

# Case Studies

## Case Study 1: Audubon String Quartet

### *Introduction*

When participants in a nonprofit enterprise avail themselves of the protections of corporate law, they must also meet the responsibilities imposed on them by law. Members of the Audubon String Quartet learned this lesson the hard way.<sup>1</sup>

The fundamental error was not that the players mixed corporate law with a creative mission—indeed, this decision provided certain tax advantages and fulfilled important business objectives including enabling them to be named the Quartet in Residence at Virginia Tech—but rather that they observed the corporation’s legal existence only in the breach. Individual members of the quartet skipped legal requirements for calling meetings of the board of directors and treated corporate assets as though they belonged to a private individual. Having made the decision to form a corporate entity, the quartet’s members took on a raft of fiduciary duties to one another and to the corporation, as well as state law obligations, to abide by requirements pertaining to the governance of the organization.

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<sup>1</sup>*Ehrlich v. Audubon Quartet, Inc.*, Opinion, Adjudication and Rule Nisi, Court of Common Pleas of Allegheny County, PA (No. GD 00-9438), available at <http://mysite.verizon.net/renardym/paruling.pdf>.

### *Allegations*

The Audubon String Quartet was founded in 1974. It won several top international string quartet competitions, recorded albums, and played for President Jimmy Carter. The quartet incorporated in 1979 as The Audubon String Quartet, Inc., a Pennsylvania nonprofit corporation. By 1980 it was the quartet in residence at Virginia Tech. Its founding cellist was Tom Shaw; its violist was Doris Lederer, who was married to Shaw. David Ehrlich joined the quartet as first violinist in 1984. Its current second violinist, Akemi Takayama, was the last to join the quartet.

Bookings of the quartet expanded over years, and eventually it acquired an agent, made a rare trip to China, and attracted positive critical reviews. The members' adherence to corporate form was less virtuosic than their playing, however. The corporation functioned on a very informal basis and held few meetings. The four players served as the four officers of the Corporation on a more or less rotating basis, although the rotation was not strictly adhered to.

In 1999, Shaw, the president of the corporation, applied to the U.S. Patent and Trademark Office to register the Audubon String Quartet trademark in his name alone. That same year, Ehrlich was unhappy with the quality of his instrument and began working behind the scenes with Virginia Tech to buy a new Bergonzi concert-class violin—worth close to a million dollars—for his use. In pursuit of a benefactor, Ehrlich, without consulting the other members, allegedly committed the quartet to give an annual free concert in the continental United States to a benefactor who would provide the Bergonzi for Ehrlich's use. These efforts came to light when Ehrlich gave second violinist Takayama a copy of his solicitation letter to use as a sample, in an effort to help her get a better instrument for herself. He admonished Takayama that the letter should not be disclosed. However, Takayama revealed the letter to the other members of the Quartet.

In 2000, Shaw, Lederer, and Takayama then met, ostensibly in the name of the corporation but without having given notice to Ehrlich, and agreed to relieve Ehrlich of his position with the Quartet. Shaw drafted a document captioned "NOTICE OF TERMINATION," in which he advised Ehrlich that his position as violinist was terminated effective immediately, as were his posts as vice president and director

of the corporation. Shaw also moved monies in the quartet's bank account out of Ehrlich's reach, by opening a new account in a different state and by removing Ehrlich as a signatory on the old account. The three members hired counsel, at the Quartet Corporation's expense, to advise on how to oust Ehrlich. Ehrlich then sued the Quartet Corporation and the other three members for:

1. An injunction, a court order prohibiting the other members from performing without him in the name of the Audubon String Quartet.
2. Dissolution of the quartet corporation.
3. Such other relief as the Court should deem appropriate.

### ***Outcome***

Referring to business corporation law, the court held that the members of the closely held quartet corporation owe each other fiduciary duties of the utmost good faith and loyalty. The court also held that the members of a closely held corporation may not act out of avarice, expediency, or self interest in derogation of their duty of loyalty to the other stockholder and to the corporation. The court determined that the ouster of Ehrlich, a member, officer, and director of the quartet corporation, was oppressive: It was done in a preemptory fashion without notice to Ehrlich. The court found Shaw's reaction to Ehrlich's attempt to secure the Bergonzi to be excessive, particularly when considering that Shaw had begun steps to appropriate the quartet's trademark to himself alone.

