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What Didn't Work

Tongue-Tied at the Top

By Pete Smith

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Tongue-Tied at the Top

While boards sat in silence, executives milked American University and the Smithsonian By Pete Smith

Smithsonian chief Larry Small enjoyed a "champagne lifestyle" at taxpayer expense while his board looked on.

PHOTOGRAPH BY GERALD MARTINEAU/THE WASHINGTON POST

Over the past few years, Washington, D.C., has witnessed two explosive nonprofit scandals. In 2005, the board of American University received a letter from an anonymous whistle-blower alleging that the university's president, Ben Ladner, was abusing his university expense account. A subsequent audit found that Ladner had indeed spent more than $500,000 of university funds on lavish personal expenses, including a $5,000 vacation in London and a $15,000 engagement party for his son. Already concerned about Ladner's compensation—which was higher than those of all Ivy League college presidents—the board split over whether to reduce Ladner's pay. The fracas filled newspaper gossip columns for months, sparked a congressional inquiry, and eventually led to Ladner's termination. The board then required two years to rebuild itself and to name a new president.

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Meanwhile, trouble was brewing at the Smithsonian Institution. In 2006, Sen. Charles Grassley of Iowa asked the Smithsonian to justify the compensation and spending of its secretary (that is, its chief executive), Lawrence "Larry" M. Small. In response, the busy Smithsonian regents trusted Small to oversee his own audit, and then passed resolutions that retroactively approved his spending. Displeased, Grassley issued another missive demanding change at the organization. The press soon buzzed with rumors of excess and impropriety at the nation's premier museum system. The board eventually dismissed Small, but not before the mudslinging damaged the reputations of both the institution and the regents overseeing it.

Both scandals invited embarrassing publicity and congressional scrutiny. Both exposed the governance flaws of experienced and well-intentioned board members. And both could have been avoided.

As a trustee of American University from 1999 to 2005 and a member of the independent review committee that evaluated the governance issues at the Smithsonian, I watched as these organizations weathered their governance crises. In both cases, practices that discouraged frank and frequent communication among board members left the greed of executives unchecked. And in both cases, changes to these systems put the organizations back on track. Yet the Smithsonian righted itself more quickly than American University because its regents ultimately reacted decisively and cohesively.

American's Error

In 1994, American University elected Ben Ladner, a former ethics professor, to be its president. Although American had only a small endowment, Ladner required that the university pay virtually all of his living expenses, which included salaries for a chauffeur and a cook, on top of his $225,000 salary. He also demanded expensive renovations to the president's residence.

From the time he arrived on campus, Ladner's financial habits invited controversy. For example, one student established a Web site to highlight the president's excesses. Ladner unsuccessfully sued to have the site shut down.

Although most board members treated students' concerns as rogue complaints, a few spoke out. Trustee Robert Pence questioned Ladner's spending in 1996, for which he was removed from the audit committee. "I think I was asking too many questions," he said in a letter to the board. Another trustee, Paul Wolff, repeatedly asked for a full account of Ladner's spending. But Ladner did not provide the requested information, and the board continued to ignore early signs of the president's excessive spending.

Meanwhile, Ladner's compensation mushroomed. In 1997, then board chair William I. Jacobs renegotiated Ladner's employment contract without asking the board to authorize the agreement. The new contract added lucrative incentives so that by 2004, Ladner's total compensation had grown to some $880,000—more than that of most university presidents. Nevertheless, in that same year Ladner asked then board chair George Collins for an additional $3 million to $5 million in compensation. An excellent strategist and communicator, Ladner had indeed strengthened the university, expanded its global reach, and improved the quality of both the faculty and student body. But Collins knew that Ladner's request for more pay would anger many trustees, and so he did not tell the board about it.

At that point, the compensation committee became concerned that Ladner was among the highest-paid university presidents. It also began to distrust his tightly controlled communication with the board. As a result, the compensation committee retained the consulting firm Towers Perrin to conduct an independent review, which concluded that the highest reasonable compensation for Ladner was $780,000. Ladner attacked the consultant's credibility and persuaded the board to hire a second firm, Mercer. Frustrated with Ladner's arrogant defense of his compensation and no longer able to support him, I resigned from the board.

