

## American University: Significant Implications for Nonprofits

by Michael W. Peregrine and Robert C. Louthian

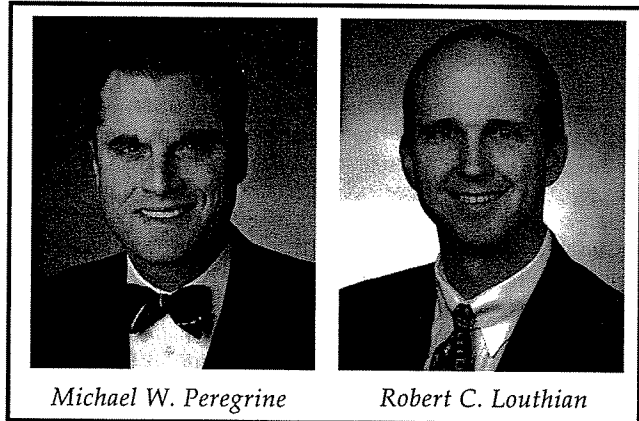
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The recent controversy involving American University, its board of trustees, and its former president/chief executive officer has thrust into the spotlight a series of difficult oversight and compensation issues that have broad implications for the nonprofit community. For American University and nonprofit organizations in general, it is the *wrong issue* (board oversight of executive compensation) at the *wrong time* (in the midst of intense scrutiny of nonprofits) in the *wrong place* (Washington, D.C.).

The core issues raised by the American University situation are the appropriate levels of discretionary expenditures incurred by a chief executive expected to be working "24/7" for the nonprofit organization; the required degree of board oversight of the executive compensation process; and the appropriateness, manner of review, and reasonableness of executive severance arrangements. The high-profile nature of this controversy, coupled with the lack of clear regulatory guidance on many of the implicated issues, have attracted broader attention of Congress, the Internal Revenue Service, and state charity officials. In particular, the American University dispute is likely to reinforce the concerns of legislators, regulators, and the general public that stronger measures may be necessary to prevent waste of nonprofit assets devoted to executive compensation.<sup>1</sup>

### The Core of the Controversy

At the heart of the American University matter is the governance challenge that may arise when board members with corporate and professional backgrounds seek to impose Sarbanes/corporate accountability principles on a nonprofit organization and its executive leadership team. Where differences exist between the board and executive leadership concerning the need for such principles and the timing/manner in which they are to be applied, destabilizing tension can result. At American University, this tension arose prin-



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cipally regarding executive compensation and discretionary expenditures.

The American University controversy sends several strong reminders to the nonprofit sector: *First*, it is crucially important that the board and senior executive leadership have a shared understanding of the importance of implementing corporate accountability principles within the organization and its governance structure. These principles would include recognized governance "best practices" as well as the recommendations of the Panel on the Nonprofit Sector.<sup>2</sup> *Second*, boards and their chief executive officers should work together to clarify corporate procedures regarding executive compensation and discretionary expenditures. Such procedures should (a) fairly reflect organizational expectations of the CEO and his/her spouse; (b) adopt mutually satisfactory and workable guidelines defining "business" and "personal" expenses; and (c) satisfy the rebuttable presumption of reasonableness and other oversight protections. Such a cooperative approach is particularly advisable given the current IRS "soft contact audit" initiative, executive compensation-related provisions of its proposed "Workplan"

<sup>1</sup>See, recent polls and surveys indicating lack of public confidence in charitable organizations and their ability to govern themselves (for example, "The Charitable Impulse," by Public Agenda (<http://www.publicagenda.org>)).

<sup>2</sup>See, for example, <http://www.nonprofitpanel.org>; also, for colleges and universities, these principles would include the NACUBO Sarbanes/Oxley Advisory Report.

for Fiscal 2006, and the September 9, 2005, issuance of proposed Treasury regulations linking intermediate sanctions transactions and loss of section 501(c)(3) exempt status.<sup>3</sup>

### Background

The roots of the American University controversy begin in an anonymous letter delivered to the board of trustees this past spring. The anonymous letter alleged various compensation and expense abuses by the CEO (for example, charging the university for a variety of expenses allegedly incurred by the CEO for personal, not business purposes). Following review of the letter, the board of trustees authorized an independent investigation under the direction of outside counsel. Upon completion of its investigation, the outside counsel delivered a written report to the board of trustees that called into question the business purpose of almost \$500,000 in expenditures authorized by the CEO and his spouse over a period of several years. The report referenced a wide variety of allegedly inappropriate expenses charged to the university; including those related to (a) a family engagement party; (b) more than \$200,000 in expenses in support of the CEO's chef; (c) more than \$54,000 in limousine services; (d) a garden club luncheon hosted by the CEO's spouse; (e) first class overseas travel for the CEO; (f) expenses associated with visits to the CEO's vacation home; (g) more than \$100,000 in social secretary services; (h) club dues; (i) expenses attributable to use of the CEO's vacation home; (j) expenses attributed to extended layover following business travel; (k) and other similar types of expenses. No records were identified that might have supported the business nature of any of the challenged expenses. The report also charged that the CEO and his spouse violated university policies concerning the use of the corporate credit card.

