How Not to Govern: Lessons From the Report to the Board of Regents of the Smithsonian Institution

By Lesley Friedman Rosenthal

What does a nonprofit cultural institution owe to the general public and its funders by way of good governance? What does the institution's board owe to the institution by way of vision and oversight? What does senior management owe to the board by way of accountability? What systems should be in place to assure adequate checks and balances, and what happens when these systems are not in place or not enforced?

An independent review committee recently delivered a thoroughgoing and scathing critique of governance and management practices at the Smithsonian Institution. Questions surrounding the compensation and business conduct of Lawrence M. Small, the Secretary (as the Institution's Chief Executive is called), cropped up in press and other accounts as early as 2001, just one year into the Secretary's tenure, and persisted and became more pervasive over time. By early 2007, Senator Charles Grassley (R-Iowa), the Ranking Minority Member of the Senate Finance Committee, put questions and document requests to the Institution. The U.S. Senate froze a $17 million appropriations increase for the Smithsonian, citing Small's compensation as excessive. On March

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26, Small resigned from his position.[1] Ultimately the Chairman of the Board's Executive Committee appointed the Independent Review Committee,[2] which delivered its report on June 19, 2007.

The findings of the Independent Review Committee were stark and unflinching. Among them:

- The total compensation of the Secretary, Lawrence Small, at just under $1 million this year, was excessive compared to that of his predecessor, his peers at other institutions, and his subordinates, especially given his performance; his expenses were under-documented, and his perks (including lavish travel expenses for himself and his wife) were disproportionate for a nonprofit organization funded primarily by taxpayer dollars. Moreover, the compensation, expenses and perks were under-disclosed to the Smithsonian Board;
- The Secretary's management of the Institution was "secretive," and his style of interacting with the Board was "imperialistic" and "insular." He, and not the Board, dominated the setting of policy and strategic direction. He actively forbade employees from sharing concerns with the Regents, even prohibited the General Counsel/Chief Ethics Officer, the Inspector General and the Chief Financial Officer from contacting the Board directly.
- Both the Secretary and the Deputy Secretary, Sheila P. Burke, were 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 six- to six-and-a-half-year period. Their outside compensation totaled close to $6 million and over $7 million, respectively, during that same period. These facts alone were sufficient to call into question where these executives placed their primary loyalties. Moreover, one or more of their board memberships, particularly with Chubb Corporation, from whom the Institution purchases insurance, created potential or actual conflicts of interest that were not properly reviewed by the Institution's General Counsel or 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 the Board.

The Committee's 100-plus page report (plus some 41 exhibits) reveals a toxic combination of unchecked arrogance by the Chief Executive Officer, a relatively disengaged Board, and a dysfunctional senior staff structure, including a General Counsel, Chief Financial Officer and an Acting Inspector General who allowed themselves to be marginalized by the Secretary from direct and proper reportage to the Board.

The Unchecked Excesses of the Chief Executive

The Committee reported a number of examples of the Secretary's excesses and the manner in which they went unchecked.

Salary

Mr. Small negotiated a high starting salary with just a small number of Regents, which was neither disclosed timely to nor formally approved by the Board. The handsome starting salary was further enhanced at the outset by a sizable housing allowance, ostensibly for the purpose of hosting Smithsonian business and social functions. Those functions hardly materialized, but the terms of the housing allowance were continued and even increased. Indeed, the recordkeeping requirements for eligibility for the housing allowance were later relaxed – upon Mr. Small's direction to management under his direct supervisory control and, again, without full Board review – such that no actual expenses need be incurred for the allowance to be paid. This arrangement, together with other "noncompensation" arrangements such as payments in lieu of pension equal to 17% of his annual base pay, and first-class air travel for the Secretary and his wife "when appropriate," were found by the Committee to be a mere "'packaging device' for delivering Mr. Small additional compensation in a manner that would conceal the true size of his pay."[3] His true total compensation far exceeded that of his predecessor and that of an appropriate peer group of comparitors.[4]

The Committee also noted the highhanded manner in which these compensation excesses were carried out. Mr. Small secured for himself a 45% increase in base salary in one year, between 2001 and 2002, by ordering and then manipulating a compensation study by an outside consultant. 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.[5]

Similar activities occurred in 2002, 2004 and 2006. The pattern continued: an outside compensation firm was retained by management, not the Board or its Compensation Committee; and the peer group was determined by management, with no input from the Regents or from the consultants, who were merely to "crunch the numbers."[6] Indeed, the consultants never met with the Smithsonian's Compensation Committee without Mr. Small and Ms. Burke present. Ultimately, Mr. Small's total compensation package jumped from $536,100 in 2000 to $915,698 in 2007.

