CORPORATE STEWARDSHIP: THE “BUCK” STOPS WITH THE BOARD

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ABSTRACT

For-profit and nonprofit corporate governance is more alike than it is different. Although chief executive officers and executive directors are usually the public face of an individual corporation, legally and structurally, the buck stops with the governing board for both types of corporations. As such, it is incumbent upon corporate governing boards to set the appropriate ethical “tone at the top” to promote the long-term health of a corporation and to prevent the kind of corporate malfeasance the United States saw in the late 1990’s and into the 2000’s. During that period, the federal government stepped up oversight efforts in response to the growing concerns about serious and seemingly pervasive illegal and unethical activities in both the for-profit and nonprofit sectors. Both legislation and regulation, such as the Sarbanes-Oxley Act of 2002 and the 2008 release of the Internal Revenue Service’s best governance practices for tax-exempt organizations, was pursued to address a perceived culture of greed and corruption. Unfortunately, the 2008-2009 financial crisis and the fraudulent loses reported by nonprofits since 2008 make it clear that laws and regulations alone are not enough to curb bad behavior. Boards of for-profit and nonprofit corporations must take it upon themselves to apply
higher ethical standards to their oversight and decision-making processes. More than mere compliance with laws, greater principles must be at play whereby boards of directors do what is right for the long-term interests of all corporate stakeholders. In this paper, I present case studies of Enron and WorldCom, on the for-profit side, and American University and the Smithsonian Institution, on the nonprofit side, to explore the similarities in governance structures between the two types of entities and to investigate the concepts and importance of applying the ethical principle of stewardship in corporate governance. It is through the application of this ethical principle that we can turn the tide back from greed inducing short-term self-interest and towards the pursuit of long-term outcomes leading to successful and sustainable corporations which are beneficial for all stakeholders.
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INTRODUCTION

During the late 1990’s and early to mid 2000’s, the United States experienced some of the most egregious corporate financial scandals in history emanating from both the for-profit and nonprofit sectors. Many, if not most, of these financial scandals had, at their core, significant misconduct perpetrated by Chief Executive Officers (CEOs) and senior executives leading to the ruin or near ruin of the organizations these executives were hired to run. The storied collapses of Enron and WorldCom are prominent examples of what appeared to be an overriding culture of greed and corruption in the for-profit arena at that time. The decline of both of these companies resulted in bankruptcy and the criminal prosecution of senior executives. Similarly, in the nonprofit arena, the Smithsonian Institution and American University faced severe public criticism regarding the misuse of nonprofit funds by the executives of those institutions for their own personal gain.

In all of these scandals, one question repeatedly rises to the surface: Where were the boards of directors of these organizations? While CEOs and/or executive directors are responsible for the daily operations of for-profit and nonprofit corporations, and are often the face of those entities, ultimately, the responsibility for governance and organizational oversight lies with the respective boards of directors. Legally and structurally, the buck stops with the governing board. As such, after these financial scandals became public, the media, public, and government legislators and regulators all wondered aloud how these corporate executives could have so easily taken advantage of their positions to pursue financial self-interest.
In this paper, I briefly discuss four of the scandals occurring during this free-wheeling, volatile period of time in our corporate history. I also discuss the similarity of corporate structures existing between for-profit and nonprofit entities, focusing on the roles of the respective boards of directors and/or boards of trustees. In addition, I quickly review the legislative and regulatory responses to the financial scandals from this time period which were intended to prevent such occurrences in the future.

In response to the growing concerns about illegal and unethical decision-making in both the for-profit and nonprofit sectors, the federal government stepped up oversight efforts and the pursued the establishment of best practices through the enactment of legislation, the Sarbanes-Oxley Act of 2002, and regulation, the 2008 release of the Internal Revenue Service’s (IRS) best governance practices for tax-exempt organizations. Although these oversight attempts were significant in their own right, they have not been enough, especially in the for-profit corporate world, as is evidenced by the banking scandals of the late 2000’s. As such, I propose that corporate society, for-profit and nonprofit alike, must strive to go above and beyond what is merely dictated by law and seek to apply the ethical principle of stewardship in the governance and decision-making activities of both for-profit and nonprofit entities.

John G. Taft, banker, financier and great-grandson of former President William Howard Taft lived and worked through the period of the Enron and WorldCom debacles as well as the banking industry collapse in the late 2000’s. His experiences in the banking industry, especially during 2008 and 2009, led him to write a book proposing the need to insert, or reinsert as the case maybe, stewardship into corporate values and
operation. He states that “[s]tewardship as a foundational principle has to do with the proposition that one’s true purpose—and that the ultimate purpose of organizations and of our communities—is to serve others” (Taft 2012, 24). It is that concept of service over self that I argue is necessary to improve the operation of for-profit and nonprofit corporations in the United States. Specifically, it is incumbent that governing boards set the ethical “tone at the top” in a manner that indoctrinates the ethical principle of stewardship within the organization. The trickledown effect of this approach will lead to the long-term health of the corporation—be it nonprofit or for-profit—and will reduce executive misconduct for future generations.

In December 2001, major newspapers across the country reported what many had thought unthinkable, Enron, one of the world’s largest energy corporations had filed for bankruptcy (Oppel and Sorkin 2001). The true nature of Enron’s rise and fall was not apparent at the time of the bankruptcy filing. However, less than a year later, a U.S. Senate Subcommittee investigating the matter nicely summarized the ripple effects of the company’s collapse in stating:

On December 2, 2001, Enron Corporation, then the seventh largest publicly traded corporation in the United States, declared bankruptcy. That bankruptcy sent shock waves throughout the country, both on Wall Street and Main Street where over half of American families now invest directly or indirectly in the stock market. Thousands of Enron employees lost not only their jobs but a significant part of their retirement savings; Enron shareholders saw the value of their investments plummet; and hundreds, if not thousands of businesses around the world, were turned into
Enron creditors in bankruptcy court likely to receive only pennies on the dollars owed them. (Permanent Subcommittee on Investigations 2002, 1)

Although Enron vehemently denied financial problems or any fraudulent activities at the time, independent investigations after the bankruptcy filing eventually revealed a company that engaged in “[h]igh-risk accounting practices, extensive undisclosed off-the-books transactions, inappropriate conflict of interest transactions, and extensive compensation plans” for its CEO and other executives, all of which were “known to and authorized by” the Enron board of directors (Permanent Subcommittee on Investigations 2002, 14).

Enron’s executive leaders, like those of several other companies before it, had decided to engage in a pattern of risky, unethical, and sometime criminal, behavior. It is important to understand that the root of the company’s downfall, however, was not just about “cooking the books.” As William A. Niskanen proposes in his research, “Enron’s collapse . . . was a result of a series of bad business decisions, not because it manipulated its accounts, and almost all of the costs to Enron’s investors, creditors, employees, and local communities were a consequence of the bankruptcy, not because of the accounting scandal” (Niskanen 2005, viii-ix). In early 2002, the country struggled to understand why Enron’s executives made such bad business decisions. As time passed, it became apparent that many of those decision were for the purpose of growing and expanding the business and structure of the corporation in order to generate greater personal wealth for those involved (Eichenwald and Henriques 2002).
Unfortunately, Enron was in reality only the tip of the iceberg. Less than a year after reporting on Enron’s bankruptcy filing, the New York Times reported that “[i]t was as if months of accounting scandals, which have already engulfed Enron, Global Crossing and Adelphia Communications, among others, . . . had finally hit critical mass with the disclosure . . . that WorldCom has masked losses by overstating its financial results by $3.8 billion – one of the largest cases of false corporate bookkeeping yet” (Romero 2002). WorldCom’s announcement not only sent shock waves through the stock exchange, it further accelerated the interest of government regulators and legislators in overseeing and investigating what appeared to be a pervasive pattern of bad behavior by corporate executives. “The United States Securities and Exchange Commission (“SEC”) filed suit against [WorldCom] immediately following the Company’s admission in June 2002 that its earnings had been overstated by more than $3.8 billion” (Breeden 2003, 9). Approximately six months later, WorldCom and the SEC settled the SEC’s enforcement action which included, in addition to a permanent injunction against any future violations of securities laws, that WorldCom would be placed under a Corporate Monitor reporting to the United States District Court for the Southern District of New York and required implementation of reforms throughout the company (Breeden 2003).