The controversy, however, extends beyond the questionable expenditures to include the reasonableness of the CEO's base compensation and the process by which it was determined. Reportedly, the CEO's \$800,000 salary was substantially in excess of that of his peers at comparably sized institutions.<sup>4</sup> Perhaps more significant were suggestions (by the chair of the board's audit committee) that the CEO inappropriately sought to limit board access to elements of his compensation package and that the reporting of compensation in the Form 990 was incomplete.<sup>5</sup> Concerns regarding board oversight of the CEO also surfaced. For example, the former audit committee chair expressed concern that "the board reported to [the CEO] rather than the

reverse."<sup>6</sup> The Board of Trustees of American University consists of experienced and sophisticated executives/leaders from corporate, financial, legal, and religious institutions.

Upon review of the report's conclusions, the board suspended the CEO. The report also recommended that the CEO reimburse the university for more than \$115,000 in personal expenses and that the CEO should have reported more than \$350,000 in additional income over a period of three years. Only recently, the board entered into a severance agreement with the CEO, providing him with a one-time payment of \$950,000, relief from repayment of almost \$1 million in premiums on a life insurance policy, and the right to receive \$1.75 million in deferred compensation, to which he would not have been entitled had he been fired.<sup>7</sup> In announcing the severance agreement, the board vice chair reportedly described the arrangement as beyond what the CEO was entitled to receive.<sup>8</sup>

### The Quandary

The board's resolution of the issues presented in the report was made significantly more difficult by the presence of a number of complicating factors. *First* was the discovery of a supplemental employment agreement that had been negotiated between the CEO and the board chair in 1997 and, apparently, was intended to replace the original 1994 CEO employment agreement. A significant dispute arose as to whether the full board had authorized the chair to negotiate the 1997 agreement (and, in fact, was even aware of its existence). Significantly, the 1997 agreement contained provisions that, from the perspective of the CEO and many board members, authorized the CEO to incur many of the challenged expenses. For example, the CEO and his supporters pointed to agreement provisions authorizing the use of "first class travel" and requiring the university to pay for all personal services (for example, dining, housekeeping, and staff) and living expenses, maintenance, and repair associated with use of the university's residence for the CEO.<sup>9</sup> The former board chair, who negotiated the 1997 agreement, claimed that the board's compensation committee had been fully apprised of the negotiations.<sup>10</sup> Thus, the validity of the 1997 agreement was likely to be a source of contention in case of subsequent litigation between the CEO and the university.

A *second* complicating factor was the offer of some concessions by the CEO to resolve the dispute, includ-

<sup>6</sup>*Id.*

<sup>7</sup>Paul Fain, "President of American University Resigns, Winning a \$950,000 Settlement," *The Chronicle of Philanthropy*, Oct. 25, 2005.

<sup>8</sup>Michael Janofsky, "College Chief at American Agrees to Quit for Millions," *The New York Times*, Oct. 26, 2005.

<sup>9</sup>Michael Janofsky, "Suspended College President Offers to Accept Lesser Pact," *The New York Times*, Sept. 24, 2005.

<sup>10</sup>*Id.*; Susan Kinzie and Valerie Strauss, "American U. Board Split on Keeping President," *The Washington Post*, Sept. 25, 2005.

<sup>3</sup>See, IRS Exempt Organizations Division FY 2006 Implementing Guidelines; Department of Treasury (Internal Revenue Service) Notice of Proposed Rulemaking Reg. 11257-05, 26 CFR Parts 1 and 53.

<sup>4</sup>But see, for example, Michael Janofsky, "College Leaders' Earnings Top \$1 Million," *The New York Times*, Nov. 14, 2005.

