

## **When Bad Things Happen to Good Institutions**

### Lessons in Board Oversight

Recently, two respected Washington, DC nonprofits have been shaken by scandals involving excessive executive pay and spending. Both situations stemmed from surprisingly arrogant self-interest on the part of otherwise successful executives. Both led to damaging public and Congressional scrutiny. Both exposed flaws in the governance being provided by experienced and well-intentioned trustees. And both could have been avoided.

The Board was already debating the level of President Ben Ladner's compensation at American University in 2005 when an anonymous letter from a whistleblower arrived, accusing Ladner of lavish personal consumption at the university's expense. The dispute over his compensation and the investigation into his expenses split the Board, filled the gossip columns for months, and eventually led to Dr. Ladner's involuntary termination. It took two difficult years for the Board to rebuild itself, reform its governance, and name a successor.

The Smithsonian Institution's governance issues were triggered by a request from Iowa Senator Chuck Grassley to explain what he believed was excessive compensation and lavish spending on the part of the Institution's Secretary, Larry Small. Treating the request as a relatively minor issue and placing too much trust in Mr. Small (who, incredibly, oversaw the audit of his own expenses), the busy Smithsonian Regents simply passed resolutions retroactively approving the spending in question. This did not sit well with Senator Grassley, and soon the press was filled details of high compensation, generous perquisites, and personal spending by top Smithsonian executives – publicity that led to Secretary Small's termination and damaged the reputations of both the Institution and the Regents overseeing it.

This article is intended to help readers understand how these situations evolved, what went wrong, and how Directors and Trustees can protect against such failures in governance.

#### The Root of the Problem

In both cases, the troubles stemmed directly from one cause: greed – in fact, inexplicable greed.

Ben Ladner, formerly an ethics professor, was selected in 1995 by American University to fill a presidency that had undergone some turmoil in previous years. An excellent strategist and communicator, Dr. Ladner moved quickly to strengthen the university, expand its global reach, and improve the quality of both the faculty and student body. At the same time, however, he quickly developed a reputation for lavish spending, with a personal chauffeur, a full-time cook, and expensive renovations to the president's residence. Virtually all of his normal living expenses were paid for with university funds.

Ladner's compensation also grew rapidly, from \$300,000 in 1995 over \$880,000 in 2004. But this wasn't enough: in 2004, he wrote then Board Chair George Collins a memorandum requesting \$3 to \$5 million in additional compensation (beyond his existing pay) over the next five years.

Larry Small joined the Smithsonian at the end of a long banking career culminating as Vice Chair of CitiBank and then Chief Operating Officer at Fannie Mae. Previous Smithsonian Secretaries came to the position with strong backgrounds in science and education; the Regents believed that Small's experience would bring needed business discipline to the Institution.

Hired in 2000, Small had amassed considerable assets from his career earnings, including pensions worth millions of dollars and a mortgage-free \$3.5 million home in Washington D.C. But he was not willing to work for the same \$300,000 salary as his predecessor. Upon hire, he negotiated a salary of \$320,000 plus a \$150,000 “housing allowance” and a \$54,400 payment “in lieu of pension” – cash compensation totaling \$524,400. The very next year, the Regents increased his base pay by another \$150,000 and his pension payment by \$25,500, bringing his total cash compensation to just under \$700,000.

What drove these executives to expect such high compensation? In Dr. Ladner’s case, I suspect that he believed his position as president of an important university warranted compensation that would enable him to live like the people with whom he was now socializing – corporate titans, ambassadors, emirs, and wealthy alumni. The fact that most university presidents, including all in the Ivy League, earned less than he did not appear to bother him. The fact that American University was saddled with an historically low endowment and with significant budget constraints apparently didn’t lessen his appetite for rich perquisites.

The reasons for Mr. Small’s greed are less clear. Wealthy by any standard when he was hired, he did not need excessive compensation. And he must have been aware that, with the majority of its funding coming from Congress, high compensation would attract negative publicity within and without the Institution. But throughout his tenure, he drove a hard bargain on compensation. When hired, he told the Regent’s Nominating Committee that the housing allowance was a “deal breaker.” And even late in the game, when his expenses were being questioned publicly, he e-mailed his General Counsel that “I will not give up one iota of what has been promised me.”

