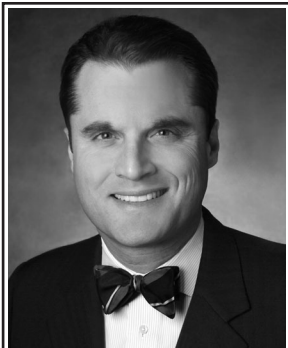


Smithsonian Controversy Spawns 'Second Generation' Best Practices

by Michael W. Peregrine



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The recent governance controversy involving the Smithsonian Institution has prompted its adoption of a series of governance policies and procedures that should be of interest to sophisticated nonprofit corporations.

The high-profile nature of the Smithsonian's problems revolved around ineffective board oversight of executive management and corporate affairs and a "secretive, insular and imperialistic" executive management culture.¹ These problems, which were the subject of much media and congressional attention, are not foreign to the nonprofit sector. The comprehensive manner with which they were addressed by the Smithsonian Board of Regents makes them quite relevant to other prominent charitable organizations.

Among the 25 procedures adopted by the board are a series that reflect a focused and aggressive response to core problems. Those procedures address such controversial but important governance issues as informed board decision-making; board/CEO relationships; board access by principal corporate gatekeepers; outside board memberships of officers and directors; conflicts of interest management; and board supervision of ancillary business ventures. They go far beyond the traditional, Sarbanes-based first-generation best practices adopted in good faith in recent years by many nonprofit organizations. The scope and content of the new procedures, combined with the prestige of the Smithsonian committee that proposed them, make them appropriate for the close attention of the broader nonprofit community.² This

is particularly the case as the IRS and state charity officials increase their scrutiny of nonprofit governance.³

Background

The new governance procedures were a principal by-product of initiatives implemented in early 2007 by the Smithsonian Board of Regents to address concerns expressed by the public and Congress regarding executive compensation, organizational spending practices, and board oversight.

Those concerns had developed in the past two years as information became available regarding confidential business initiatives and practices at the Smithsonian. Criticism arose regarding (a) executive compensation practices; (b) alleged abuses of travel and expense policies; (c) participation by senior executives on for-profit corporate boards; and (d) the absence of transparency in transactions involving the Smithsonian's affiliate, Smithsonian Business Ventures (SBV), and third parties.⁴ Compounding those problems were perceived deficiencies in board oversight, including: the failure of the board to routinely receive or demand information necessary to support informed decision-making; the absence of critical relationships necessary to bring to the board important issues and concerns; and the inability of internal monitoring systems to raise the necessary "warning flags" to the board when circumstances warranted.⁵ The result was a loss of trust in both senior management and in the Board of Regents' ability to exercise effective oversight of the institution. Criticism from the Senate Finance Committee was particularly harsh.

The Board of Regents responded with a two-pronged process focused on addressing Smithsonian governance problems. The *first prong* was the appointment of a Governance Committee charged with reviewing Smithsonian governance policies and procedures (including

¹A report to the Board of Regents of the Smithsonian Institution, June 18, 2007, Charles A. Bowsher, Stephen D. Potts, A.W. ("Pete") Smith, Jr., p. 2. http://newsdesk.si.edu/releases/IRSC_report.pdf.

²Members of the Governance Committee included Patty Stonesifer, CEO of the Bill and Melinda Gates Foundation; Rep. Donna Matsui, D-Calif.; and Diana Aviv, president and CEO of Independent Sector.

³See, e.g., comments of IRS Commissioner (Tax Exempt and Government Entities) Steven T. Miller, for example, promotion of good governance is a new "pillar" of the IRS' service and enforcement programs for exempt organizations. "IRS Official Speaks on Exempt Organization Issues," *Tax Notes*, May 1, 2007.

⁴Smithsonian Institution, the Board of Regents, "Report of the Governance Committee to the Board of Regents," June 14, 2007, p. 3. http://newsdesk.si.edu/releases/Governance_Committee_Report.pdf.

⁵*Id.*, p. 4.

oversight practices), comparing them with best practices in the nonprofit sector, and making related recommendations to the board. The *second prong* was the establishment of an Independent Review Committee that would evaluate governance and management issues that had been raised by a variety of sources, including Senate Finance Committee ranking minority member Chuck Grassley, R-Iowa.⁶

In essence, the work of the Governance Committee was a “clean-slate” analysis, applying nonprofit governance best practices to the Smithsonian. The work of the Independent Review Committee was an extensive factual investigation, involving many interviews and the review of voluminous records. Though each committee worked independently of each other, the Governance Committee and the Independent Review Committee reached remarkably similar conclusions about weaknesses in the Smithsonian’s governance and management. The board released its report based on the Governance Committee recommendations on June 14, and the Independent Review Committee released its report on June 18.⁷

Why We Care

The new Smithsonian governance policies are relevant to the broader nonprofit community for two reasons. *First*, they are the by-product of a process that applied to the Smithsonian “the best practices in 21st century nonprofit governance.”⁸ *Second*, the governance problems prompting the analysis — weak board oversight, excessive executive compensation, and “immoderate spending practices” — are not unique in the nonprofit sector.