As with Enron, WorldCom was forced to file for bankruptcy. During the bankruptcy proceedings, the court found more than mere bad decision-making on the part of the company’s executives, it found fraudulent activities seemingly be based upon the desire for personal gain by the company’s executives. WorldCom’s bankruptcy court found that “in at least as early as 1999, responding to the pressures on WorldCom’s
earnings, management undertook a succession of measures designed to shore up the Company’s income statement . . . [t]hese measures deteriorated into a concerted program of manipulation that gave rise to a smorgasbord of fraudulent journal entries and adjustments” (Thornburgh 2002, 105).

Like Enron, WorldCom sought to grow in order to generate revenue. Using WorldCom stocks, CEO Kenneth Lay engaged in one leveraged buyout after another to grow the size and reach of the company. In using the practice of leveraged buyouts, Lay was able to “acquire a company without contributing a great deal of cash” (Skeel 2005, 115). The use of stock to engage in such leveraged buyouts resulted in a strong need to maintain the value of WorldCom’s stock and Lay rewarded his senior executives at WorldCom who found ways of keeping revenue at the company up. WorldCom’s bankruptcy court reported in 2003 that the “aggressive personal enrichment attitudes reflected in [WorldCom’s] compensation practices with regard to Ebbers and [Chief Financial Officer (CFO)] Sullivan were so corrosive of responsible behavior that they may have implicitly created a climate conducive to the fraud that occurred” (Breeden 2003, 60).

Unfortunately, Lay’s aggressive business practices were known to and authorized by WorldCom’s board of directors. Scholars Dennis Moberg and Edward Romar posit that WorldCom’s demise is best boiled down to three major issues: “the corporate strategy of growth through acquisition, the use of loans to senior executives, and threats to corporate governance created by chumminess and the lack of arm’s-length dealing”
Moberg and Romar 2006, 2). They also argue that even though “2002 saw an unprecedented number of corporate scandals: Enron, Tyco, Global Crossing . . . [i]n many ways, WorldCom is just another case of failed corporate governance, accounting abuses, and outright greed” (Moberg and Romar 2006, 1).

Greed and financial misconduct have not been restricted to the for-profit sector, however, as was evidenced by the scandals in the mid 2000’s at the Smithsonian Institution and at American University. In March 2007, the Washington Post reported that the Secretary of the Smithsonian, the equivalent of the national museum system’s CEO, had “resigned under pressure following revelations regarding his housing allowance and office and travel expenditures” (Trescott and Grimaldi 2007). The resignation, while abrupt, was not unexpected. “As early as 2001, there was public criticism of action taken by Mr. [Lawrence M.] Small that should have raised questions about his ability to manage the Smithsonian effectively . . . several newspaper articles [for example] questioned Mr. Small’s use of a privately chartered plane for Smithsonian business” (Bowsher, Potts, and Smith 2007, 9).

Throughout the term of his service at the Smithsonian, which began in 2000, Small faced criticism regarding the approach he took to his office and the institution beginning with the perception that he had brought with him a “corporate mentality to an institution that long resembled a university campus” (Trescott and Grimaldi 2007). The public outcry against Small’s leadership, which grew increasingly louder as time went on, eventually led the museum’s board to appoint an independent committee to investigate
Small’s operation of the nonprofit. Ultimately, this independent investigating committee concluded that Small “placed too much emphasis on his compensation and expenses” and that he, and his immediate deputy secretary, were absent from institutional operations for more than “400 and 550 work days, respectively” over a period of approximately six years due to vacation time and “time spent serving on corporate and other boards and performing other non-Smithsonian-related duties” (Bowsher, Potts, and Smith 2007, 7). In addition, the investigating committee found that despite the ongoing public criticism of Small, the minutes and transcripts of the Smithsonian’s board meetings gave no indication that the board questioned Small’s expenses or the excessive compensation granted to him.

Similar to the experience of the Smithsonian, American University faced public criticism and scandal in the mid 2000’s when reports became public concerning the compensation and spending of its President Benjamin Ladner. In 2005, after Ladner had been in office for more than ten years, an “anonymous letter [was sent] to the board in March 2005 [accusing Ladner and his wife] of ‘severe expense account violations’ – of blowing the university’s cash on a French chef, on weekends abroad, on extravagant parties for friends and family” (Jaffe 2006). This letter, which also became public, forced the board to investigate the charges and opened the door for a series of newspaper articles reporting on the misconduct of Ladner and the inaction by what became known as a severely dysfunctional board of trustees. In the fall of 2005, the Washington Post reported that Ladner’s compensation the previous year was “more than $800,000, well above that of presidents at comparable schools, according to outside analysts . . . [and he]
and his wife . . . were charging antiques and cashmere to the university as well” (Kinzie and Strauss 2005).

After the negative publicity and Ladner’s resignation from American University, the problems with American University’s board, and its lack of appropriate oversight of the institution and its president, became increasingly apparent. In 2006, an ad hoc committee of the Faculty Senate published a report alleging that many “of the difficulties of the recent past have stemmed from a failure to ratify executive committee decisions . . . [for example, the] president’s 1997 compensation contract was not widely known and never formally ratified by the board as a whole . . . [and the] executive committee’s decision to place the president on administrative leave in August 2005 was neither widely discussed within the board as a whole nor ratified” (Faculty Senate ad hoc Governance Committee 2006). Ladner’s increasing salary demands caused tension on the board, according to Pete Smith, one of the members of American University’s board of trustees during Ladner’s tenure. It was during a debate over another salary increase request that “the whistle-blower’s letter arrived, forcing the board to examine Ladner’s expenses . . . [and the board] hired an independent auditor who uncovered the president’s extensive spending of university funds and questioned his use of university staff for personal duties” (Smith 2009, 66).

The case studies discussed in this paper, that of Enron, WorldCom, the Smithsonian Institution and American University, all feature organizations incorporated for business in the U.S. Despite the fact that these organizations are viewed as having
different roles and purposes in society, all of these entities are incorporated for business and must maintain substantially similar governance structures. There is no doubt that for-profit and nonprofit organizations must often answer to different laws and regulations, but it is important to understand that at their very basis, both types of corporations are required to meet the same foundational rules (Green 2005, 264; Rezaee 2007, 419). This paper focuses on for-profit corporations that are publicly traded and nonprofit organizations that fall into a specific IRS classification that includes the majority of large organizations that the public would recognize as being nonprofit (public charities, private foundations, colleges and universities, and religious congregations).

The concept of incorporation of for-profit companies has a long history in the U.S. What is now known as the modern corporate structure of publicly traded companies “began to appear in the 1850s and 1860s as industrialization increased complexity of business operations . . . [with] the public limited liability corporation, in which a shareholder’s liability was limited to their investment, [taking] hold only in the 1900s” (Green 2005, 11-12). The rules governing the operation of for-profit corporations is a mix of “federal and state laws, court decisions, and regulations; the rules of the stock exchanges and the major creditors to a corporation; and the rules approved by each corporate board” (Niskanen 2005, 337).