In determining a remedy, the court permitted the name Audubon String Quartet to remain with Shaw, Lederer, and Takayama as its members, directors, and officers. However, the court deemed monetary damages appropriate and required that the quartet (as a corporation) and the other individual members pay Ehrlich a 25 percent share of the cash in the possession of the quartet on the date of the termination letter (\$33,502), 25 percent of the quartet's liquidated pension (\$10,239), unpaid expenses incurred prior to the date of the letter (\$14,583), unpaid fees for performances already given (\$19,951), and one-fourth of the value of the quartet as a going concern business, as determined by the Court.

In assessing the value of the quartet, the court found it to be a business corporation disguised as a nonprofit because all of its

performances were for a fee and all of the income it received went to the players as income, or to cover normal business operating expenses. Substantially agreeing with experts offered by Ehrlich, the court concluded that the quartet's value, including the teaching position with Virginia Tech, was about \$1.6 million. Thus, the other members owed Ehrlich approximately \$400,000. Ehrlich was also awarded court fees totaling \$132,844. In total, the corporation and the individual players were ordered to pay Ehrlich more than \$600,000. Lacking the resources to pay this sum, the musicians faced the prospect of putting up their homes and instruments to raise the money to pay the judgment.<sup>2</sup> The parties later settled after an investor offered to buy the instruments and let the musicians borrow them back. The defendants used the proceeds of the sale to pay Ehrlich.<sup>3</sup>

***Lessons Learned (with Chapter References)***

Fiduciary duties (Chapter 1)

Observing corporate law requirements: books and records, notices of meetings, minutes, and resolutions (Chapter 2)

Board governance (Chapter 3)

Founders' syndrome (Chapter 7)

Trademark ownership and usage (Chapter 8)

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<sup>2</sup>Daniel J. Wakin, "Lost in Bitter Legal Battle: Chamber Players' Instruments," *New York Times*, December 15, 2005.

<sup>3</sup>Daniel J. Wakin, "How Audubon Musicians Kept Their Instruments," *New York Times*, February 7, 2006.

## Case Study 2: Stevens Institute of Technology

### *Introduction*

In late 2009, the attorney general of the State of New Jersey filed a 90-page complaint against Stevens Institute of Technology, an esteemed 140-year-old institution of higher learning based in Hoboken, New Jersey. Stevens has 6,000 students focusing on engineering, science, and management.

The State was acting *parens patriae*, meaning in its role as the guardian of public charitable trusts and nonprofit corporations. The state has both common law and statutory powers to protect the common and general interest in charitable trusts and nonprofit corporations.

### *Allegations*

The state attorney general's complaint alleged that the president was overpaid in comparison to similarly sized (and even larger) schools, and that with the complicity of the board chair, the president exercised control over the committees that determined his compensation, notwithstanding that he was not a member of those committees. The compensation committee of the board also allegedly did not follow the school's bylaws requiring full board approval for the president's pay. The complaint further accused the president of receiving \$1.8 million in illegal low-interest loans for vacation homes, half of which were later forgiven. The state alleged that these loans were beyond the scope of authority of those approving the loans and an improper use of the institution's funds.

The attorney general also maintained that the board ran operating shortfalls that it covered by plundering the endowment and restricted trusts, as well as improperly borrowing. The complaint alleged that the president and board chair hid and failed to adequately inform the board of their and the executive committee's actions, using multiple sets of books to hide its deteriorating financial condition.

Additional allegations included failure to maintain books, records, and accounts; gross negligence in spending, borrowing, and other elements of financial management; mismanagement and misuse of charitable trusts, restricted assets, and endowment funds;

breach of fiduciary duty of obedience; and breach of duties of candor, loyalty, and good faith.<sup>4</sup> Stevens disputed the claims and countersued the Attorney General.

### *Outcome*

The state and Stevens ultimately settled the matter without admission of liability or unlawful conduct. The president stepped down and promised to repay the balance of the loans. Stevens also agreed to governance reforms, including amending its charter and/or bylaws provisions regarding board term limits and role, executive compensation review, and changes to board committee processes regarding membership, minutes, and other matters. Under the settlement, the board's audit committee would engage a professional with appropriate financial expertise to serve as a trustee and chair the committee. The compensation committee's charter would establish a formal objective process to decide compensation. The nominating and governance committee and the investment committee also planned changes. The board committed to approve a new gift acceptance policy.