<sup>5</sup>Susan Kinzie and Valerie Strauss, "AU's Ladner Defends His Spending," *The Washington Post*, Sept. 24, 2005.

ing reimbursement of certain disputed expenses, and the engagement of an independent accountant to resolve specific tax reporting matters. The CEO argued that his ability to justify the business purpose of many of the challenged expenses had been hampered by a university policy that required expense records be maintained only for one year.<sup>11</sup> A *third* complicating factor was the unauthorized release to *The Washington Post* of the entire report, as well as subsequent written board communications, which allowed the board's deliberations to be played out in the national media on a daily basis. *Fourth*, the CEO made a series of allegations relating to the competency of the board, including those relating to (a) excessive application of Sarbanes-Oxley principles to the controversy, which application the CEO argued did not apply to nonprofit organizations;<sup>12</sup> (b) failure to adequately qualify compensation decisions for the rebuttable presumption of reasonableness, failure to conduct an annual performance review of the CEO in connection with compensation decisions, and deferring decisions on reasonableness to legal counsel rather than making the decision itself; (c) inadvisably using an affiliate of the university's audit firm to conduct the investigation of his expense reports; and (d) failing to recognize the extent of volunteer activity conducted by his spouse on behalf of the university.<sup>13</sup>

Throughout the controversy, the board of trustees remained almost evenly, and deeply, divided as to whether the CEO deserved to be reinstated, with a principal divisive factor being whether the CEO's actions had been authorized by the board, either explicitly (by means of the 1997 agreement) or implicitly (by nonaction in the face of knowledge of the CEO's spending habits). Divisions on the board also led some trustees to challenge the accuracy of some of the report's conclusions, and to open separate settlement discussions with the CEO designed to facilitate his return. The final decision to terminate the employment relationship was followed by the resignation of several prominent board members.

#### Enter Senator Grassley

Whether the controversy would devolve into litigation between the parties was rendered "moot" by the university's receipt of an October 27, 2005, "inquiry

letter" from Sen. Chuck Grassley, chair of the Senate Finance Committee.<sup>14</sup> The letter announced the committee's intention to review the compensation-related decisions of the university and its board, and requested substantial related documentation. In his letter, Grassley referred to the university as "the poster-child" for why review and reform [in the nonprofit sector] are necessary.

Among the subjects of the committee's inquiry were (a) documents relating to the underlying employment agreements; (b) documents relating to board governance and transparency; (c) IRS filings; and (d) specific details of individual executive compensation arrangements. Unique factors of the inquiry letter were its focus on specific trustee conduct regarding CEO oversight, and compliance with intermediate sanctions regulations.

#### Issues Presented

It is important to note that there has been no determination of any violations of law or breach of fiduciary duty in connection with the American University matter. Nevertheless, the entire unpleasant episode is of enormous significance to the larger nonprofit community to the extent that it deals with a thorny issue that has been bubbling under the surface of the current debate over nonprofit executive compensation: how to effectively and equitably distinguish between expenses fairly incurred by the CEO or his/her spouse in the course of employment, and expenses that are purely personal in nature to the CEO/spouse. This issue has become increasingly important for many nonprofit organizations and their chief executives, particularly when there is an expectation that the CEO's employment obligations extend beyond the fundamental management of corporate affairs to being a larger "symbol" of the organization in terms of charitable solicitation and public presence. In such a situation, when *is* the CEO acting on personal, as opposed to business, matters? Thus, American University focuses attention on the following important exempt organization corporate, compensation, and tax issues.

**Board Oversight of Executive Compensation:** (i) the role of the board/compensation committee in determining what is reasonable compensation, and the independent consultant's role in that process;<sup>15</sup> (ii) the relationship between compensation and the economic

<sup>11</sup>Janofsky, Sept. 24, 2005, *supra*.

<sup>12</sup>While such a perspective is not unusual, it is the authors' experience that a substantial majority of exempt organization executives either embrace, or at least recognize the fundamental public policy implications of the corporate responsibility environment. Further, query who should have had the responsibility of advising the Board on such important developments as the Final Report of the Panel on the Nonprofit Sector, and NACUBO's Sarbanes/Oxley Advisory.

<sup>13</sup>"In His Own Words: Benjamin Ladner Takes Questions on His Pay, His Perks and His Fate"; *The Chronicle of Philanthropy*, Sept. 30, 2005.

<sup>14</sup>See, <http://finance.senate.gov/press/Gpress/2005/org102805.pdf>. The inquiry letter is reminiscent of the Finance Committee's previous inquiries of The Nature Conservancy and The United Way of the National Capital Area.

<sup>15</sup>The CEO argued that the board's obligation is to determine reasonableness in light of all relevant facts and circumstances, and that the American University board inappropriately limited its consideration to amounts provided by outside counsel (that is, the board should have given greater deference to the CEO's performance).

resources/financial condition of the institution;<sup>16</sup> (iii) Use of appropriate industry comparables; (iv) satisfaction (as a basic board practice) of all requirements for satisfaction of the rebuttable presumption of reasonableness under the intermediate sanctions rules; (v) the "link" between intermediate sanctions violations and loss of tax-exempt status; and (vi) the importance of good faith efforts to remediate excess benefit transactions before IRS intervention.