Individual state law, which is controlling with respect to actual incorporation of a company, requires the establishment of a board of directors (Nofsinger and Kim 2003, 91). In this paper, I discuss good for-profit corporate governance in the context of
viewing boards of directors as agents for shareholders and other stakeholders of for-profit public corporations. In that context, the “objective of wealth maximization is more than an end in itself; it is a means to the end of efficient resource allocation and economic growth” for the long-term health of the corporation (Kaen 2003, 16). A significant, if not primary, responsibility of boards of directors is to review and analyze the actions of the CEO and if “board members doubt the CEO’s plans, abilities, or integrity, they must take the necessary steps to inform themselves and prepare for action” (Colley and others 2005, 76).

When looking at the downfall of companies like Enron and WorldCom, where executive compensation, bonuses, and CEO loans were central to the misconduct that occurred, it can be easily argued that the “balance and judgment of management was ‘bought off’ by large stock-based compensation awards with very short-term payoff and limitless bonus payments” which were not countered with strong governing board oversight keeping the long-term health of the company in mind (Lorsch, Berlowitz, and Zelleke 2005, 36). Although not the case in all of the corporate collapses in the 2000’s, a “striking symptom of [these large scandals] is how unquestioned and powerful the bosses’ leadership was. Ken Lay, Bernie Ebbers [and others] – all of them were, if not founders, then certainly men who personally shaped empires with obsessive drive and little respect for the rules” (Ward 2003, 17). This paper explores how the boards of directors for Enron and WorldCom failed to maintain their independence from the respective CEO and failed to adequately fulfill their oversight responsibility with respect to both the CEO and the organization.
As noted previously, while Enron and WorldCom may be emblematic examples of illegality and ethical failure in the for-profit sector, similar failures occurred during the same period of time in the nonprofit sector. In 2009, Deborah L. Rhode and Amanda K. Packel reflected upon the for-profit and nonprofit “moral meltdown” in the 2000’s and aptly wrote that “the corporate sector has no monopoly on greed” (Rhode and Packel 2009, 29-30). A significantly interested witness to the moral and ethical failures in the nonprofit world is Pete Smith who was on the board of trustees at American University from 1999 to 2005, during the time that the university president was investigated, and he was a member of the independent review committee appointed to evaluate the operation of the Smithsonian Institution following the publication of the Secretary’s financial misconduct. From his unique perspective, Smith observes that it was the “practices [of the board] that discouraged frank and frequent communication among board members [which] left the greed of executives unchecked . . . changes to these systems put the organizations back on track . . . [but] the Smithsonian righted itself more quickly than American University because its [board members] ultimately acted decisively and cohesively” (Smith 2009, 65).

Although the failures of for-profit boards are likely to have more of a detrimental impact on the individual financial welfare of shareholders (stock owners), I am comparing the operation of nonprofit boards with that of for-profit boards because of the unique and important role that nonprofit organizations play in U.S. society. As reported by the 2005 Panel on the Nonprofit Sector, “[the] expansive network of charitable organizations enriches American’s communities by providing vital services in such fields
as health, education, social assistance, community development, and the arts. The nonprofit sector provides the means for people to engage collectively and collaboratively in critical research, community-building, and advocacy efforts that strengthen democracy, advance freedom of expression, and add richness and diversity to community life” (Panel on the Nonprofit Sector 2005, 20).

As of 2013, more “than 1.6 million nonprofit groups [were] registered with the federal government, and they control more than $4.5 trillion in assets” (Stephens and Flaherty 2013). Along with the significant control of assets, it must be emphasized that the status of nonprofit conveys with it “tax exemption and other privileges unavailable to for-profit entities” (Panel on the Nonprofit Sector 2005, 21). The combination of tax exemption, tax deductibility, and “because Americans contribute their resources and time to nonprofit organizations, government officials and the public have a right to expect these organizations to conduct themselves in and ethical manner” (Panel on the Nonprofit Sector 2005, 21).

The concept of meeting this sense of public trust, which lays over both the for-profit and nonprofit corporate sectors as an ever present and legitimate expectation, is the essential element that was shattered by the scandals of the 2000’s. Restoring that trust is exactly what the U.S. government was seeking to address when it passed legislation (Sarbanes-Oxley Act) and new guidance (IRS Governance Best Practices) following these crises. As reported by the U.S. Securities and Exchange Commission (SEC), the Sarbanes-Oxley Act “mandated a number of reforms to enhance corporate responsibility,
enhance financial disclosures and combat corporate and accounting fraud, and created the ‘Public Company Accounting Oversight Board,’ also known as the PCAOB, to oversee the activities of the auditing profession” (U.S. Securities and Exchange Commission 2012).

Unfortunately, not everyone welcomed the passage of the law nor did everyone see it as solving the problems that were endemic in the Enron and WorldCom scandals. In 2005, Niskanen analyzed the recently enacted Sarbanes-Oxley Act and wrote that the law “was to some extent a political response to a wide variety of perceived misdeeds, some of which are always with us (greed), and some of which had nothing to with accounting or crime” (Niskanen 2005, 19-20). He further theorized that the “hastily written law was unnecessary, harmful, and inadequate” (Niskanen 2005, 21).

Ironically, at the same time that the for-profit scandals were dominating the headlines, some news outlets started to examine the activities of executives in the nonprofit sector. As the years passed, instances of illegal and unethical practices by nonprofit organizations and their executives and staff created growing concern within the federal government. In September 2004, the chairman of the Senate Finance Committee, Senator Charles Grassley (R-IA), and the ranking member, Senator Max Baucus (D-MT) sent a letter to Independent Sector, a coalition representing thousands of nonprofit organizations which sought to establish best practices towards advancing the public good, “encouraging it to assemble an independent group of leaders from the charitable sector to consider and recommend actions to strengthen governance, ethical conduct, and
accountability within public charities and private foundations” (Panel on the Nonprofit Sector 2005, 15). Additionally, the Senate Finance Committee encouraged the IRS to upgrade its oversight role. The agency responded by revising its Form 990, the financial and informational document required to be filed with the IRS by almost all nonprofits, and by publishing new governance best practice guidelines (Internal Revenue Service 2007b; Internal Revenue Service 2008).

In hindsight, neither the passage of the Sarbanes-Oxley Act, and other federal regulatory efforts, nor the revised IRS reporting requirements and guidance have solved the illegal and unethical activities by for-profit and nonprofit executives as was evidenced by the bank failures in 2008 and 2009 and numerous nonprofit thefts reported into this decade. In 2013, the Washington Post reported that a 2012 study by a Boston-based security firm found that “nonprofits and religious organizations accounted for one-sixth of major embezzlements, placing second only to the financial services industry” (Stephens and Flaherty 2013). I argue in this paper that the key to resolving the majority of these issues is to focus not on laws and regulation but to instead emphasize instituting the ethical principle of stewardship in the governance structures of for-profit and nonprofit corporations.