Nothing in Mr. Small's performance was found to justify these figures. Indeed, according to the Committee, private contributions to the Smithsonian declined during the Small administration. Business revenue, including from Smithsonian Business Ventures (SBV), dropped by 10% over the same period. Both of these declines meant the institution would rely even more heavily on the federal government for funds. Certain business deals that SBV did enter into, such as a semi-exclusive television contract with Showtime Networks Inc. for 30 years, were criticized as being unfair to researchers and scholars.

Excessive Absences and Outside Compensation

Mr. Small took off 403 days in six years, of which 339 were vacation days and 64 were work days missed for non-Smithsonian obligations, such as attending Chubb and Marriott board meetings. His Deputy, Ms. Burke, took off 546 days in six and a half years, including 130 vacation days and 416 work days missed for non-Smithsonian obligations. Ms. Burke served on the boards of Chubb and Wellpoint, Inc., as well as the Kaiser Family Foundation, the ABIM Foundation, and Community Health Systems. Part of her outside hours also included unpaid service to a number of nonprofit organizations such as teaching at Harvard University's Kennedy School of Government in Cambridge, Massachusetts, and several other institutions of higher learning, and service on other advisory boards or committees in the health policy field.[7]

The Committee expressed deep concern about the executives' ability to devote due energies and loyalty to their primary employer, the Smithsonian, under these circumstances. Also of concern was that there was no policy in place limiting leave, and the Board was evidently unaware of both the lack of a leave policy and these frequent absences.

Mr. Small's outside compensation during his six-year tenure at the Smithsonian totaled nearly $6 million, essentially from service on the boards of Chubb and Marriott. Ms. Burke's outside compensation for her board service, including options, was estimated to be worth about $7.2 million from 2000 through 2007. The size of these figures, particularly when compared to these executives' salaries for their purportedly full-time work at the Smithsonian, again calls into question where their loyalties were likely to lie.

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Other Matters

The Institution has been subject to criticism throughout the Small administration on arguably overly restrictive conditions set by donors on certain gifts, and the scope and content of some shows and displays.[8] In response, the Regents revised grant approval processes to include Board approval in certain instances, but there was no general overhaul of the Board's oversight role on program, policy and long-range planning until the 2007 crisis that led to the resignation of the Secretary, the Senate Finance Committee inquiry, and the formation of a governance committee and the Independent Review Committee.

An Antiquated Board Structure and Disengaged Members

The Independent Review Committee characterized the Smithsonian Board structure as "antiquated and in need of reform."[9] The Board of Regents is composed of just 17 persons: 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.[10] By tradition, the Chief Justice serves as Chancellor.

This structure assures quite a distinguished Board to carry out the noble mission of the Institute;[11] but given the heavy public responsibilities of the many public officials on the Board towards other primary constituents and stakeholders, it is almost by definition not a terribly engaged body. Moreover, of the nine public members, only two of them may 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. Thus, while the prestige of the organization attracts extremely distinguished figures from the for-profit, nonprofit and government sectors to serve on the Board, it is structurally not well suited to act in accordance with modern expectations of oversight.

Thus, it is no surprise that the Committee found "[h]istorically the Smithsonian Board of Regents appears not to have taken on a strong oversight role."[12] The Committee concluded that roles of the public officials should be clarified, and perhaps the number of "lay" leaders expanded, so that the Board may properly discharge its fiduciary function.

Moreover, the Smithsonian is a complex institution including some of the nation's leading museums, research centers, a zoo, retail shops, restaurants and buildings. In order for the Board to provide proper oversight and strategic guidance, the Committee concluded that future Board candidates should possess expertise in financial management, investment strategies, audit functions, governance, compensation and facilities management, as well as an interest in and a devotion to the arts and sciences.[13]

Ultimately, concurrent with the appointment of the Independent Review Committee, the Board created a standing Regents' Governance Committee with a mandate to swiftly and comprehensively review Smithsonian policies and practices as well as determine how the Board could better oversee the Institution. The Governance Committee has now made recommendations to strengthen the Regents' leadership and governance of the Institution.[14] The recommendations of the Governance Committee parallel many of the conclusions reached by the Independent Review Committee:

