What Didn’t Work

Tongue-Tied at the Top

By Pete Smith
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.

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 misive 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 muddling 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
nuisance 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 Wölf, repeated
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 J. 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 $860,000—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 communica-
tion consultant, Ladner had indeed strengthened the university, expanded its
global reach, and improved the quality of both the faculty and stu-
dent 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 uni-
versity presidents. It also began to distrust his
tightly controlled communication with the board. As a result, the compensation commit-
tee retained the consulting firm Towers Perrin
to conduct an independent review, which
concluded that the highest reasonable
compensation for Ladner was $970,000. Ladner attacked the con-
sultant’s credibility and persuaded the board to hire a second firm,
Mercer. Puzzled with Ladner’s arrogant defense of his compensa-
tion 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 quabbled 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 uni-
versity 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 in-
dependent auditor who uncovered the president’s extensive spend-
ing 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 compensa-
tion 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 insti-
tution’s secretary in 2000, they were departing from a tradition of
leaders with strong backgrounds in science and education. The re-
gents believed the complex and growing institution needed man-
agement 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 $350,000, which
included a salary of $350,000, an annual housing allowance of
$30,000, 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 employ-
ment contract did not share the details of the contract with the full
board and informed the public only of Small’s base salary.

The next year, the same small group of regents increased Small’s base
pay by another $30,000 and his pension payment by $59,500,
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 36 received no salary increase. The adjust-
ments 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 $4,400
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

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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, not 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” preceding 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 $935,698, 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. The American board moved to reform governance as well, but more slowly. Where the Smithsonian regents looked at each other and said, “You are the problem,” the two sides of the American dispute looked at each other and said, “We all have a problem.”

But during their times of crisis, American University and the Smithsonian Institution, similar governance mistakes awakened 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 coopted 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.

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.