Boards hire the best leaders they can find, and having done so are inclined to trust and support them. In most cases, this works out. But the judgment of some leaders can’t be trusted. And that is why strong, active, independent oversight is needed in every organization.

#### Where’s There’s Smoke, There’s Fire

One of the interesting similarities in both of these cases is that there were early warning signs that could have nipped these problems in the bud.

At American University, Dr. Ladner’s expenses and living style were questioned almost from the first day he arrived on campus. One student even established a web site, benladner.com, to highlight perceived excesses. (Ladner sued unsuccessfully to have the web site shut down.) At Board meetings, one Trustee repeatedly asked for a full accounting of Ladner’s expenses, but little information was forthcoming. Generally, the Board treated the issue as rogue complaints from disgruntled students, no more.

Similarly, there were early concerns expressed about spending habits during Larry Small’s tenure at the Smithsonian. In 2002, *Washingtonian* magazine published an article critical of Small’s management and questioning his expenses and compensation. Some of this criticism could have been expected: Small was a business executive occupying a position typically filled by someone with strong scientific credentials. The Regents took no action.

Had these boards conducted independent investigations of the allegations raised, it is likely that the reports would have required the boards to confront the issues head on. One can imagine the Chair of the AU Board telling Ladner that while the Board was very happy with his performance,

the cook and chauffer and other extravagances would have to go. Similarly, the Smithsonian Board could well have stipulated no more first class travel or housing allowance for Small.

These confrontations would likely have produced one of two results: a change in policies with compensation levels more appropriate for public, non-profit institutions, or the voluntary termination of the executives involved. Either result would have been far better for both organizations than what ensued.

### Impediments to Oversight

What kept the Boards from addressing these issues early on?

In both institutions, communications between Trustees and key officers were constrained. At the Smithsonian, this was by design: Secretary Small made it very clear to the Chief Legal Counsel, Financial Officer, and Inspector General that all communications with Regents were to go through his office only. At American University, officers in these comparable positions were reluctant to share their concerns directly with Trustees for fear of retaliation. In both institutions, these constraints shut off communications that could have helped Trustees see trouble brewing.

Critical issues in both cases were often dealt with by a small group of Trustees, not by the full Board. At American University, for example, Dr. Ladner's employment contract was negotiated by a prior Board Chair without the involvement of any other Trustee. A small group of Regents negotiated Mr. Small's employment contract without input from, or approval by, the full Board.

Except for brief meetings to approve compensation increases each year, neither organization had an executive session where matters could be discussed without the President being present. And even in the compensation area, management tightly controlled communications. Management retained the compensation consultants, and management approved their Board reports in advance.

When a small group of Trustees handles sensitive issues, with either explicit or tacit approval from the full Board, it is easy for Trustees outside this group to assume that issues they might perceive as problems are being quietly addressed – but often they are not. At American University, this condition was exacerbated by the fact that some key Trustees, including the head of the Audit Committee, were close friends of the Ladners.

The Smithsonian Regents had another problem: the Chancellor (the Smithsonian's name for the Board Chair) ran very tight meetings. By tradition, the Chief Justice of the United States has been appointed Chancellor of the Smithsonian Board of Regents, a position Chief Justice William H. Rehnquist accepted eagerly. Justice Rehnquist, perhaps practicing Board leadership in the same manner as presiding over Supreme Court sessions, stipulated that none of the quarterly Board meetings should run longer than 1½ hours. Discussions on issues were strictly limited<sup>1</sup>; for the most part, the meetings entailed brief summaries of previously distributed reports, and Board votes when necessary.

The Smithsonian Regents tried to work around this problem by convening meetings of a "Committee of the Whole" prior to the official Board meetings, a process that provided some

---

<sup>1</sup> Justice Rehnquist is reported to have said to Senator Patrick Moynihan, speaking up at his first Board meeting, "Senator, you may address the Board only when recognized by the Chancellor. When you are so recognized, your comments will be pertinent, brief, and non-redundant."

time for meaningful discussions. But even there, with management controlling the agenda, the meetings did not lead to an open, frank discussion of issues.