> Despite regular attendance by most Regents and active participation in meetings, in the end the Regents did not provide the level of leadership and oversight that they had intended. Contributing to the situation was an agenda and information flow tightly controlled by the Office of the Secretary. Information leading to difficult and critical decisions was at times prepared and presented in a summary fashion that did not encourage full and complete discussion. As a result, the Regents were at times unable to thoroughly consider the major and strategic issues facing the Institution.[15]

Lessons Learned From the Smithsonian Example: How Not to Govern

Trustees, senior executives, academics and others interested in the not-for-profit sector may take away some lessons from the Smithsonian's experience. Key lessons for attentive students of the sector include:

1. Properly run organizations have an active governing board with a vision and strategy for carrying out the mission of the institution, and a Chair and other Board-level leaders who can provide the time properly to oversee the carrying out of the mission. As remarkable an opportunity though it may be to have individuals of singular prominence and importance serve in leadership roles on the Board (such as, here, the Vice President and the Chief Justice), the interests of the organization are better served by governing board members and a Chair with the time and attention necessary to devote to the fiduciary responsibilities of overseeing operations and management. In addition, it is important that the Board be the right size and possess the time, expertise and independence necessary to discharge its duties. Active committees should include Audit and Review, Governance and Compensation, and Human Resources, and these should include, if necessary, non-Board members with special expertise. Committees that include non-Board members may be constituted as committees of the corporation rather than as committees of the Board.
2. Prominent persons – donors, artists, scientists, public officials and others – with an interest in the organization's program but lacking the time, availability or expertise to provide meaningful oversight may serve the organization in a non-fiduciary capacity, such as on an honorary or advisory board or on professional councils.
3. The Board should meet regularly – the Committee recommends no less than once every other month, although reasonable practices differ – and/or there should be a robust Executive Committee that is empowered, within legal limits, to discharge the duties of the Board between meetings. Where there is such an Executive Committee, its deliberations and actions should be promptly reported out to the full Board for review. The minute-taking function is not merely a ministerial or "housekeeping" matter, but a substantive responsibility that must be discharged assiduously.
4. The Board must not permit a single executive to run and dominate Board meetings, set agendas, or determine what information would be provided to Board members. At meetings of the Board, there must be adequate opportunity for members to receive and discuss reports from not only the Chief Executive, but also, as appropriate, directly from program executives, other in-house and outside professionals, and independent consultants if necessary. Time should be reserved for executive sessions, from which management should be excluded so that its performance may be fully and freely discussed.
5. Compensation and expenses of senior management, outside professional involvements, and transactions with interested parties should all be regularly reviewed by an Audit Committee and reported to the Board. Discussions of such matters should be documented for future and ongoing reference. Gatekeepers of the organization – general counsel and corporate secretary, chief financial officer, outside auditors, inspector general or the functional equivalent – *e.g.*, an internal auditor – must be assured independence and regular and direct access to the Audit Committee and Board in order to properly carry out these functions.
6. Executives' service on outside boards, particularly for-profit boards, and other outside activities should be carefully and continuously monitored by an Audit Committee or similar committee, because of (a) the time commitments that may be involved;

(b) the impact of compensated service, particularly where such compensation may be sizable relative to the employee's compensation at the nonprofit institution; and (c) business relationships between the outside organization and the institution that may be, or appear to be, a conflict of interest.

Additional Observations About the Committee Report

The Smithsonian Institution and its Board have shown admirable courage in undergoing a detailed and unflinching self-examination in such a public manner. The Committee's affection for the Smithsonian is evident. And, as noted above, the sector as a whole may benefit from the insights of the Independent Review Committee and the Governance Committee.

Readers should be cautioned, however, not to overgeneralize from the findings and recommendations of the Committee. The Smithsonian is a particularly visible nonprofit institution, but its governance failures should not be taken as endemic to the sector as a whole. The sector is considered by many to be reasonably regulated by a combination of voluntary measures, state and local law, industry self-regulatory bodies, watchdog reporting groups such as the Better Business Bureau and Guidestar, and federal disclosure and accountability measures such as the Internal Revenue Service Form 990 and rules against excess benefit transactions.[16]

Indeed, the Smithsonian itself was already subject to external rules and internal procedures that could have avoided many of the circumstances documented in the report, if they had just been properly deployed. Expenses were already required to be documented. Senior officials and employees with contracting authority were already required to complete conflict of interest forms every year.[17] Outside auditors and consultants were regularly brought in to review the books and expenses as well as conduct regular executive compensation reviews. The Institution and its executives were already subject to internal rules, such as bylaws, and external rules, such as Treasury Department regulations, regarding excess benefit transactions. Evidently the internal gatekeepers as well as the external regulators were equally stymied by those inclined to exploit weaknesses in the system.