Taft states that while he believes the financial crisis of 2008-2009 had innumerable origins, the “key cause of the crisis was a lack of Stewardship values in our society and our financial institutions” (Taft 2012, 11). Many business scholars argue that while “laws, regulations, and policies” have a role in regulating conduct and establishing
oversight responsibilities, they are “relatively expensive and ineffective” and cannot guarantee either competence nor morality (Lorsch, Berlowitz, and Zelleke 2005, 44). As such, corporations should strive to operate in a manner that exceeds that which is required by law and should be required to institute an “enforceable code of ethics that sets the appropriate ‘tone at the top’ of promoting ethical and professional conduct and establishing the moral structure for the entire organization is the backbone of effective corporate governance” (Rezaee 2007, 440). This code of ethics should be based on the principle of stewardship such that corporations, regardless of what type they are, operate in a manner that is focused on service to others over self-interest.

In summary, corporate boards of directors and/or trustees must promote operational practices that rise above mere compliance with law and are grounded in the higher ethical foundation of stewardship.
At the pinnacle of their marketplace and industry dominance, Enron and WorldCom were looked up to as models for corporate governance and business practices. Touted by financial gurus for achieving strong growth and profits year after year, they were both companies who portrayed an exemplary path towards continued success. That is until the bottom dropped for each and the façade of the companies were pulled back to show how deeply in debt and dysfunctional both entities were. In each case, the company was run by a strong CEO who pushed the company to achieve new heights resulting in extreme personal gain. And, in both cases, the boards of directors of the companies failed in their responsibilities to oversee the respective CEOs as well as the strategy and direction of the corporations. The following summaries briefly outline the major issues reported as leading to the demise of each organization, the financial abuses of the CEOs and notes some of the areas of failure by the individual boards of directors.

**Enron**

Immediately prior to its collapse, Enron was one of the top energy companies in the U.S. and had been run for many years by one CEO, Kenneth Lay, who was “held in awe for his unflappable calm, his free-market fervor, and his A-list Washington and Texas contacts” (Skeel 2005, 151). Lay was responsible for the rapid expansion of Enron during the 1990s by correctly predicting how “deregulation would transform the natural-gas industry from its traditional status as the poor cousin of oil . . . to a lucrative business
in its own right” (Skeel 2005, 145). One of the most significant corporate achievements of Enron during that period was the “creation of an online trading business that bought and sold contracts to deliver energy products like natural gas, oil or electricity. Enron treated these contracts as marketable commodities . . . but [developed this practice] outside of existing controls on investment companies and commodity brokers” (Permanent Subcommittee on Investigations 2002, 7).

Even as the company was spiraling downward internally, Lay bragged publicly in 2001 about Enron becoming “the world’s greatest company” (Eichenwald and Henriques 2002). His entire career at Enron was a testament to that goal. Lay “pushed the regulatory envelope from the beginning . . . [which included launching] an acquisition spree, buying gas pipelines and bidding on utility projects all over the world” (Skeel 2005, 145). The combination of acquiring other energy companies and tangible assets, such as pipelines, as well as the development of the energy online trading business required Enron to borrow significant amounts of money and caused the company to experience “large earnings fluctuations from quarter to quarter” (Permanent Subcommittee on Investigations 2002, 7).

In order to stabilize its cash flow problems, Lay and his senior executives sought to find partnerships with other companies who might be willing to invest in Enron’s energy assets. Apparently these partners were few and far between which forced Enron’s leaders to conjure up new ways to address its debt and earnings fluctuations. One solution presented to the Enron board of directors was for Enron “to sell or syndicate its
assets, not to independent third parties, but to ‘unconsolidated affiliates’ – businesses like Whitewing, LJM, JEDI, the Hawaii 125-0 Trust and others that were not included in Enron’s financial statements but were so closely associated with the company that Enron considered their assets to be part of Enron’s own holdings” (Permanent Subcommittee on Investigations 2002, 8).

Under this structure, Enron was able to hide its massive debts by pushing them off on these affiliates while also claiming the alleged assets of those companies. Unfortunately, what was not readily transparent is that these contractual relationships “were financed, in effect, with Enron stock . . . [and those] transactions could fall apart if the stock price fell too far . . . [because] Enron’s contracts with some of these partnerships had provisions, called triggers, that required Enron’s stock price to stay above specific levels” in order to keep the hidden financial losses from being discovered (Eichenwald and Henriques 2002).

Another factor complicating these contractual arrangements is that the affiliated companies were established and run by Enron’s CFO Andrew Fastow—which placed him in the cozy position of “buying and selling” with his employer. The absurdity of these arrangements with their glaring conflicts of interest should have raised concern within Enron’s board of directors. As it was structured, this debt hiding plan “essentially permitted Enron’s top financial control officer – an individual with personal knowledge of Enron’s assets, liabilities and profit margins – to set up his own company and sit on both sides of the table in negotiations between his business and his employer”
In addition, the arrangements set Fastow up to be the beneficiary of transactions where Enron was solely liable and all of the profits the affiliates earned “were at Enron’s expense” (Permanent Subcommittee on Investigations 2002, 35).

It was only after the Wall Street Journal published an article in October 2001 alleging that Fastow had received more than $7 million dollars in compensation from Enron’s transactions with LJM (an affiliated entity he formed), that the board directed two of its members to talk with Fastow about his LJM investment and his compensation. Upon being questioned by Enron board members, Fastow admitted he had received at least $45 million in compensation from LJM which was almost exclusively money from Enron (Permanent Subcommittee on Investigations 2002, 34).

Fastow was not the only executive who gained enormous financial wealth at the expense of Enron. To facilitate the growth of the company and to ensure continued revenue generation, Lay recommended the Enron board approve some of the highest compensation and bonus packages seen at that time. According to findings of a special U.S. Senate subcommittee established to investigate Enron’s collapse, “[t]he Enron Board, through its Compensation Committee, was not only informed of the company’s lavish executive compensation plans, it apparently approved them with little debate or restraint . . . [when interviewed, one] Board member said . . . that Enron’s philosophy was to provide ‘extraordinary rewards for extraordinary achievement’; others claimed
that the company was forced to provide lavish compensation to attract the best and the
brightest employees” (Permanent Subcommittee on Investigations 2002, 49).

Many of the compensation packages included access to stock options and it was
this “broad use of stock options as executive compensation [which] further encouraged
risky behavior” (Niskanen 2005, 3). After the fact, Enron board members stated that “it
had not occurred to them that, by giving Enron executives huge stock options awards,
they might be creating incentives for Enron executives to improperly manipulate
company earnings to increase the company stock price and cash in their options”
(Permanent Subcommittee on Investigations 2002, 51). This short sightedness by the
Enron board also extended to its approval of executive bonuses as well as its extension of
loans and a line of credit to its CEO.

With respect to bonuses at the company, less than a year before restating earnings
and declaring bankruptcy, Enron paid some of its executives tens of millions worth of
“special bonus checks,” as authorized by the board, as a “reward for the company’s
strong reported profits” (Eichenwald and Henriquez 2002). In a prior year, Enron had
“paid out almost $750 million in cash bonuses [to executives and employees] for a year
in which the company’s entire net income was $975 million” (Permanent Subcommittee
on Investigations 2002, 51). In addition, records gathered by the Permanent
Subcommittee reflect that Enron’s Compensation Committee extended a line of credit to
Lay, the company’s CEO, but then failed to monitor his use of this credit. Indeed, Lay
regularly drew down the line of credit and used that money to repay personal loans and to
buy expensive personal items for himself and his family and friends (Permanent Subcommittee on Investigations 2002). The media was quick to connect the Enron collapse to the board’s glaring failure “[by] rewarding executives with outsize pay packages and by failing to heed [other] signs of danger” (Byrne 2002).