After Mercer reached the same conclusion as did Towers Perrin, the American trustees quarreled bitterly over whether to reduce Ladner's compensation. One group pushed for the reduction, while the other argued that Ladner was doing such a good job running the university that his earnings and expenses were reasonable.

During this debate, the whistle-blower's letter arrived, forcing the board to examine Ladner's expenses. The trustees hired an independent auditor who uncovered the president's extensive spending of university funds and questioned his use of university staff for personal duties. Ladner countered that most of the expenses were necessary for his position as the president and chief fund raiser. Some board members continued to support him.

The deep division between pro- and anti-Ladner board members then turned destructive. With the board unable to agree on what to do about Ladner, the anti-Ladner camp leaked the audit findings to *The Washington Post*. Almost daily for the next few months, the *Post* published increasingly embarrassing reports about Ladner's compensation and spending. Eventually, on Oct. 10, 2005, the board asked for Ladner's resignation. Several board members also resigned over the controversy. Meanwhile, the board's bitter public disagreements dimmed the interest of several candidates who might have succeeded Ladner, as well as alienated some very generous donors. It took the fractured board two years to find Ladner's successor.

A SMALL PROBLEM

The Smithsonian Institution's board of regents similarly failed to rein in its spendthrift executive. But when called to task for their oversight, the regents repaired their governance more quickly and completely than did American University's trustees, providing an excellent lesson in crisis management.

When the Smithsonian regents hired Larry Small to be the institution's secretary in 2000, they were departing from a tradition of leaders with strong backgrounds in science and education. The regents believed the complex and growing institution needed management discipline. With a long banking career that included terms as vice chairman of Citibank and chief operating officer of Fannie Mae, Small seemed to offer just that.

Through his experience, Small had reaped considerable assets—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. Instead, Small negotiated a total compensation package worth more than $530,000, which included a salary of $330,000, an annual housing allowance of $150,000, and an annual payment in lieu of pension of $54,400.

Concerned that this level of compensation would cause adverse publicity, the small group of regents that negotiated Small's employment contract did not share the details of the contract with the full board and informed the public only of Small's base salary.

> Board members need to keep their antennae up. Where there's smoke, there's usually fire. But quick action can douse the flames before they damage an institution.

The next year, the same small group of regents increased Small's base pay by another $150,000 and his pension payment by $25,500, bringing his total cash compensation to just under $700,000. Small justified these increases to the executive committee by saying that they would allow him to adjust the salary structure for other worthy Smithsonian employees.

But salary increases for other top Smithsonian employees were far more modest than Small's 41 percent raise. The next highest raise for a top executive was 21 percent; 14 executives received raises averaging 10 percent; and 16 received no salary increase. The adjustments for all employees except Small could have been made under the existing salary structure.

By 2002, observers began to express their concerns about Small's compensation, leadership, and spending. For example, an extensive *Washingtonian* magazine article titled "Money Man" questioned Small's management style and lavish spending, including the $14,600 he spent to charter an executive jet for a trip to San Antonio. Still, the regents took no action. Negotiating Small's compensation was left entirely to the executive committee.

One reason the Smithsonian regents failed to address the growing concerns is that the chancellor (the Smithsonian's board chair) ran very tight meetings. By tradition, the chief justice of the U.S. Supreme Court serves as Smithsonian board chancellor—a position that then Chief Justice William H. Rehnquist accepted eagerly. Perhaps applying the same techniques that he used in Supreme Court sessions, Rehnquist stipulated that none of the quarterly board meetings run longer than 90 minutes, and he strictly limited discussions. According to former regent Anne d'Harnoncourt, he once told regent Daniel Patrick Moynihan: "Senator, you may address the board only when recognized by the chancellor. When you are so recognized, your comments will be pertinent, non redundant, and brief."

For the most part, meetings of the regents entailed brief summaries of previously distributed reports and board votes when necessary. There were few opportunities to introduce new agenda items. Moreover, the board rarely met without Small present, and so the regents had few chances to discuss his performance openly.

The Smithsonian regents tried to work around this problem by convening meetings of a "committee of the whole" preceeding the official board meetings, a process that provided some time for meaningful discussions. But even there, Small controlled the meeting agendas and presentations, precluding frank and open discussion.