So there was a confluence of events precluding effective governance: busy trustees not finding the time to dig into signs of potentially serious problems; trustees assuming that other, more senior trustees were investigating these issues; constrained communications with key officers; management control of input from outside advisers such as external auditors and compensation consultants; and insufficient processes to engage the full Board in important discussions. This thick brew of weaknesses enabled the leaders of both institutions to live larger than they should have, and do so longer than they should have, damaging their reputations and those of the institutions and their boards.

### Crisis Time at American University

Here, the stories diverge. While problems leading up to the crises were quite similar, the two Boards reacted differently when the crises erupted, and we shall consider them separately.

The American University crisis came in two stages, the first involving compensation and the second lavish spending. In 2004, troubled by reports that Dr. Ladner was among the highest paid university presidents in the country, some Board members asked for an independent review. A new compensation consultant was hired, who concluded that highest supportable reasonable compensation for Dr. Ladner was \$780,000, significantly less than he was then making.

The debate over this issue exposed deep rifts in the Board, with one group of Trustees pushing for a reduction in Ladner's pay and another arguing to keep it unchanged. Ladner attacked the credibility of the compensation consultant and eventually persuaded the Board to agree to hire a second consultant, who came to precisely the same conclusion as the first. At one point, the Board voted to reduce Ladner's compensation by the proposed amount, but this vote was overturned at a later Board meeting. Board member relations were severely strained.

Into this mix came an unexpected complication: a letter from a whistleblower accusing Dr. Ladner of abuses of his University expense account. Now the Board was forced to address the expense issues officially, and they hired an independent auditor to investigate the allegations. The auditor's report, eventually made public, found that Dr. Ladner had charged over \$500,000 in personal expenses to the university, including \$5,000 in expenses for a brief holiday in London and \$15,000 for an engagement party for his son. The report also questioned the need for and use of personal staff hired by the University but providing services primarily to the Ladners, including a personal chef and chauffeur.

Even with this information, some Board members continued to strongly support Dr. Ladner, who himself attempted to justify most of the expenses as necessary for his position as the President and chief fundraiser. The Board's factions hardened at two extremes: those who thought Ladner's pay and living style were unconscionable; and those who thought that Ladner was doing such a good job running the university that his earnings and expenses were reasonable.

Then, the deep division on the Board turned destructive. With the Board unable to reach a consensus on how to handle the problem, the anti-Ladner group leaked information on the investigation to the *Washington Post*, which over the next few months published increasingly embarrassing reports on Ladner's compensation and spending. Eventually, this led the Board to ask for Ladner's resignation and to begin what turned out to be a long search for a successor.

Who was to blame for the destructive publicity? Well, everyone. Ben Ladner could have resolved the problem and kept a prominent, lucrative position by acceding to the Board's wishes on his compensation, accepting appropriate expense allowances, and paying back any personal expenses identified by the auditors. Trying to protect \$1 million or so of future pay and benefits, he lost many millions and a contract provision that provided a lifetime tenured professorship.

The pro-Ladner Trustee group performed no better. The information on Ladner's expenses would be embarrassing if made public; two recognized compensation consultants had independently confirmed that his compensation was unreasonable; there were growing issues with students and faculty about these problems. Public disclosure of the debate would be damaging. These Trustees should have persuaded Ladner to accept the reports of the consultants and auditors, and worked with the rest of the Board to resolve the matter quietly.

By going to the press with all the sordid details, the anti-Ladner group failed as well. Granted, they eventually achieved their objective of forcing the Board to fire Ladner. But the publicity they generated damaged the credibility of the University and of everyone involved. They should have worked harder, privately, to achieve a consensus with the full Board.

Throughout this crisis, there should have been one question on everyone's mind: "What's best for American University?" It isn't clear that this was on anyone's mind.

#### Crisis Management at the Smithsonian

When the Smithsonian crisis reached a boiling point, the Smithsonian Board performed much better, except for one early mistake.