The biggest problem at the Smithsonian may not have been a lack of rules and procedures, but a lack of enforcement and a lack of real Board oversight. Accordingly, the Committee's final recommendation – that "achieving effective oversight and governance at nonprofit organizations may ultimately require legislative action"[18] – may be an overreaction to one, admittedly spectacular, failure. Are new laws required or simply better enforcement of the existing ones, and a greater attentiveness by a more reasonably constituted Board?

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Similarly, with respect to executive compensation, readers should be wary of substituting their own judgment for the judgments of persons with deep institutional knowledge of the subject organization and its leadership needs. It is not necessarily realistic to assume that an institution, even one of our nation's most august and respected nonprofits, will be able to attract top senior management talent just by the prestige of the organization alone. While the Committee would have expected to see a substantially lower CEO salary because "serving as Secretary is an honor" and that "compensation levels should reflect this,"[19] it is also clear from the report that the job of Secretary is enormously complex. Certainly salaries in the nonprofit sector, even for demanding, complex and highly visible jobs such as senior executives of a major museum, university, hospital or cultural complex, are nowhere near compensation levels for senior executives in positions of like responsibility in the Fortune 500. Nor should they be: most organizations' budgets, donors and the general public – who subsidizes these organizations directly through public grants and indirectly through the tax subsidy – will not permit it.

But trustee members of the organization's compensation committee, as informed by compensation consultants reporting directly to them, are much better situated to assess the particulars of what they need to pay to attract and retain suitable executives than anyone else. While there are certain professions, particularly in the program areas – curatorial and programming functions, certain academic fields, fundraising and the like – where the nonprofit world presents the only or most obviously viable career path, there are many other fields – legal, financial, investment, HR and labor relations, facilities management, marketing, and PR, just to name a few – where there is considerable competition from the for-profit labor markets that must be reckoned with. The need to attract business-savvy executives to the nonprofit world only becomes more compelling as more and more nonprofits enter an entrepreneurial mode, growing their commercial activities to improve their earned income streams in light of government funding cutbacks.[20]

As a point of comparison, outside service providers such as law firms, auditing firms, investment firms, search firms, construction contractors and consulting firms, are able to command full or close to full fees from nonprofits, with some notable and much appreciated pro bono exceptions.[21] These outside service professionals are not expected to perform their services primarily for the "honor" of it, even though they, too, may benefit psychologically or reputationally from being associated with a prestigious and beloved client organization.

The Committee's concerns about outside activities are also noted, but the lessons should not be taken too far. While the Secretary's and Deputy Secretary's vacations and absences as documented by the committee are of genuine concern to the Smithsonian, it would not be sound for other institutions reflexively to discourage service to outside companies or organizations as a result. Outside board service, whether for-profit or not-for-profit, as the Committee notes, *may* indirectly benefit the primary institution in meaningful ways: by providing access to prospective donors and corporate sponsors, fresh perspectives and exposure to the ideas of leaders in other fields. Moreover, particularly regarding outside nonprofit activities, perhaps the question should be analyzed more broadly – for example, whether service to a professional association or other nonprofit entity benefits the entire sector, and accordingly may also benefit the institution itself. There should be reasonable limits to the number of outside boards an executive serves on, both in terms of outside compensation and in terms of time,[22] but those limits very much depend on the person, the outside entity and the nature of the involvement.

The lessons of the Smithsonian should be noted well, even by nonprofit organizations that have not experienced similar failures of governance and the attendant public criticism. In this post-Sarbanes Oxley era, standards of good governance in the nonprofit sector are rapidly evolving. The Smithsonian report both incorporates those lessons and makes a significant contribution to that continuing discussion. ■

1. In June 2007, the Deputy Secretary of the Institution and the President of Smithsonian Business Ventures, its for-profit arm, also announced their resignations.

2. The Committee was chaired by Charles A. Bowsher, former Comptroller General of the United States, and also included Stephen D. Potts of the Ethics Resource Center and A.W. "Pete" Smith. The full report is available at http://smithsonianirc.org/images/FINAL_IRC_REPORT.pdf ("Report").