The Smithsonian is not, of course, a traditional nonprofit corporation. It is, in essence, a trust instrumentality established by Congress in 1846 to hold in trust property donated by James Smithson and to carry out the related provisions of his will. Board members include congressional regents, and both the chief justice of the U.S. Supreme Court (as chancellor) and the vice president also sit on the board. Further, many Smithsonian employees are treated as federal employees (others are treated as trust employees).

Nevertheless, the Smithsonian is similar to the typical nonprofit organization in many respects. For example, the regents are regarded as analogous to directors of a nonprofit organization and must fulfill the fiduciary duties of directors, including the duties of care and loyalty. The Smithsonian also is tax-exempt as an organization described in I.R.C. section 501(c)(3) and therefore is subject to code provisions on compensation and benefits (and also to the new focus of the IRS on corporate

governance).⁹ It should also be noted that the Governance Committee conducted its review with a nonprofit-oriented methodology.¹⁰

Therefore, to dismiss or excessively qualify these new governance policies and procedures as unique to quasi-governmental organizations would be to ignore the Smithsonian’s legal and organizational structure, and the nonprofit-focused nature of the work of the board, the Governance Committee, and the Independent Review Committee.

Accordingly, mainstream nonprofit organizations (including 501(c)(3) organizations) may consider the Smithsonian analysis and recommended best practices as highly relevant to their own governance structures and practices. As the Independent Review Committee report summarizes:

The problems at the Smithsonian are not unique. As the media and Congressional oversight committees have made clear, there have been similar problems at several large tax exempt organizations, including major museums and universities.¹¹

What We Learn

As noted above, the board adopted 25 procedures in response to management and governance problems. These were almost equally split between practices designed to (a) promote a “constructive partnership” (in other words, improve the oversight relationship between the board and the secretary/CEO of the Smithsonian); and (b) strengthen the “culture of accountability” (in other words, improve the ability of the regents and senior management to engage in effective oversight and hold staff, and themselves, more accountable).¹²

Any process of applying existing best practices to the governance structure of a prominent, quasi-nonprofit organization should attract the attention of the nonprofit sector (particularly given the qualifications of Governance Committee members). A number of the new procedures at the Smithsonian are noteworthy because they respond to several important and highly sensitive issues of governance that are of concern not only to the Smithsonian, but to many sophisticated nonprofit corporations. In so doing, they merit consideration as *second-generation governance best practices*, boldly elevating the discourse beyond the structure of Sarbanes-based considerations. These “second-generation” best practices, and the problems they were designed to address, include the following.

1. Informed Decision-Making

(a) **The Problem.** A concern expressed throughout both the Governance Committee and Independent Review Committee reports is that the board (as historically structured) did not exercise the oversight necessary to

⁶*Id.*, p. 2-3. See, e.g., “Grassley Letter Questions Smithsonian Business Venture Management,” *Tax Notes*, May 17, 2007. See also news coverage and links to written testimony presented at the June 26, 2007 hearing of the Senate Rules and Administration Committee, *Doc 2007-15301*, 2007 TNT 124-6.

⁷*Id.*

⁸*Id.*, p. 2.

⁹See discussion at pages 28-33 of Independent Review Committee report.

¹⁰Governance Committee report, p. B-2.

¹¹Independent Review Committee report, p. 108.

¹²Governance Committee report, p. 6-7.

oversee the operations and management of the Smithsonian. The regents did not regularly receive, nor did they require, the information needed to support informed decision-making. This was despite regular attendance and active participation by most regents in meetings. For example, the Governance Committee determined that most regents were unaware of important provisions of the secretary's employment contract, significant issues associated with the business practices of SBV, and the non-uniform application of organizational policies and procedures.¹³

(b) The Resolution. Through a series of related governance policies, the board seeks to establish a "culture of inquiry," in which expectations regarding meeting preparation, attendance, and participation are established. Emphasis is placed on the constructive skepticism to be exercised by board members in their role as advocates of the organizational mission. Requirements are set forth regarding the number of regular board meetings, executive session practice, and minute-taking and other document practice to enhance transparency and assist deliberations.¹⁴

(c) The Relevance. The Smithsonian's unique governance structure (which includes the chief justice and vice president) aside, the quality of governing board oversight is a vitally important subject for internal board self-evaluation by all nonprofit organizations. Boards must come to grip with factors that prevent or restrict robust oversight of operations and management and need to consider features that could enhance deliberation and action. The business judgment rule and *Disney* notwithstanding, inadequate oversight practices remain the "soft underbelly" of many nonprofit boards.