In the ensuing years, Small's compensation increased an average of 5 percent per year—not atypical for nonprofit leaders in this period. Nonetheless, by 2007 Small's total compensation had grown to $915,698, which was higher than that of almost all nonprofit CEOs in the United States and more than three times that of his predecessor.

In June 2006, Sen. Grassley, then chair of the Senate Finance Committee—overseer of the Smithsonian's budget—requested an audit of Small's compensation and expenses. The Smithsonian undertook an internal audit, during which Debra Ritt, then the institution's inspector general (the federal term for internal auditor), complained that Small put pressure on her to curtail the audit.

Ritt eventually resigned, saying that her independence was compromised because she had to report to Small rather than to the regents. Small similarly instructed Ritt's successor, Sprightley Ryan, to have no direct communication with the regents. Small also isolated the Smithsonian's general counsel and chief financial officer from the regents.

The regents then ordered a separate external audit, which identified nearly $500,000 of questionable expenses, which included first-class travel and repairs to Small's home. Yet on receiving this report, the regents merely passed two resolutions that retroactively approved the expenses. Small's office drafted the resolutions.

This did not please Grassley, who in March 2007 wrote another letter—this time lengthy and highly critical. He asked many detailed questions about what appeared to be an "anything goes" culture at the Smithsonian, which forced taxpayers to subsidize Small's "champagne lifestyle." Grassley also released the letter to *The Washington Post*, putting severe pressure on the regents to address the issues fully.

Realizing at last that they had a major governance issue on their hands, the regents took three decisive steps. First, they formed a special ad hoc governance committee to review the structure and processes of the board and to recommend changes.

Next, the regents created an independent committee, chaired by former U.S. Comptroller General Chuck Bowsher, to conduct a separate review of the crisis, as well as of the governance problems that led to its development. Finally, Regent Eli Broad phoned Small to suggest that the best way to avoid further damage to the institution was for Small to leave, and Small agreed. Small received no severance payment.

With these steps, the regents shifted their focus from the past to the future. Working apart from each other, the independent review committee and the governance committee reached very similar conclusions about how to improve governance at the Smithsonian. The committees' recommendations included (1) full board review and approval of the secretary's compensation; (2) periodic meetings of the full board without the secretary; (3) processes for regular communications between the regents and the CFO, chief legal officer, and inspector general; and (4) clear, appropriate policies for travel expenses.

The regents communicated these governance reforms to congress and the public. With these steps, and with a clear focus on the future, the regents were able to quell the public outcry over Small's excesses, attract an excellent new secretary, and put the negative publicity behind them.

THE BETTER PATH

At American University and the Smithsonian Institution, similar governance missteps avalanched into full-blown crises. In the absence of board-wide discussions, board members assumed that other, more senior members were keeping an eye on executives. Management also conspired to keep trustees in the dark about important decisions regarding compensation and expenses by controlling the input of external sources. And board dynamics—ruled by contention at American University and excessive efficiency at the Smithsonian—discouraged open, honest discussions. This thick brew of weaknesses enabled the leaders of both institutions to live larger than they should have, and to do so longer than they should have.

But during their times of crisis, American University and the Smithsonian reacted differently. In contrast to the American trustees, the Smithsonian regents acknowledged the deficiencies in their oversight and, finally recognizing the depth of their problems, acted decisively to change leadership and reform their governance.

The American board moved to reform governance as well, but more slowly. Where the Smithsonian regents looked at each other and said, "We all have a problem," the two sides of the American dispute looked at each other and said, "You are the problem." American might have recovered much faster, and with far less damage to the university, if its trustees had found a way to resolve their differences more quickly and privately.

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 strong, active, independent oversight is needed to assure that leaders do not go astray. This includes the type of good governance that has become so common in post-Enron corporate boards: full board discussions of important issues, including leadership compensation; regular executive sessions with only the outside directors, external auditors, and legal counsel present; open lines of communication between officers such as the CFO and chief legal counsel; and a culture open to whistle-blowers.

Most important, board members need to keep their antennae up. Where there's smoke, there's usually fire. But quick action can douse the flames before they damage an institution. ■