These cash and stock option rewards led Enron executives and employees to seek to continue to grow the company in the manner pushed by Lay. In the fall of 2001, as the financial reality of Enron became clear to senior internal leaders, Lay attempted to save Enron by reaching out to another energy company, Dynegy, to discuss a possible merger of the companies. At first, the merger appeared to be “Enron’s salvation” and the companies’ boards tentatively agreed to the merger on Nov. 7, 2001 (Eichenwald and Henriques 2002). At that time, however, Enron was unable to continue to hide the discrepancies in its debt and earning statements and “Enron [was forced to announce] that its storied financial performance since 1997 had been an illusion, one created in large part by Mr. Fastow’s partnerships” (Eichenwald and Henriques 2002). Enron’s restatement of earnings at the time finally illuminated the seriousness of Enron’s indebtedness and the chairman of Dynegy’s board cancelled the proposed merger. Without the merger, Enron’s board understood that there were no other options left and voted to file for bankruptcy on December 1, 2001 (Eichenwald and Henriques 2002).

The following day, on December 2, 2001, Enron officially filed for bankruptcy “with assets then estimated at $63 billion, the largest bankruptcy to that date, after six straight years of being considered the most innovative corporation in the United States”
(Niskanen 2005, 1-2). Among other responses, Enron’s bankruptcy filing spurred a criminal investigation into the actions of Enron executives as well as other parties connected to the company. In the end, the government’s investigation into Enron’s practices “resulted in 16 guilty pleas by Enron executives, and four convictions of Merrill Lynch bankers” (Barrionuevo 2006). For those cases that went to trial, prosecutors focused on a “‘lies and choices’ theme [transforming] the case [brought against Lay and Skilling] into a test of credibility between the former chief executives and the more than half a dozen witnesses from inside Enron who testified for the government” (Barrionuevo 2006).

While some Enron executives, including Lay, were criminally prosecuted, no Enron board member was ever charged despite early speculations that the business practices leading to the company’s collapse had been authorized, in some manner, by the board. In early 2002, the New York Times reported that “[t]here is increasing evidence that Enron’s board, composed of many prominent and financially sophisticated people, was actively involved in crucial decisions that may have led to the company’s downfall” (Abelson 2002). During its investigation, the Permanent Subcommittee identified “more than a dozen red flags that should have caused the Enron Board to ask hard questions, examine Enron policies, and consider changing course . . . [by] failing to provide sufficient oversight and restraint to stop management excess, the Enron Board contributed to the company’s collapse and bears a share of the responsibility for it” (Permanent Subcommittee on Investigations 2002, 55).
Specifically, the Permanent Subcommittee found that based upon the vast amount of evidence it gathered and reviewed, the Enron board “failed to safeguard Enron shareholders and contributed to the collapse of the seventh largest public company in the United States, by allowing Enron to engage in high risk accounting, inappropriate conflicts of interest transactions, extensive undisclosed off-the-books activities, and excessive executive compensation” (Permanent Subcommittee on Investigations 2002, 3). In fact, Enron documents revealed that “step by step, the Enron Board allowed the establishment of Whitewing [and similar entities such as LJM1 and LJM2], supported it with Enron stock, restructured it as an off-the-books entity, approved of its use as an off-balance sheet vehicle to purchase Enron assets, monitored billions of dollars in Enron asset sales to Whitewing [and other similar entities], and monitored Whitewing’s impact on Enron’s financial statements and its claims on Enron stock” (Permanent Subcommittee on Investigations 2002, 39).

In addition, despite being advised by the company’s auditors in 1999 that Enron was engaging in accounting practices considered to be “high risk,” no board member, including “a one-time Stanford University accounting professor who had been chairman of the audit committee for more than 10 years, objected to the procedures described by the auditors, requested a second opinion, or demanded a more prudent approach” (Byrne 2002). According to evidence reviewed by the Permanent Subcommittee, a number of Enron’s high ranking external auditors were aware of the edgy accounting practices as well as the significant conflicts of interest proposed by the partnerships with the
companies run by the CFO and raised these issues to the Enron board (Permanent Subcommittee on Investigations 2002, 15-20).

When the affiliation agreements were being contemplated, Enron’s outside auditors encouraged board discussion about the proposed partnership and suggested Board approval. What is puzzling, however, is how quickly and easily board approval occurred. The Permanent Subcommittee found that while Enron board members acknowledged the unprecedented nature of these partnerships, the board authorized code of conduct waivers and “approved the [affiliation proposals] with little study or debate” despite understanding, among other things, that “contrary to the Board’s usual practices, the LJM1 proposal was never reviewed by the Finance Committee before it was submitted to the full Board for consideration” (Permanent Subcommittee on Investigations 2002, 25). Over the course of several years, the Enron board waived its own code of conduct three times so that Fastow could establish private equity funds and, ultimately, earn millions of dollars at the expense of his employer—Enron (Skeel 2005; Permanent Subcommittee on Investigations 2002; Byrne 2002; Abelson 2002; Barrionuevo 2006; Niskanen 2005; Eichenwald and Henriches 2002).

In retrospect, the legal and ethical concerns found in Enron’s business practices raise serious questions regarding a lack of independence on the part of many of the Enron board members. The failure of the board members was more than that of mere inattention. Although, the Permanent Subcommitte’s investigation “found a Board that routinely relied on Enron management and [its outside auditors] with little or no effort to
verify the information provided, that readily approved new business ventures and complex transactions, and that exercised weak oversight of company operations,” it also found that many of the board members had personal connections to Lay and business connections with the company itself (Permanent Subcommittee on Investigations 2002, 14).

During the period of time relevant to the end of the company, Enron’s board, “which was comprised of 15 members . . . epitomized the notion of being captive to their CEO” (Nofsinger and Kim 2003, 103). In addition to having personal relationships with Lay, a number of Enron board members had financial ties to Enron, including being service providers to the company, “which, collectively, raise questions about Board member independence and willingness to challenge management” (Permanent Subcommittee on Investigations 2002, 14). Furthermore, Enron’s board members were some of the most highly compensated corporate board members of the time. “The total cash and equity compensation of Enron Board members in 2000 was valued by Enron at about $350,000 or more than twice the national average for Board compensation at a U.S. publicly traded corporation” (Permanent Subcommittee on Investigations 2002, 11).

The bottom line is that “Enron’s board knew about and could have prevented many of the risky accounting practices, conflicts of interest, and hiding of debt that led to the company’s implosion simply by asking some obvious questions” (Byrne 2002). Nearly a year and a half after Enron’s bankruptcy filing, Richard Breeden, who had been appointed as a Corporate Monitor in WorldCom’s bankruptcy case, noted that “[t]he
willingness of Enron’s board to suspend its code of conflicts to allow the CFO and other finance department personnel to participate in financial schemes with a personal financial interest contrary to Enron’s is emblematic of the problem of very large corporations engaging in aggressive business practices which boards of directors have “failed to stop” (Breeden 2003, 24).

**WorldCom**

In 1985, Bernard Ebbers, an early investor in Long Distance Discount Services, Inc., was elected to be the CEO of the company by the board of directors. Starting as a small Mississippi long distance service provider in 1983 under Ebbers’ leadership the company, later known as WorldCom, grew over the course of 15 years to become one of the largest telecommunications companies in the world (Lyke and Jickling 2002; Thornburgh 2002). Interestingly, this rapid development occurred, despite the fact that Ebbers “had no prior experience in the telecommunications industry” before becoming CEO (Thornburgh 2002, 13). Although he was not steeped in knowledge about telecommunications, Ebbers recognized the opportunities presented by deregulation of the industry in the 1990’s.

