

## Price of Board Inaction: \$5.5-Million for One Charity

By Michael Peregrine

Nonprofit board members who think they don't face any risks if they provide lax oversight should pay close heed to the \$5.5-million price tag the New York attorney general just put on inattentiveness. Every board member should understand the strong message government officials were sending about the level of diligence expected from them, especially when it comes to conflicts of interest involving top executives.

The case at issue involved Educational Housing Services, its founder and CEO George Scott, and its board of directors.

The organization was created to provide low-cost housing to students and faculty members of New York City colleges. The board came under scrutiny because of a series of financial relationships between the housing group, the CEO, and a separate company controlled by Mr. Scott and his wife, Yun Suk Scott. The state found that the housing group was offering overly generous compensation and said the Scotts were siphoning millions of dollars for their own use through a shell company.

In the settlement, the Scotts did not admit to any wrongdoing and their lawyer says they did nothing illegal.

What bothered the attorney general so much about the board's role in overseeing the charity was that it didn't ask tough questions about what was involved in the deals between the company and the nonprofit, especially whether issues of self-interest could be at stake. He was also concerned about the lack of questioning from the board about the chief executive's salary and about how the trustees decided to pay themselves.

Part of the problem, the attorney general said, was that the board allowed the CEO to control the flow of information and that trustees did too little to verify the accuracy of the information they did receive.

Regulators have drawn such conclusions about lack of due diligence at other nonprofits, but the severity of the penalties levied in this case is what should receive broader attention from all boards. Mr. Scott, his controlled subsidiary company, and the charity's five board members were required to pay an aggregate of \$5.5-million to settle the matter.

Board members were told to pay a total of \$1-million of that price tag, both as a penalty for their breach of fiduciary duty and to make up for the pay they received. Even more powerful is this message: The board members were told to resign and were banned for life from serving in any fiduciary role at any New York nonprofit.

Nonprofit boards shouldn't dismiss the New York case settlement as an extreme example of egregious conduct. Indeed, Educational Housing Services is a prominent charity, and its leadership included prominent education and business leaders. Rather, they should look more closely at the focus of concern—the trustees' failure to look hard enough when they are asked to review financial deals involving charity insiders.

Board members are often asked to evaluate whether arrangements involving charity officials or trustees could involve a conflict of interest and undue compensation.

Whenever a nonprofit is doing business with an organization involving a top executive or board member, it's vital for the board to evaluate the situation and get independent advice and, in some cases, a review from

outside advisers. Failure to take those steps could get a board in trouble if it turns out an individual is getting too big a financial gain from a nonprofit.

New York's attorney general declared in announcing the settlement that "the breakdown in corporate governance at Educational Housing Services was stunning." Now we know what the cost is for such breakdowns, both for nonprofits and for the people who govern them.

*Michael Peregrine is a lawyer at McDermott, Will, and Emery's Chicago office.*