculty participation in governance because professional expertise is indispensable to the formulation and implementation of academic policy.”<sup>16</sup>

#### IV: The Diligence Obligations of the University Board of Trustees

A. Recent cases:

1. American University 2005—financial irregularities and use of university funds by the president and family for lavish lifestyle; president eventually fired but settled with a generous payout.<sup>17</sup>

2. West Virginia 2007—Governors’ daughter appointed chief operating officer of a large company whose chair was major contributor to the governor’s campaign and on the university board where he donated \$20 million. Issue was whether the daughter had executive MBA; it tuned out

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<sup>13</sup> Areen, *Supra*, at 699-700.

<sup>14</sup> Areen, *supra*, 701-702.

<sup>15</sup> *NLRB v. Yeshiva University*, 444 U.S: 672 (1980).

<sup>16</sup> *Id.*, at 688-89.

<sup>17</sup> Michael Janofsky, *College Chief at American Agrees to Quit for Millions*, N.Y. TIMES, Oct. 26, 2005, at A20. The president was later permitted to resign and provided with a generous settlement. *Id.*

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she never received an MBA causing the resignation of the board chair and the university president in the ensuing scandal<sup>18</sup>

3. University of Illinois 2009—special admissions to well connected families sponsored by lawmakers and university trustees. The result was the resignations of a number of officials.<sup>19</sup>

B. Legal Framework:

1. Most governed under the Model Non-Profit Corporation Act forms of which have been adopted in all but two states.<sup>20</sup>

2. Duty of Care substantially similar to that applied to for profit enterprises.

a. A Director must pay attention to organization matters and participate fully in Board review and decision making and must exercise the care that an ordinarily prudent person would exercise in a like position and under similar circumstances.<sup>21</sup>

3. Duty of loyalty may differ because of the distinct nature of the enterprise (maximize the charitable purpose of the institution rather than maximize profit).<sup>22</sup>

a. Director must put the needs of the organization ahead of any personal interest when making decisions affecting the organization; a director must be faithful to the organization's mission and may not act in a manner that is inconsistent with this mission.<sup>23</sup>

4. Liability rules different:

a. No recourse to derivative actions.

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<sup>18</sup> Ian Urbina, *University Investigates Whether Governor's Daughter Earned Degree*, N.Y. TIMES, Jan. 22, 2008, at A15.

<sup>19</sup> Ashley C. Killough, *Report Calls on All U. of Illinois Trustees to Resign*, CHRON. HIGHER EDUC., Aug. 6, 2009, <http://chronicle.com/article/Report-Calls-on-All-U-of-I/47969>.

<sup>20</sup> Elizabeth A. Moody, Foreword, MODEL NONPROFIT CORPORATION ACT xix (3d ed. 2009). Delaware and Kansas regulate charitable corporations under their business corporation acts, requiring that their articles of organization provide that the corporation is not created for profit and prohibiting dividend distributions. MARION R. FREMONT-SMITH, GOVERNING NONPROFIT ORGANIZATIONS 152 (2004).

<sup>21</sup> Association of Governing Boards, Fiduciary Duties, available <http://agb.org/knowledge-center/briefs/fiduciary-duties>. ; see also Beth Dougherty and Morgan Carol Cheshire, *Serving on a Non-Profit Board: What Lawyers Need to Know*, ALI CLE Dec. 5, 2012.

<sup>22</sup> Areen, *supra.*, 712-716.

<sup>23</sup> Association of Governing Boards, Fiduciary Duties, available <http://agb.org/knowledge-center/briefs/fiduciary-duties>.

- b. “Most states, therefore, have enacted statutes authorizing the state attorney general to intervene when the board of a charitable organization fails to fulfill its duty of care or loyalty.”<sup>24</sup>
- c. Can other affected parties seek relief or must they complain to the state attorney general?

C. Core issue: care and “blindness to risk”

- 1. Board’s awareness of risk
- 2. What is the role of executive officers (and others) in notifying the board.

D. Core issue: Loyalty—conflict of interest

- 1. Ethics rules
- 2. Broad definition of conflict beyond financial—constituent relationship rules where needs of constituency may be in conflict with institutional mission<sup>25</sup>
- 3. Protect institutional reputation
- 4. Domination and control, especially where either administrative officials or officials appointed by the Governor have split loyalties in political or policy contests in which senior administrators or the governor are partisans

E. Core Issue: Severance and Retirement Benefits

- 1. Severance packages for high officials
  - A. Spanier package and relationship to tenure issues
- 2. Limits on termination may be under pressure.
- 3. Tied to focus on accountability.<sup>26</sup>
  - a. AGB Statement: “Boards are accountable to (1) the institution’s mission and cultural heritage, (2) the transcendent values and principles that guide and shape higher education, (3) the public interest and public trust, and (4) the legitimate and relevant interests of the institution’s various constituencies.”<sup>27</sup>

V. The application of these rules to the Penn State Board—From November 2011 to the Present

A. Monitoring of senior administrators before 2011

- 1. Individual duty—board members acting reasonably
- 2. Institutional duty—construction and reasonable operation of a system of monitoring:
  - a. Senior administrators

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<sup>24</sup> Areen, *supra.*, 712-13.

<sup>25</sup> Association of Governing Boards, Conflict of Interest, available <http://agb.org/conflict-interest> (Listing 12 principles).

<sup>26</sup> Association of Governing Boards, Statement on Board Accountability. Available <http://agb.org/sites/agb.org/files/u3/AccountabilityStatement2007.pdf>.

<sup>27</sup> *Id.*

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- b. sampling and testing reasonableness of reliance on senior administrator information
      - c. Whistleblowing tolerated?
    - 3. Information sharing among all board members
  - B. Loyalty Issues
    - 1. Second Mile; directors or officers serving at both Penn State and Second Mile
    - 2. Domination and Control issues
  - C, Conflict issues
    - 1. Which master did board members serve?
  - D, The termination of Spanier and Paterno
    - 1. Follow internal rules?
    - 2. Action plans?
    - 3. Availability of outside counsel?
  - E. Post Termination Investigation
    - 1. Appointment of an independent investigation committee
      - a. Issue of independence contested
      - b. Compromise ability to control investigators
      - c. Ability to respond to external investigations and litigation
    - 2. Supervision of hired investigator agent—the Freeh Group
      - a. Did the board committee lose control and by doing so breach a duty to monitor
      - b. Cede authority of the board to Freeh Group?
      - c. Engagement with Conclusions and recommendations?
        - i. Did board committee approve report conclusion without substantial engagement and direction; were recommendations necessary?
  - F. NCAA Investigation
    - 1. Relationship of investigation to Freeh Group Recommendation; were the recommendations endorsed and thus legitimately used as a basis of the NCAA proceedings?
  - G. Surrounding Proceedings: Litigation and settlement oversight
    - 1. Victims
    - 2. University officers and board members
    - 3. Whistleblowers
  - H. The future.