2. Relationship With CEO

(a) The Problem. Closely associated with deficient oversight practices was an essentially dysfunctional relationship between the secretary and the board. An impression was created that the board deferred excessively to the secretary; it was as if "the Board reported to [the Secretary] rather than the Secretary reporting to the Board."¹⁵ The secretary was perceived as creating a secretive, imperialistic, and insular culture in which he, rather than the board, "dominated the setting of policy and strategic direction for the Smithsonian."¹⁶ Meeting agendas and information flow were "tightly-controlled" by the secretary. Information relevant to important board decisions was often prepared and presented in a summary fashion, which limited the board's ability to give thoughtful consideration to important strategic issues.

The board tolerated this condition by failing to "look behind" the limited data provided by the secretary, and it did not engage in the kind of "constructive skepticism" of the secretary's actions championed by best practice.¹⁷

(b) The Resolution. Through a series of related governance policies, the duties and responsibilities of the board are now set forth in detail and in a manner designed to confirm clear governance responsibilities while preserving a basis for a constructive partnership between the board and the secretary. Emphasized are (a) the board's obligations regarding strategic direction and oversight of financial, ethical, and legal obligations; (b) a clarification of appropriate reporting relationships (for example, the board establishes major institution policies and oversees their implementation by the secretary); and (c) transparency and open communication between the board and the secretary. Also noteworthy is a new commitment to regular executive session practice (no staff present), including periodic sessions with key gatekeepers (for example, general counsel, chief financial officer, inspector general).¹⁸

(c) The Relevance. Even in this post-Sarbanes environment, there is still concern about the extent to which boards are too deferential to the chief executive officer, and about the vestiges of the "imperial" chief executive. This is no less prevalent in the nonprofit sector as it is in the for-profit sector. Accordingly, the steps taken by the Smithsonian board are likely to be perceived as reflective of the efforts that must be taken to preserve fundamental organizational control in the board while preserving appropriate balance between governance and executive management and supporting the traditional authority of the CEO.

3. Gatekeeper Access

(a) The Problem. Key reporting and access protocols necessary for corporate gatekeepers to provide the board with important information were not in place. The general counsel, the chief financial officer, and the inspector general were prohibited by the secretary from having direct access to the board, whether to present information, concerns, or to serve as staff to the board. In this regard, the Independent Review Committee report reached several disturbing conclusions.

First, the office of the general counsel appears to have been marginalized by the former secretary. The general counsel was isolated from the board and was denied any meaningful role in the oversight of the secretary's office. Staffing of the general counsel's office was reduced while the complexity of its workload increased (limiting the ability of the general counsel to address ethics and governance issues).¹⁹ Similarly, the role and activity of the inspector general appears to have been reduced.

(b) The Resolution. The board has responded to these problems in a farsighted manner. It adopted policies designed to enhance corporate gatekeepers' access to the board, to bring forward matters deserving board attention, and to serve as resources for informed deliberations. Those policies are:

¹³Governance Committee report, p. 4.

¹⁴*Id.*, p. 8, 9, A-8.

¹⁵Independent Review Committee report, p. 2, 67-68.

¹⁶*Id.*

¹⁷See, for example, Task Force on Corporate Responsibility, Am. Bar Ass'n, Report of The American Bar Association Task (Footnote continued in next column.)

Force on Corporate Responsibility, p. 25-29 (see also fn. 62, p. 31) (2003), available at http://www.abanet.org/buslaw/corporate_responsibility/final_report.pdf.

¹⁸Governance Committee report, p. 8-9, A-4, A-5.

¹⁹Independent Review Committee report, p. 84-87.

(i) The general counsel, chief financial officer, and inspector general will have clear reporting relationships to the board and related committees. The general counsel and the chief financial officer will have direct access to the board and shall attend board and relevant committee meetings.

(ii) The general counsel, chief financial officer, and inspector general will have the right and obligation to bring directly to the board information within the scope of their respective responsibilities that they reasonably believe should be brought to the attention of the board.