**CEO Employment Contracting:** (i) The need for detail, and expression of specific expectations concerning discretionary expenditures of the CEO; (ii) board approval vs. board ratification of CEO employment agreements; and (iii) the potential for regulatory-prompted limitations on the ability of a committee with board-delegated powers to implement executive compensation decisions.<sup>17</sup>

**Board Fiduciary Duties:** (i) Whether the duty of loyalty is violated by disclosure to the media of a confidential report to the board; (ii) whether the duty of care is violated by a failure to more closely monitor discretionary spending by the CEO; (iii) which party — the CEO or the board — is obligated to raise for consideration application of the intermediate sanctions rules; and (iv) whether governing board members with background/experience in the specific issues at controversy (for example, law, accounting, compensation) may be held to a higher standard of conduct regarding their individual duty of care.<sup>18</sup>

**Discretionary Spending:** (i) What is the appropriate spending authority of a chief executive officer who is expected (essentially) to serve the institution on a "24/7" basis, especially when fundraising and donor solicitation duties are included; (ii) in such circumstances, what is the distinction between personal and business-related expenses; (iii) what are appropriate business-related expenditures of the CEO's spouse; (iv) what are proper reporting and record keeping procedures regarding such expenditures; (v) what is the proper board oversight of discretionary spending and (vi) what are the related intermediate sanctions and individual income tax implications?

<sup>16</sup>A suggestion made by some trustees and members of the student body was that the compensation and expense issues should be particularly scrutinized given the economic foundation of the university — for example, where 90 percent of operating revenues come from student fees, and faculty member raises had been limited to single digits in recent years.

<sup>17</sup>That is, whether perceived failures in the American University board CEO review process will prompt regulators to restrict a board's ability to rely on the actions of a committee with board delegated powers.

<sup>18</sup>The general rule is that such board members would not be held to a higher fiduciary standard. The 2004 decision of the Delaware Chancery Court in *In re Emerging Communications, Inc.* suggested to the contrary. However, a broader application of *Emerging Communications* beyond its specific facts and circumstances has been disputed.

**Executive Severance Arrangements:** (i) Under what circumstances are executive severance arrangements appropriate; (ii) what is outside counsel's role in the process of negotiating and reviewing executive severance arrangements; (iii) what are board members' responsibilities and duties if they disagree with proposed executive severance arrangements; and (iv) how best to address the intermediate sanctions and tax exemption issues raised by such arrangements.

**Federal Income Tax Reporting:** (i) What is the potential impact from an income tax standpoint for failure to report taxable income; (ii) what are the possible income tax withholding and FICA obligations; (iii) when does unreported income become an automatic excess benefit transaction; and (iv) when should a previously filed Form 990 be amended to correct errors found subsequent to filing?

### Specific Relevance

The American University controversy is noteworthy for three principal reasons:

1. It is consistent with the current, extraordinary level of congressional, regulatory/IRS, and general public focus on nonprofit executive compensation issues, and what constitutes proper board oversight of the process by which compensation is determined and monitored.

2. It increases the potential that regulators will expand their scrutiny of chief executive officers and governing boards regarding their respective roles in the compensation process, based on the perspective that discretionary spending abuse may be widespread in the nonprofit community.

3. Like earlier controversies with prominent organizations such as the United Way of the National Capital Area and The Nature Conservancy, it may serve as a "hometown" (for example, D.C.) reminder to those legislators who believe that greater federal oversight legislation is needed to correct perceived abuses in the nonprofit sector.

### Recommended Action Items

To better position the organization to address similar types of compensation, discretionary spending, and board oversight concerns, nonprofit boards and CEOs may wish to work collaboratively to do the following:

1. Assure a common vision between the governing board and management concerning implementation of corporate accountability principles at both governance and operational levels.

2. Confirm specific organizational expectations regarding discretionary spending by the chief executive officer, the presence of limitations thereon, and a vehicle by which the parties can resolve open related questions.

3. Make certain that the CEO employment agreement (or any amendment thereto) accurately reflects the parties' understanding regarding discretionary spending.

4. Review the executive compensation determination process for (a) compliance with recognized "best practices"; (b) satisfaction of the rebuttable presumption of reasonableness criteria; (c) the appropriate role of the compensation consultant; (d) appropriate limitations/involvement of the CEO's role in the process; and (e) transparency with the full governing board.

5. Identify a workable record keeping process that will enable the CEO to promptly and efficiently record the business purpose of discretionary expenses incurred in the conduct of executive affairs.

6. Periodically (for example, every other year) conduct a board audit of the discretionary spending prac-

tices of the CEO (and spouse, if necessary, and appropriate).

7. Apply appropriate federal income tax reporting guidelines for expenses deemed "personal" in nature.

8. Qualify executive compensation-related decisions for the rebuttable presumption of reasonableness wherever possible.

Note: This article is based in part on a series of articles during both September and October appearing in *The Washington Post*, *The New York Times*, and *The Chronicle of Philanthropy*.