In combination with deregulation, the speedy development of communications technologies and increasing competition for these services all helped set the stage for WorldCom and other telecommunications companies to rapidly expand. WorldCom, however, appeared to be able to grow faster than most. During the 1990’s, WorldCom made a series of acquisitions of other telecommunications firms—including, among
others, MCI, UUNet, CompuServe, and America Online’s data network—which increased the company’s “reported revenues from $154 million in 1990 to $39.2 billion in 2001, placing it 42nd among Fortune 500 companies” (Lyke and Jickling 2002, 2). Some of the company’s acquisitions “constituted the largest mergers of their time in the telecommunications industry” (Thornburgh 2002, 11).

All of these acquisitions appeared to be led by Ebbers who “sported a closely trimmed white beard and portrayed himself as a folksy, downhome hero who was taking on stodgy telecom giants . . . and holding his own” (Skeel 2005, 151). According to Dick Thornburg, a U.S. Bankruptcy Court appointed examiner in WorldCom’s bankruptcy proceedings, “WorldCom did not achieve its growth by following a predefined strategic plan, but rather by opportunistic and rapid acquisition of other companies. The unrelenting pace of these acquisitions [caused WorldCom to] constantly redefine itself and its focus” (Thornburgh 2002, 6).

Similar to moves made by Enron, WorldCom engaged in leveraged buyouts of other company’s using its own stock as collateral. “While it posed as a high growth Company, WorldCom was highly levered and suffered from high cost levels that left it much weaker than investors realized” (Breeden 2003, 14). The pressure of debt, generated both because of the leveraged buyouts and because of the high costs of telecommunications business, meant that a higher stock price was extremely important to the company (Thornburgh 2002; Lyke and Jickling 2002).

Between 1999 and 2001, WorldCom, unlike other similar companies “publicly reported sustained and often impressive revenue growth . . . [much of which] was
manufactured through improper accounting adjustments and entries that were made for the specific purpose of enabling WorldCom to achieve particular revenue targets or results” (Beresford, Katzenbach, and Rogers 2003, 130). In layman’s terms, WorldCom reduced its operational debt—like that which arose with the purchase of equipment, such as telecommunications lines—by shifting these costs out of its income statements and at the same time exaggerated its reported revenues to meet certain preset amounts established, prior to the reporting period, by Ebbers and his closely held circle of senior executives (Beresford, Katzenbach, and Rogers 2003; Lyke and Jickling 2002).

Ebbers sought to present increased revenue in every reporting period regardless of losses by other telecommunications companies present in the stock market. Thornburgh’s initial report to U.S. Bankruptcy Court, illustrated the progression of revenue of the company reporting that in 1984, Long Distance Discount Services, Inc. (one of WorldCom’s predecessor companies) reported an annual revenue of approximately $1 million. A little over ten years later, at the end of 1996, [WorldCom] reported annual revenues of approximately $4.8 billion and on December 31, 2001, WorldCom “reported annual revenues of over $35.2 billion and total debt of $30.2 billion” (Thornburgh 2002, 22).

The push for such extraordinary revenue increases in order to “avoid or postpone [significant] stock market losses . . . creates a powerful incentive for corporate management to engage in accounting practices that conceal bad news” (Lyke and Jickling 2002, 2). Ebbers pushed the company to maintain a public face of prosperity while also taking steps to internally insure that the company’s structure and culture prevented
financial misconduct from being readily disclosed. It is apparent that a significant numbers of employees, especially in the various accounting departments at WorldCom, were aware of the fraudulent accounting practices that were occurring but there was little incentive in the culture to report such misconduct. After the fact, WorldCom’s board speculated that those employees did not act because the messages emanating from corporate headquarters “emphasized making the numbers above all else; kept financial information hidden from those who needed to know; blindly trusted senior officers even in the face of evidence that they were acting improperly; discouraged dissent; and left few, if any, outlets through which employees believed they could safely raise their objections” (Beresford, Katzenbach, and Rogers 2003, 18).

As a result, awareness of the financial misconduct leading to the downfall of the company came too late and on “July 21, 2002, WorldCom, Inc. and substantially all of its direct and indirect subsidiaries filed voluntary petitions seeking relief under Chapter 11 of the United States Bankruptcy Code . . . WorldCom made its initial bankruptcy filings approximately four weeks after the Company publicly disclosed…that it had discovered substantial accounting irregularities that would result in adjustments to its financial statements totaling more than $3.8 billion” (Thornburgh 2002, 1).

Ebbers, despite being the engine behind WorldCom’s rapid expansion and push for inflated revenue postings, was not the company’s CEO when it declared bankruptcy. In April 2002, John W. Sidgmore became WorldCom’s chief executive three months prior to the company’s bankruptcy filing. Sidgmore was inserted as CEO immediately “after WorldCom’s longtime leader, Bernard J. Ebbers, resigned following the
company’s disclosure that Mr. Ebbers owed WorldCom more than $366 million for loans and loan guarantees the company had granted him” (Romero 2002).

In addition to his role as the long standing CEO of WorldCom, Ebbers had interests in a number of external unrelated businesses. Because of these external business interests, Ebbers was debt ridden by the time he resigned from his position with the company. “Throughout the 1990s, Mr. Ebbers routinely guaranteed or pledged shares of his WorldCom stock to secure numerous bank loans made to him or to entities he controlled . . . Mr. Ebbers either personally guaranteed or pledged WorldCom stock as security for in excess of $1 billion in personal and business loans, including personal bank loans, personal brokerage loans and loans on behalf of Mississippi College, Douglas Lake Land & Timber Company, Douglas Lake Cattle, BC Yacht Sales, Joshua Timberlands and Master Hospitality Services [all of which were businesses owned principally by Ebbers]” (Thornburgh 2002, 71-72).

Overall, Ebbers “personally guaranteed or pledged WorldCom stock as security for more than $1 billion in personal and business loans. The company itself lent Mr. Ebbers $425 million . . . [and] though the money was intended to help him cover the margin calls on bank loans that he collateralized with WorldCom stock, Mr. Ebbers . . . used $27 million of the proceeds for other personal reasons” (Sandberg and Pulliam 2002). Among the personal uses, Ebbers used this loan money to pay for construction of a new house and provided personal loans to family members and friends (Thornburgh 2002, 80).
Initially, Ebber came to the board seeking permission to sell some of his WorldCom shares to take care of his debts. Instead of granting him permission to sell his stock shares, WorldCom’s board chose to authorize granting him several loans. On each occasion that Ebbers came to the board’s Compensation Committee seeking permission to sell WorldCom stock, the Committee made the judgment that “a loan was in the best interests of WorldCom and its shareholders . . . [on the] premise . . . that, if Mr. Ebbers were to sell [WorldCom] shares to satisfy his margin calls, the price of WorldCom’s stock would fall, as it apparently had fallen once before when Mr. Ebbers sold some of his shares” (Thornburgh 2002, 78). While granting loans to Ebbers should have, in and of itself, raised serious governance questions, the “sheer magnitude of the loans to Ebbers was breathtaking . . . [and was] the largest amount any publicly traded company [had] lent to one of its officers in recent memory . . . [and] WorldCom charged Ebbers slightly more than 2 percent interest, a rate considerably below that available to ‘average’ borrowers and also below the company’s marginal rate of return” (Moberg and Romar 2006, 5).

