

What's Next for Private Universities? Accountability

By Peter F. Lake

A potential crisis for the private, nonprofit university is looming. Congress has just regulated for-profit colleges as never before; most observers believe that even more regulation—this time of private nonprofit higher education—is coming. Will it be our own 1933? That was the year Congress passed landmark securities legislation to correct a corporate culture that had inflamed the crash of 1929 and then the Great Depression. Are we—should we be—on the verge of a legal revolution in accountability?

The answer: Most likely, and soon.

Public higher education's regulatory structure is usually more accountable than private higher education's. But failures in the private-college system will cause more students to flood public institutions, which do not have the capacity to handle the influx. Mismanagement in the private sector will thus lead to challenges to the entire delivery system of higher education. The longer we wait, the more painful change is likely to be. If Congress doesn't act quickly, our nation's goal of increasing the number of people with college degrees will be in jeopardy.

Most nonprofit colleges have existed in a tiny crack in corporate law that insulates them from significant corporate legal accountability. The dangers of that fault line were barely visible during higher education's nearly uninterrupted post-WWII boom. Now that we are experiencing a college "market correction" of unprecedented proportions—with the money to support our half-century of expansion drying up—the gap in corporate law has seismic potential. Nonprofit higher education faces the very real threat of closures, serious downsizing, even the risk of confidence-shaking scandals.

Private, charitable nonprofit corporations can exist in a number of forms. What principally distinguishes them from their for-profit counterparts is the absence of owners or shareholders. In the nonprofit world, the corporation takes the "profits." It may, but need not, have dues-paying or other members, who often have voting rights, hence governance rights. Members may also have so-called derivative rights to hold boards of directors accountable. Those rights can include the right to raise fiduciary and other governance issues in court—a tremendous power for fostering accountability when coupled with voting rights. If there are no members, governance is vested in the hands of a self-perpetuating board of directors or trustees. The lack of members, or shareholders, is the corporate legal fissure.

Private nonprofit colleges are some of the last "corporations" that survive that way. Essentially, corporate law permits most private, nonprofit institutions of higher education to operate without any significant external legal accountability. We are not like our cousins in the rest of the nonprofit sector—think Dupont Circle—that have elected boards accountable to an organization's membership.

Lack of membership has its privileges and its consequences, particularly as colleges operate more and more like corporations. Witness the big increase in the cost of college, the supply-and-demand problems (institutions pumping out graduates with little regard for the hiring market; failing to create sufficient numbers of graduates for key social needs), the creation of an indentured economic underclass of the newly educated who are paying debt service, and the lack of industrywide assessments of student competencies.

The law does vest oversight power over nonprofits in state attorneys general, who are responsible for ensuring that a nonprofit acts in accordance with its mission and that its directors are fulfilling their fiduciary duties. But the general public—or the student body—has no standing to challenge perceived wrongs. As a number of authors have pointed out, regulation of nonprofits by attorneys general has been largely ineffective. Lack of resources and mandates from state legislatures, political pressure, unfamiliarity with these corporate creatures, years of the veneration of successful higher-education management (like growing endowments), historical laissez-faire attitudes toward regulating higher education—all combine to undermine oversight effectiveness. Most important, higher education in the late 20th century evolved from modest roots into a big, interstate—indeed, global—enterprise. Expecting state regulation is simply too much to ask.

There are other potential sources of legal accountability. Some colleges have engaged in voluntary compliance with the Sarbanes-Oxley Act of 2002, which sets standards to protect shareholders and the public from business fraud, although the law does not, in most cases, apply to nonprofits. The IRS has increasingly sought more disclosures from nonprofits, particularly regarding conflicts of interest, but it lacks the direct power to regulate nonprofits' fiduciary duties. One might hope that faculty members would provide some oversight. However, they, like students, lack the legal standing to bring the derivative actions to seek accountability that are a ubiquitous check on corporate governance in the for-profit sector. A court in Alabama in the 1970s (recall the recession in the 70s—it was the other moment when higher education's business boom was interrupted) held that students could bring derivative actions against colleges. The Alabama Legislature later changed that.

The old corporate order of higher education under law worked well in a world of modest endowments and tiny intercollegiate athletic systems, when college was a local experience. Today the illusory promise of self-policing governing boards must be tempered with reality.

Some boards or board members come to give; but as *The Chronicle* [recently reported](#), some may come to take as well. Although board members cannot receive financial gain from a nonprofit, their companies may do business with a college (although doing so may jeopardize the institution's tax status). Even more troubling, a board or board member may arrange sweetheart deals with other businesses. A college needs services just like a city—garbage, security, etc. Promote a lucrative contract with a service provider and perhaps your company will get a valuable concession in a collateral contract with that provider. There are a variety of ways a board member could benefit substantially from board membership without direct profit-taking.

I do not mean to suggest that every collateral benefit to a board member is a breach of fiduciary duty, or that breaches of fiduciary duty are rampant. Most boards and board members provide exemplary service to their colleges. But not all board members are saints, as we have seen in recent, highly visible nonprofit scandals.

Moreover, there are at least three other concerns under our current legal structure. First, board members are usually a mix of politicians, business people, wealthy people, successful alumni, and the like. What is noticeably lacking among most board members is extensive frontline experience as college administrators or professors. That can lead to a disconnect between a board's priorities and a college's educational mission, a disconnect that can be seen in the facts that faculty pay and security have moved forward very little in the past decade and that student-teacher ratios have often climbed, even though almost every campus has grown immensely in physical plant (and athletic facilities). Endowments rose astronomically until the recent recession, but students are paying more than ever before, and student debt is rising.

Second, higher-education boards often manage in questionable ways from a business point of view. Board members often blur the line between setting policy and executing it. It is not uncommon, for example, for administrators to be in direct contact with board members about operational decision-making. Management by committee is usually bad for business.

Third, there will be substantial temptation in this major economic correction for boards to use their power to wallpaper over previous mistakes. If boards find their financial decisions coming back to haunt them, they may turn—as is typical in the for-profit corporate world in such a cycle—to an unprecedented round of higher-education mergers and acquisitions, and even some

liquidations. We are already seeing deferred maintenance, hiring and pay freezes for faculty and staff members, fringe-benefit changes, and increases in rates of admission. There is no particular legal incentive to design innovative strategies to reclaim the industry.

We can either remedy this crack in corporate-governance law or wait for an earthquake. Accountability may be the best way to preserve our colleges and help them grow. Accountability is not the end of self-governance. It is the necessary response to corporate behavior that can cause lack of innovation from within.

In any event, new federal rules on accountability are almost inevitable. At present those look as if they will focus on issues like graduation rates, cost versus value, and student competencies and outcomes rather than on legal accountability. But federal regulation of any kind would be less necessary if corporate-governance rules for private nonprofit higher education—which might well achieve many of the government's goals—were revised.

Boards would be wise to adopt strict accountability principles for themselves. Some, like DePaul University, already have. However, voluntary compliance will very likely not be enough. Congress and the U.S. Department of Education should understand that reforming federal student lending will not, on its own, ensure the future of the core mission of American higher education. The precise fixes needed in corporate law may not be clear. There are several potential choices—like permitting derivative actions or requiring a membership class that has voting rights. None are perfect. Derivative actions, for example, could flood the courts and colleges with expensive and time-consuming lawsuits; it's not clear who would be members: students, faculty members, the public?

But it is time to start the debate, before we have our very own Bernard Madoff or Enron. Higher education has become an enormous corporate business, and the law should evolve to reflect that fact.

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