(iii) A specific board committee is charged with reporting to the board on whether sufficient resources are made available to the general counsel, chief financial officer, and inspector general to allow them to perform their functions effectively.²⁰

(c) The Relevance. The mandate, authority, and (especially) board access rights of the general counsel and other corporate gatekeepers have long been corporate responsibility concerns. A common theme among many of the Enron-era corporate scandals was an effort on the part of the CEO to limit the access of corporate gatekeepers to the board and to otherwise marginalize their role. That effort, of course, denied the board immediate access to the general counsel and other gatekeepers when called on to address issues within the scope of authority of the gatekeepers. Thus, by adopting these policies, the board likely will be perceived as setting a powerful yet necessary example of the importance of gatekeeper access to the board.

4. Outside Board Services

(a) The Problem. An unlimited leave policy allowed the secretary/CEO and the deputy secretary/chief operating officer to be absent from the institution for approximately 400 and 550 work days, respectively, over a six-year period. The absences were attributable in part to vacation leave, but also in large part to responsibilities associated with their service on corporate and other boards. For example, both officers served on the boards of for-profit corporations, for which they earned substantial additional compensation (cash, stock, and stock options). Indeed, the deputy secretary's total compensation from outside board service was triple the compensation she received from the Smithsonian during the same period. The concern was that such extensive outside board service was inconsistent with, and a distraction from, full-time employment at the Smithsonian.²¹

(b) The Resolution. The obligations of, and compensation received for, the outside board service prompted questions regarding the involved executives' personal commitment and loyalty to the Smithsonian. To obviate those concerns, the board will prohibit senior organizational executives from service on the board of for-profit companies. Interestingly, the Independent Review Committee also recommended a policy (that the board did not

adopt) that service on nonprofit boards be subject to board approval and that related compensation received by the executive be payable to the Smithsonian.²²

(c) Relevance. Senior executives of many sophisticated nonprofit organizations often have significant outside board service commitments. In most situations, outside service is conducted with the approval (or at least awareness of) the nonprofit's board. The perception is that outside service contributes to the perspective and experience of the participating executive. There normally are, however, underlying concerns about time commitment and proper allocation of any related compensation. Thus, the Smithsonian policy is likely to be both of great interest to, and controversial among, boards and their senior executive leadership. However, the merits of this policy as a best practice can be seen in the corporate responsibility focus on the duty of loyalty and full-time attentiveness to corporate affairs owed by senior executives.

5. Affiliate Business Activity

(a) The Problem. SBV was created in 1999 as a separate corporate affiliate through which commercial activities were to be conducted. The expectation was that concentrating Smithsonian business activities in a separate business unit would lead to improved efficiency and better financial results. To that end, SBV was permitted to operate more like a commercial enterprise than a charity, and to adopt its own travel, accounting, contracting, and human resources policies. However, SBV became involved in projects involving confidential business arrangements (for example, "Smithsonian On Demand," a book publishing agreement, and an image licensing arrangement) with outside companies that generated substantial criticism from Congress, the public, and Smithsonian staff. The underlying issues involved failure of internal controls, inappropriate activity, and excessive executive compensation. From a governance perspective, the concern was with failures in oversight of SBV's activities by Smithsonian senior management and the board — including oversight by Smithsonian board members who also served on the SBV board.²³

(b) The Resolution. To address issues of accountability, the regents acknowledge their ultimate responsibility for, and oversight of, SBV. Future SBV operations are to be conducted in a manner consistent with established Smithsonian policy, except in some preapproved circumstances when an exception is necessary to accomplish SBV mission requirements. This is particularly true regarding such important matters as compensation and

²⁰Governance Committee report, p. 9, A-15, A-16, A-17.

²¹Independent Review Committee report, p. 73-80.

²²Independent Review Committee report, p. 73-80; Governance Committee report, p. 12, A-23.

²³Governance Committee report, p. 10, 13. See also, Timothy Taylor, "Smithsonian to Ask for Senior Official's Resignation," *Tax Notes*, June 27, 2007; James V. Grimaldi and Jacqueline Trescott, "A Tough Sell for Smithsonian's Stores," *The Washington Post*, July 25, 2007.

travel expenses. Further, the status, mission, and operations of SBV are to be reviewed and evaluated by the board.²⁴

(c) Relevance. Many nonprofit organizations similarly conduct commercial, noncharitable activities through a separate business affiliate like SBV. Effective oversight of separate commercial affiliates is an ongoing concern for such organizations. There is likely great sympathy in the nonprofit sector for the plight of a charity that may have lost institutional control of its commercial affiliate, particularly when the affiliate may have been established for good-faith, bona fide purposes. Accordingly, the regents' response — assumption of responsibility; close review of status, mission, and operations; and no deviation from established Smithsonian policies — may be a course of action that other nonprofits, concerned with oversight of their own business affiliates, may choose to follow.