3. Report at 4.

4. Section 4958 of the Internal Revenue Code (Intermediate Sanctions) imposes a tax on excess benefits for tax-exempt nonprofits. Excess compensation (including bonuses, benefits and deferred compensation) may lead to excise taxes on the disqualified person (up to 25% of the excess benefit amount), as well as on organization managers who knowingly participate in the transaction (including individual board of compensation committee members who approve the payment), up to 10% of the excess benefit amount. Treas. Reg. § 53.4958-1 *et seq.*

5. According to the Committee, while it is generally a good idea to obtain and provide to Trustees comprehensive information on management compensation, the process here was subverted by management itself and "was not used by the Regents for a thorough discussion of compensation strategy or what would constitute reasonable compensation for these individuals." Report at 47.

6. Report at 50.

7. Ms. Burke's attorneys argued in a letter to the Committee that her outside board service, teaching and other non-Smithsonian activities were properly disclosed by her and known to the Board. Letter of Gibson Dunn & Crutcher LLP, to Charles A. Bowsher, dated June 7, 2007, annexed to Report as Exh. 35.

8. For example, in May 2001, Mr. Small negotiated a gift of $39 million from the Catherine B. Reynolds Foundation to finance a permanent exhibition at the National Museum of American History to commemorate the achievements of prominent Americans. The gift was criticized by Smithsonian curators and scholars who questioned the degree of control Ms. Reynolds would have over the project. Report at 69 (citing Jacqueline Trescott, *Smithsonian Gifts with Strings Alarm Some Scholars; Secretary's Dealings with Big Donors Questioned by Staff*, Wash. Post, May 26, 2001 at C1).

9. Report at 2.

10. 20 U.S.C. § 42.

11. The Smithsonian is a trust instrumentality that was established by Congress in 1846 to hold in trust property donated by James Smithson and to carry out the provisions of his will for the "increase and diffusion of knowledge." The Smithsonian Act of August 10, 1846, as amended and codified, 20 U.S.C. §§ 41–67.

12. Report at 3.

13. Report at 20.

14. Report of the Governance Committee, dated June 14, 2007, *available at* http://newsdesk.si.edu/releases/Governance_Committee_Report.pdf.

15. *Id.* at 5.

16. In the years following adoption of Sarbanes Oxley corporate governance mandates for publicly listed companies in the for-profit sector, there was a great deal of discussion about adoption of SOX principles by state legislatures for nonprofits. While many nonprofits adopted such measures voluntarily, such as updating Audit Committee charters and conflict of interest policies and instituting whistleblower policies, to date only one state – California – has actually passed additional regulation.

17. Conflict of interest questionnaires were to be collected and reviewed by the Smithsonian's General Counsel, who also carried the title Chief Ethics Officer. However, in some years the questionnaires of the Secretary and other senior officials were not submitted to the Chief Ethics Officer, but rather kept within the Secretary's immediate area. There was a duly constituted Audit and Review Committee that was charged with reviewing the disclosure forms each year, although evidently no one questioned the absence of questionnaires from the Secretary or the lack of disclosure of certain relationships that were clearly disclosable.

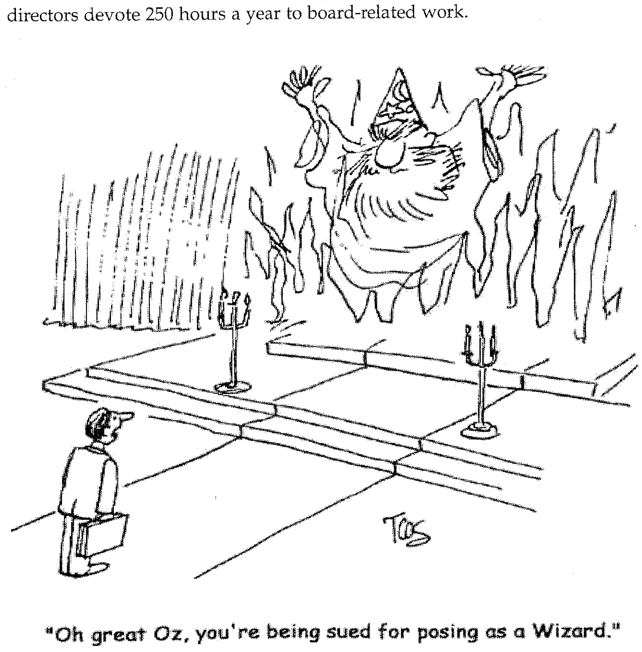
18. Report at 107–08.

19. Report at 14.

20. *See generally Nonprofit Law, Economic Challenges, and the Future of Charities*, ___ Fordham L. Rev. ___ (forthcoming 2007).