Although it was the compensation committee of WorldCom’s board which arranged the details of the loans provided to Ebbers, of which there were few, the entire WorldCom board “ratified and approved the Compensation Committee’s actions” (Beresford, Katzenbach, and Rogers 2003, 300). It was only in retrospect that WorldCom’s board recognized and acknowledged that the loans it provided to Ebbers “were contrary to the interests of WorldCom and its shareholders” (Beresford, Katzenbach, and Rogers 2003, 292).
WorldCom’s loans to Ebbers were emblematic of governance failures by the board of directors but, in fact, only one example of the skewed compensation schemes present at the corporation. According to Corporate Monitor Breeden the “Compensation Committee of the board seemed to spend most of its efforts finding ways to enrich [the CEO] Ebbers, and it certainly did not act as a serious outside watchdog against excessive payments or dangerous incentives” (Breeden 2003, 17). In fact, from January 1999 through December 2001, Ebbers “received more than $77 million in total compensation,” an average of about $25.7 million annually (Thornburgh 2002, 64).

In addition to the extraordinary compensation that Ebbers received, bankruptcy court examiner Thornburgh found information leading him to believe that Ebbers and his senior leaders had significant control over bonuses paid to WorldCom employees that did not match the quantitative performance based system approved by the compensation committee and supposedly used by the company. Indeed, Thornburgh stated that information “provided by WorldCom shows that the performance bonuses paid to individuals of the same rank varied tremendously . . . [and some] individuals, even at lower ranks, were paid massive performance bonuses equal to many times their base salaries, while others received bonuses equal to only a small percentage of their salaries” (Thornburgh 2002, 67). It appears as though WorldCom’s “compensation practices were focused almost exclusively on short term top line revenue growth, without any correlation to short or long term profitability, or other drivers of long terms value creation” (Breeden 2003, 60).
Specifically, WorldCom’s board authorized Ebbers “to pay $238 million in ‘retention’ grants to favored executives and employees in 2000, without standards or supervision . . . [t]he retention program was in effect a giant slush fund” (Breeden 2003, 2). It is hard to understand why the WorldCom board agreed to “retention bonuses” for senior company executives as WorldCom’s stock prices started to slide, but it is even more confounding why these retention bonuses, including $10 million each to Ebbers and CFO Scott Sullivan, were paid in lump sum upfront as opposed to being paid overtime as the executives remained in their positions (Thornburgh 2002, 68-69).

WorldCom’s board, in retrospect, acknowledged that there was no “specific measure of performance [which] received greater scrutiny within WorldCom generally, and by Ebbers personally, than revenue growth” (Beresford, Katzenbach, and Rogers 2003, 134). And, that it was Ebbers’ recommendations regarding base salaries as well as bonus pay that was paramount in the decision-making of the board. The reality of Ebbers’ influence during his tenure is that he became one of the highest paid CEOs in the U.S. and Sullivan was one of the highest paid CFOs (Beresford, Katzenbach, and Rogers 2003, 6).

The governance failures of WorldCom’s board of directors were astounding. This revelation, however, only became truly apparent after the company was forced to file bankruptcy. In the summer of 2003, the Wall Street Journal reported on several “long-awaited reports” which “[blasted] not only top management, but also fault a breakdown in the cornerstone of the company’s corporate governance structure, including failures by
its external and internal auditors, lawyers and board members” (Blumenstein and Pulliam 2003).

Corporate Monitor Breeden noted that “WorldCom’s board didn’t do many things that might have prevented or limited the tragedy. For example, the board does not appear to have been adequately involved with the Company and its personnel” (Breeden 2003, 21). This accusation was supported by an independent WorldCom board investigating committee which wrote that the board had not operated in a manner that would have “made it likely that [it] would notice red flags” (Beresford, Katzenbach, and Rogers 2003, 30). This included the fact that board members had little interaction with the company outside of meetings; that most of the directors were closely connected to Ebbers in some manner; and, that the board “ceded leadership to Ebbers” in almost every conceivable way (Beresford, Katzenbach, and Rogers 2003, 30).

Generally speaking, the WorldCom board of directors met on a quarterly basis. “The minutes of Board meetings reflect that from at least 1999 to May 2, 2002, all matters that required Board approval were approved unanimously [no dissents on any vote were noted]” (Thornburgh 2002, 38-39). In addition, WorldCom’s “Audit Committee spent as little as three to six hours per year in overseeing the activities of the company with more than $30 billion in revenue, while the WorldCom Compensation Committee met as often as 17 times per year” (Breeden 2003, 21).

A lack of presence or time commitment on the part of WorldCom’s board members was not, however, the “board’s worst failing,” which was, by far, its lack of independence. “Rather than making clear that Ebbers served at the pleasure of the board,
and establishing reasonable standards of oversight and accountability, the board deferred at every turn to Ebbers . . . [who] controlled the board’s agenda, the timing and scope of board review of transactions, awards of compensation, and the structure of management” (Breeden 2003, 22). Although at the time WorldCom restated its earnings and was required to file for bankruptcy, its board of directors was comprised in a manner that met the definition for independence—a total of 10 members with two inside directors and eight directors—there is clear evidence showing that Ebbers “exercised substantial influence over the Board’s decision-making process and actions” (Thornburgh 2002, 37).

Thornburgh notes that from his “interviews of Board members . . . [Ebbers’] sway was attributable to the Board’s perception of [WorldCom]’s success and growth under his direction, the high esteem in the Wall Street financial community in which he seemingly was held, his apparently innately forceful personality, and the loyalty of the Board members whose companies had been acquired by WorldCom and whose personal fortunes through ownership of [WorldCom] stock has, for a long period of time, been greatly enhanced during his leadership of WorldCom” (Thornburgh 2002, 38). In the end, it is clear that “no director said ‘no’ when the Ebbers loans of $408 million came before the board, no director said ‘no’ to the $238 million retention plan giveaway, no director said ‘no’ to grants of massive volumes of stock options, and no director appears to have questioned Ebbers competence and fitness to serve as CEO until the disaster was unavoidable” (Breeden 2003, 23). In addition to Ebbers influence and control over the board raising serious questions about the independence of members of the board, the fact that several board members had business relationships with the company, including at
least one board member who had a “sweetheart deal” to use WorldCom resources (a company jet) per an agreement arranged by Ebbers, and/or had long standing business associations with Ebbers’ other companies also challenges the notion of independence (Thornburgh 2002, 64).

Finally, WorldCom’s board of directors “received compensation consisting of both cash and stock options, with overall compensation heavily weighted towards the latter . . . . [and because] many of WorldCom’s Directors had held substantial stakes in companies acquired by WorldCom, they owned a significant amount of WorldCom stock” (Beresford, Katzenbach, and Rogers 2003, 266-267). Ownership of stock options in this manner placed additional pressure on board members to consider the value of WorldCom stock. This became no more apparent than when WorldCom’s board of directors refused to let Ebbers sell his company stock in order to pay off his extraordinary debt “on the grounds that it would depress the stock price and signal a lack of confidence about WorldCom’s future” (Moberg and Romar 2006, 5).

Ironically, after determining that it was in the best interest of the company for Ebbers to step down, the WorldCom board negotiated a severance package with Ebbers that granted him an annual cash payment of $1.5 million plus medical and life insurance coverage for his lifetime, as well as lifetime use of a corporate jet and the conversion of his more than $400 million worth of company loans into one single loan with a “significant annual interest rate subsidy” (Thornburgh 2002, 65). Despite this lavish severance package, it is interesting to note that WorldCom’s board eventually concluded that it had not appropriately acted “as a check on Ebbers and he created a corporate
environment in which the pressure to meet the numbers was high, the departments that served as controls within the company were weak, and the word of senior management was final and not to be challenged” (Beresford, Katzenbach, and Rogers 2003, 283). In its own way, WorldCom’s board members indicated after the collapse that the “buck” stopped with them and they failed to set the appropriate “tone at the top.”