6. Conflicts of Interest Management

(a) The Problem. At the Smithsonian, the general counsel also serves as chief ethics officer. The former secretary's efforts to reduce the staff and budget of the general counsel's office (while the complexity of its workload was increasing) limited the general counsel's involvement in governance and ethics issues. The general counsel was unable to maintain a "rigorous ethics program" for Smithsonian employees and was similarly unable to dedicate a member of his staff to monitor ethics, conflicts of interest, and governance issues.²⁵

(b) The Resolution. In another bold corporate responsibility gesture, the board has assigned to the general counsel primary responsibility for the identification and management of potential conflicts of interest involving senior corporate executives. The general counsel is to review the annual financial disclosure statements and outside activity requests of all senior executives and unit heads. Also, the general counsel will provide a written annual report to the Audit and Review Committee on (a) the conclusion of the annual financial disclosure process and (b) reported outside activities of senior executives. The Audit and Review Committee is then required to report the general counsel's conclusions and recommendations (if any) to the board. The secretary is instructed to develop an accessible database to advise corporate officials when a conflict may exist.²⁶

(c) Relevance. Assigning specific conflicts of interest oversight and management duties to the general counsel recognizes the inherently legal nature of the conflicts process. The regents' action also enhances the efficiency of the conflicts determination process and creates a clear reporting relationship to a dedicated board committee. The database concept is particularly meritorious, as it addresses what should be at the core of any conflicts management process — alerting covered persons that a conflict of interest may exist. The conflicts process need not be adversarial or "gotcha" in nature or operation. The interests of the organization and good governance are

well served when the organization assists executives and board members in identifying potential conflicts. Many organizations would benefit from extending the general counsel's authority in this respect to cover board members in addition to executives and unit heads.

7. Transparency

(a) The Problem. Closely tied to issues of informed decision-making are those related to internal and external transparency. The Smithsonian was criticized for a perceived lack of transparency within its governance, resulting in its stakeholders (including the board, executive leadership, and Congress) being unaware of those operational aspects of particular interest to each. That was especially true regarding business ventures and contracting. The concern was made more acute given the core Smithsonian mission, to increase and diffuse knowledge.²⁷

(b) The Resolution. The board will adopt an "ethos of transparency," to be manifested by a strategy to (a) increase available information about the board and organizational activities and operations, and (b) enhance communications with the board. The strategy is to be based on best practices of nonprofit organizations, universities, and federal agencies and will include the following components: (i) enhanced use of the Internet to increase the availability of information about Smithsonian policies, governance, finances, operations, programs, activities, and decision-making processes; (ii) improved communications between and among senior management and the board, staff, and other stakeholders; and (iii) a communications plan to ensure all constituencies are routinely informed of important decisions and current issues, with the opportunity to provide input to the board and senior management.²⁸

(c) Relevance. The concept of transparency — regarding both financial reporting and governance — has received substantial focus by the nonprofit sector in the post-Sarbanes environment. Internal transparency enhances the decision-making process, while external transparency is an important means of assuring stakeholders that the organization is operating in a manner consistent with its nonprofit mission. That the Smithsonian has unique stakeholders (for example, Congress) does not detract from the significance of the regents' notable emphasis on creating an "ethos of transparency."

8. Other Recommendations

The regents' response was not limited to the above-described innovative actions. It has also initiated other significant steps that fall more within the traditional range of "first-generation" best practices. These include: (a) reviewing the appropriate size, structure, and composition of the governing board; (b) adopting written job descriptions for key governance and executive positions; (c) receiving the role, function, and charter of each board committee; (d) restructuring the process for evaluating

²⁴*Id.*, p. 13, A-25.

²⁵Independent Review Committee report, p. 84-87.

²⁶Governance Committee report, p. A-24.

²⁷Governance Committee report, p. 4.

²⁸Governance Committee report, p. 11, A-21.

executive compensation and performance; (e) adopting an overarching organizational code of ethics; and (f) tightening rules governing, and board oversight relating to, travel, representational activities, and special events (including expenses incurred by the CEO/secretary).

Conclusion

The management and governance problems encountered by the Smithsonian may not be unique to peer nonprofit organizations, but the regents' reaction to those problems may well be, at least in terms of the aggressive steps it endorsed to address identified problems. The board's action in researching and applying 21st century nonprofit governance best practices to the Smithsonian resulted in a comprehensive, informed response. Not only did the board endorse many of the recognized best practices emerging from Sarbanes-Oxley; it also developed new governance policies that are clearly "second-generation" in nature and thus worthy of close notice by other nonprofit organizations.