Part of the institution's settlement of the matter also included a promise to hire a general counsel and professional corporate secretary to help implement governance reforms and to take a more holistic view of the organization's legal needs.<sup>5</sup> Previously Stevens had used various outside counsel to address discrete matters, but no general counsel was responsible for overseeing the whole legal picture. The new general counsel, hired within a few months of the

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<sup>4</sup>New Jersey's 90-page complaint (pdf), filed in September 2009 by then-Attorney General Anne Milgram. [http://pdfserver.amlaw.com/cc/AG\\_complaint122110.pdf](http://pdfserver.amlaw.com/cc/AG_complaint122110.pdf). Final consent judgment available at <http://www.stevens.edu/pdf/fcj.pdf>.

<sup>5</sup>David Hechler, "Just What the AG Ordered: Stevens Institute of Technology Welcomes Its First GC," *Corporate Counsel Magazine*, December 22, 2010. Available at [www.law.com/jsp/cc/PubArticleCC.jsp?id=1202476515883&Just\\_What\\_the\\_AG\\_Ordered\\_Stevens\\_Institute\\_of\\_Technology\\_Welcomes\\_Its\\_First\\_GC=&src=EMC-Email&et=editorial&bu=Corporate%20Counsel&pt=Corporate%20Counsel%20Daily%20Alerts&cn=cc20101222&kw=All%20Right%2C%20If%20You%20Won't%20Hire%20a%20General%20Counsel%2C%20the%20AG%20Will%20FORCE%20You!](http://www.law.com/jsp/cc/PubArticleCC.jsp?id=1202476515883&Just_What_the_AG_Ordered_Stevens_Institute_of_Technology_Welcomes_Its_First_GC=&src=EMC-Email&et=editorial&bu=Corporate%20Counsel&pt=Corporate%20Counsel%20Daily%20Alerts&cn=cc20101222&kw=All%20Right%2C%20If%20You%20Won't%20Hire%20a%20General%20Counsel%2C%20the%20AG%20Will%20FORCE%20You!)

settlement, was charged with building a law department, preparing new trainings for the board, and becoming involved in strategic meetings with faculty on policy-oriented work.<sup>6</sup>

***Lessons Learned (with Chapter References)***

Executive compensation (Chapters 2, 3, 7)

Restricted gifts (Chapters 5, 6)

Endowment spending (Chapters 5, 6)

Audit committee (Chapters 2, 3)

Accurate books and records, internal controls (Chapter 6)

Board governance, minutes, private inurement, insider transactions  
(Chapters 2, 3)

Gift acceptance policy (Chapters 2, 5)

Role of General Counsel (Chapters 1, 11)

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<sup>6</sup>*Id.*

## Case Study 3: Smithsonian Institution

### *Introduction*

The case of the Smithsonian Institution, the world's largest museum and research complex, was not a case where the organization lacked a general counsel or policies and procedures to detect and stop the chief executive from taking advantage of board inattention. Instead, this case demonstrates how crises can occur even where formal governance structures are in place, as those structures can be circumvented.

In 2007 a crisis led to the resignation of the chief executive, an inquiry by the Senate Finance Committee, and formation of a Governance Committee and an Independent Review Committee to study what went wrong.<sup>7</sup>

### *Allegations*

The Smithsonian's Board of Regents, established in 1846, consisted of the vice president of the United States, the chief justice of the United States, three members of the Senate, three members of the House of Representatives, and nine other persons selected by joint resolution of Congress. By tradition, the chief justice served as chancellor. Of the nine public members, only two of them could be local residents of Washington D.C.; the other seven must be from other states, virtually assuring at least some degree of geographic distance from the institution's central locus of activity.

This structure assured quite a distinguished board to carry out the noble mission of the institution; but the small size of the board and the heavy public responsibilities of many of its members laid the groundwork for a leadership crisis that came to a head in 2007.

The root causes of the Smithsonian's problems were found by an independent review committee to be failures of governance and management:

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<sup>7</sup>A *Report To The Board Of Regents Of The Smithsonian Institution*, June 18, 2007, available at [http://smithsonianirc.org/images/FINAL\\_IRC\\_REPORT.pdf](http://smithsonianirc.org/images/FINAL_IRC_REPORT.pdf)

The governance structure of the Institution is antiquated and in need of reform. The relationship between the Board of Regents and Mr. [Lawrence] Small, as Secretary, was contrary to effective oversight. At a time when organizations are expected to operate with increasing transparency, the operation of the Smithsonian, and especially the actions of Mr. Small and those who reported directly to him, had become increasingly secretive. Mr. Small created an imperialistic and insular culture in the Office of the Secretary in which the Secretary, rather than the Board, dominated the setting of policy and strategic direction for the Smithsonian. The Board of Regents allowed this culture to prevail by failing to provide badly needed oversight of Mr. Small and the operations of the Smithsonian. The Board did not look behind the tightly controlled data provided by Mr. Small. Nor did it engage in the active inquiry of Mr. Small and Smithsonian management that would have alerted the Board to problems.