Complaints about Secretary Small's spending and compensation came to the Regents in a lengthy letter from Senator Chuck Grassley of Iowa. The letter raised questions about the level of Small's compensation, the need for his housing allowance, and spending on items such as first class travel and expensive floral arrangements for internal meetings.

Appropriately, the Board hired an independent auditing firm to look into these allegations. Inappropriately, the audit was overseen by Smithsonian management. When the resulting report was presented, problems were minimized and the Board's Audit Committee decided to resolve any questions about excess spending by retroactively changing the Institution's policies to allow first class travel and related expenditures for the Secretary. His compensation was unchanged.

Senator Grassley was not pleased, and wrote a second letter to the Regents requesting further review and action by the Smithsonian Board. Concurrently, the *Washington Post* began a series of articles detailing allegations of overspending and questionable management practices at the Smithsonian.

At this stage, the Regents realized that they had a major governance issue on their hands. Within weeks, they took three decisive steps:

1. The Regents formed a special ad hoc Governance Committee, to conduct a thorough review of the structure and governance processes of the Board, and to recommend changes as appropriate.

2. They also formed an Independent Review Committee, chaired by the former Controller General of the United States, Chuck Bowsher, to conduct a separate, independent review of the issues and governance problems that led to their development.
3. In the long-term interests of the Institution and to lessen further adverse publicity, they persuaded Secretary Small to resign his position, effective immediately, and without a severance package that undoubtedly would have angered the community.

With these steps, the Regents shifted the focus from the past to the future. Working totally apart from each other, the Independent Review Committee and the Regent's Governance Committee came to remarkably similar conclusions of how governance at the Smithsonian should be improved. Included in these recommendations were stronger Board oversight, with periodic executive sessions without the attendance of the Secretary; a clear statement of each Regent's fiduciary responsibilities; processes for regular communications with the Chief Financial Officer, Chief Legal Officer, and Inspector General; the stipulation that future compensation consultants would report directly to the Board's Compensation Committee; and clear, appropriate policies for travel, expense allowances, etc.<sup>2</sup>

The principal difference between the Smithsonian Regents' action in crisis and that of the American University Board is that the Smithsonian Regents recognized that there were deficiencies in their oversight and, in so doing, were open to reforming their governance. As a result, the negative publicity was relatively short-lived, and the Institution emerged from the crisis with a stronger and more unified Board.

#### Lessons for Directors

Boards cannot make themselves free of the risks discussed in this article, especially if management is determined to keep them in the dark. But common-sense steps can significantly lessen the possibility of embarrassing situations:

1. Trust but verify – it's OK to ask tough questions of a leader you respect.
2. Keep your antenna up. If something doesn't sound right, even something minor, ask around enough until you are satisfied that there isn't a problem, or that the problem is resolved.
3. Encourage frank, open discussions in Board and Committee meetings. Don't discourage Directors from asking tough or potentially embarrassing questions.
4. Structure the Board agenda so that there is sufficient time to discuss potential problems, risks, and concerns. Don't limit discussions just to status reports or items requiring Board action.
5. Meet regularly in executive session, without any members of management present. Even if these meetings are very brief, they give Trustees the opportunity to raise concerns that might be difficult to express otherwise.

---

<sup>2</sup> Full copies of these reports can be found at <http://newsdesk.si.edu/kits/governance/default.htm> and <http://smithsonianirc.org/>.

6. Keep open lines of communications with key officers – CFO, legal counsel, internal auditor. Encourage them to raise concerns with Board members when they have them.
7. When crises arise, handle them as quickly as they can be handled well. Resolve them before they get to the press.
8. Listen to whistleblowers and encourage their input. Sometimes these are just disgruntled employees, but often they are telling you important things the Board should know.
9. Finally, remember that your fiduciary duty is to the organization itself, not the Board or any executive. In a crisis, always ask what's best for the institution you serve.

*A. W. (Pete) Smith, Jr. is President of Smith Consulting, a firm that advises nonprofits on management compensation issues. The retired CEO of a major consulting firm, Mr. Smith served as a Trustee of American University and on the Independent Review Committee formed to evaluate governance issues at the Smithsonian Institution. He can be reached at [pete@petesmithconsulting.com](mailto:pete@petesmithconsulting.com).*