21. Lincoln Center for the Performing Arts in New York City has harnessed the expertise of major law firms and in-house counsel departments, which provide strategic and legal advice on a pro bono basis. L.F. Rosenthal, *'Redeveloping' Corporate Governance Structures: Not-for-Profit Governance During Major Capital Projects, A Case Study at Lincoln Center for the Performing Arts*, ___ Fordham L. Rev. ___ (forthcoming 2007).

22. The National Association of Corporate Directors estimates that typical directors devote 250 hours a year to board-related work.



"Oh great Oz, you're being sued for posing as a Wizard."

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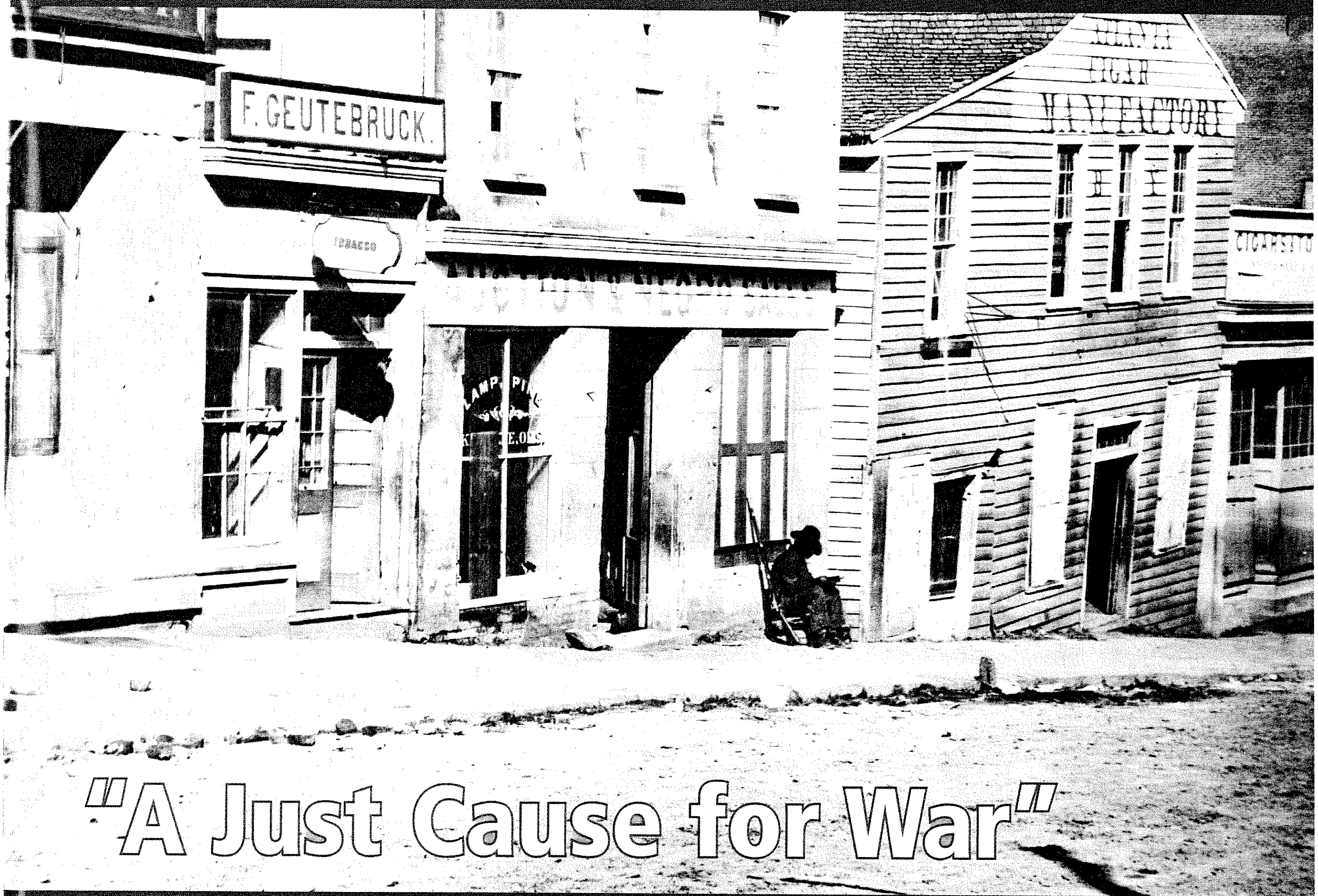

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