These matters culminated in a crisis that led to the resignation of the secretary and correction of the underlying structural deficiencies and controls.

Among the problems detailed by the Independent Review Committee were a troubling lack of access between board members and senior management (other than the CEO), excessive executive compensation, absenteeism, conflicts of interest, and business venture transactions with for-profit entities that did not serve the public interest. In detail:

- The secretary discouraged or forbade employees from sharing concerns with the regents, and even prohibited the general counsel/chief ethics officer, the inspector general, and the CFO from contacting the board directly.
- The total compensation of the secretary was ultimately found to be excessive compared to that of his predecessor, his peers at other institutions, and his subordinates, especially given his performance. The secretary secured a 45 percent increase in base salary in one year, between 2001 and 2002, allegedly by ordering and then manipulating a compensation study by an outside consultant. According to the Independent Review Committee, he went so far

as to dictate the comparables for the outside consultant to use and the percentile that was to be referenced. The resulting recommended increase was passed through the Executive Committee but not the full board, contrary to the Smithsonian's governing documents. Moreover, the Chief Executive was present when the consultants met with the board's Compensation Committee. Nothing in the secretary's performance was found to justify these figures. Indeed, according to the Committee, private contributions to the Smithsonian declined during his tenure and business revenue dropped by 10 percent over the same period.

- Both the secretary and the deputy secretary were found to have been absent for substantial periods due to vacation, compensated service on corporate boards, and uncompensated service to nonprofit entities. The absences of the Smithsonian's first- and second-in-command totaled 403 and 546 days, respectively, over a 6-to-6½ year period. Their outside compensation totaled close to \$6 million and over \$7 million, respectively, during that same period. These facts called into question the executives' primary loyalties according to the Independent Review Committee.
- Moreover, one or more of their board memberships, particularly with Chubb Corporation, from whom the Institution purchased insurance, created potential or actual conflicts of interest that were not properly reviewed by the Institution's general counsel nor vetted by the board or its Audit Committee on an ongoing basis.
- Smithsonian Business Ventures, the division responsible for managing the commercial activities of the Smithsonian, was declining in revenue while salaries and expenses increased, and the division lacked adequate oversight by both senior management and board. Moreover, certain business deals that SBV did enter into, such as a semi-exclusive television contract with Showtime Networks Inc. for 30 years, were criticized in Congressional oversight hearings as a misuse of nonprofit assets because they benefited a private, for-profit party to the detriment of scholars, researchers, and others wishing to access these materials for mission-related purposes.

### ***Outcomes***

Ultimately, both the secretary and the deputy secretary resigned as a result of the allegations. The board created the Independent Review Committee to study the governance matters. The Committee published a set of recommendations for governance improvements. The recommendations included the creation of a Governance Board, the expansion of the Board of Regents to include members with expertise in financial management and facilities and museum management, acceptance of fiduciary duty by most members of the Board of Regents, and strengthening of internal audit controls. A Senate committee hearing was held on the Independent Review Committee's report. A year after the scandal was first reported in the *Washington Post*, a new secretary was hired at roughly half of the ending salary of his predecessor. As of December 1, 2009, the Smithsonian had fully implemented 39 of the 42 recommendations in the IRC report.

### ***Lessons Learned (with Chapter References)***

Fiduciary duties (Chapter 1)

Board composition, size (Chapter 2)

Business ventures by nonprofits with for-profit companies, private benefit, private inurement (Chapters 2, 5, 6)

Executive compensation (Chapters 2, 3, 7)

Independence of gatekeepers such as General Counsel, Chief Ethics Officer, Inspector General, audit committee (Chapters 1, 3, 11)

Internal controls (Chapter 6)

Role of CEO vis-à-vis the board and counsel (Chapters 1, 3, 7, 11)

Importance of CEO adherence to organizational policies (Chapter 7)