In both of the above cases, the respective boards of directors of Enron and WorldCom failed in their fiduciary duties to monitor the CEO and the operation of the company. That failure greatly contributed towards two of the largest corporate bankruptcies ever seen in the U.S. It was not just one component or committee on these boards which failed. Rather, all of the members failed in their moral, ethical and legal roles (Rogers 2012; Beresford, Katzenbach, and Rogers 2003; Silverstein 2013).
CHAPTER 2
NONPROFIT CASE STUDIES:
SMITHSONIAN INSTITUTION AND AMERICAN UNIVERSITY

Similar to what was seen in the cases of Enron and WorldCom, nonprofit entities such as the Smithsonian Institution and American University were also led by charismatic leaders during the 2000s. Both chief executives were lauded for the prestige they brought to their respective institutions as well as the money they were perceived to bring in the door. In reality, when the curtain was pulled back, both leaders were found to have taken advantage of their positions and misappropriated organizational funds for their own personal purposes. And, as with Enron and WorldCom, the boards of these two nonprofit entities failed in their responsibilities to oversee their respective chief executives. The summaries below briefly outline some of the significant issues reported as leading to a public scandal for each organization, the financial abuses of the institutional leaders and notes the areas of failure by the respective boards.

Smithsonian Institution

The Smithsonian Institution is an American icon. Established by federal statute in 1846, the Smithsonian Institution is “the world's largest museum complex and research organization. It's composed of 16 museums and galleries, as well as the National Zoo, and maintains a collection numbering over 142 million objects” (Chua 2002). The organization “is both a nonprofit organization under tax laws and a creation of Congress that receives 70 percent of its funding from the federal budget—$715 million last year”
The Smithsonian is governed by a Board of Regents which is responsible “for appointing the Secretary, who is charged with managing the operations of the Smithsonian” (Bowsher, Potts, and Smith 2007, 29). The Smithsonian’s board is comprised of many heavy hitters including the Chief Justice of the Supreme Court, the Vice President of the United States, several members of Congress and other prominent U.S. citizens. Despite their respective status and stature, the inattention of these board members to the oversight of the Secretary and the operations of the institution during the early to mid-2000s helped to promote an environment leading to public scandal.

Although questions about his qualifications and actions had been raised early on in Lawrence M. Small’s tenure as Secretary of the Smithsonian Institution, the pot really began to boil over in February 2007 when “The Washington Post began a series of articles reporting on the history of compensation and benefits for Small and his close circle of executives at the Smithsonian . . . [and], Senator Charles Grassley, R-Iowa, the Ranking Minority Member of the Senate Finance Committee, posed a number of specific questions to the Smithsonian about the compensation and benefits granted to Mr. Small, and asked for a number of documents related to these matters” (Bowsher, Potts, and Smith 2007, 24). In response to the growing negative publicity and the inquiries from Senator Grassley, the chair of the Smithsonian’s board executive committee “asked Charles A. Bowsher, former Comptroller General of the United States, to chair a committee to review issues raised by the news reports and by Senator Grassley” (Bowsher, Potts, and Smith 2007, 24).
Bowsher accepted the responsibility of chairing this independent review committee on “the condition that he would be allowed to choose other members…and that the Committee be allowed to select counsel of its own choice to assist in the review . . . [and] be granted unfettered access to documents and that it be allowed to interview current employees of the Smithsonian Institution” (Bowsher, Potts, and Smith 2007, 25). Bowsher choose Stephen D. Potts, who was chairman of the Ethics Resource Center, and A.W. “Pete” Smith, Jr., a retired executive with experience in both the nonprofit and for-profit sectors, to serve as his colleagues on the Independent Review Committee (IRC). In total, the IRC examined more than 15,000 pages of Smithsonian documents and conducted 46 interviews with board members and staff. The only two individuals who refused to meet with the IRC or to provide some sort of response to questions from the committee was Secretary Small and his personal assistant (Bowsher, Potts, and Smith 2007).

Ultimately, the issues uncovered in the news articles and the IRC’s investigation all led back to Secretary Small, his management style and the control he held over the institution. Many people within and outside the institution believed that Small was to blame “for a litany of transgressions, from selling the museum's name to the highest bidder to callous decisions regarding the closure of certain research facilities” (Chua 2002). He also appeared to take a very aggressive posture towards fundraising, in a manner, some argued, that was detrimental to the Smithsonian. This included “bestowing [upon] corporations and private donors too much authority over the running of museum exhibits,” such as when he allowed a Virginia businesswoman to stipulate that her $38-
million donation could only be used for a specific exhibit of her liking (Chua 2002). When this stipulation was made public, which represented an inordinate amount of control being ceded to a donor, the “uproar that followed led her to retract her donation nine months later, while Small found himself in front of a congressional panel, defending donor rewards” (Chua 2002).

Another telling sign of Small’s leadership failings and his somewhat dismissive approach to the heart of the Smithsonian’s mission is when, towards the end of his tenure as Secretary, he was “convicted in a misdemeanor plea agreement after federal investigators found that his 1,000-piece personal collection of Amazonian tribal artifacts held at least 219 items containing feathers protected under the Endangered Species Act, the Convention on Intentional Trade in Endangered Species or the Migratory Bird Treaty Act” (Rosenberg 2005). Furthermore, although this type of information may have become public too late to prevent Small from being hired as the Secretary, there were other warning signs before and during his tenure. Small’s ethical lapses started earlier in his career as an executive. Prior to joining the Smithsonian, Small was the president of mortgage company Fannie Mae and according to a Washington Post report, “a federal investigation into Fannie Mae’s business practices found that Small was prominent among executives there who encouraged employees to hit profit targets so that managers, including himself, would receive larger annual bonuses . . . [and that] Small advocated tactics that violated generally acceptable accounting rules and misled investors” (Trescott and Grimaldi 2007).
Even setting aside the unethical conduct described above, a key red flag for the Smithsonian board should have been the approach Small took towards his own compensation, that of his core executive team, and how they all could spend the resources of the Smithsonian. The IRC reported that they believed Small “brought a ‘for-profit’ mind set to the Smithsonian’s compensation practices,” because he set in place a process for compensating himself and his management team in a manner that “was not objective and became used primarily as a method of justifying substantial compensation increases for Secretary Small and his management team” (Bowsher, Potts, and Smith 2007, 47). In addition, the IRC “determined that the problem was not merely one of misunderstood guidelines, nor was it one only of poor decisions in spending Smithsonian funds on expensive or lavish travel, entertainment and personal needs” (Bowsher, Potts, and Smith 2007, 1). The IRC felt that Small was able to misuse his position for personal gain because of lax oversight by the Smithsonian board.

In its investigation, the IRC focused in on Small’s approach to compensation, benefits and the payment of expenses at the Smithsonian. According to the IRC final report, “Small’s total cash compensation for his first year – 2000 – came to $536,100, over sixty percent higher than . . . the $330,000 figure that was publicly disclosed” and significantly more than the prior Smithsonian Secretary had made the previous year (Bowsher, Potts, and Smith 2007, 36). In addition, The IRC reported that Mr. Small’s employment agreement “stipulated that he ‘fly’ first class,” and that his spouse’s travel expenses be paid when it was appropriate (Bowsher, Potts, and Smith 2007, 36). Small’s compensation grew annually while he was Secretary and by the time he left office in
2007, his total compensation was $915,658, “almost 2½ times the compensation of his predecessor” (Bowsher, Potts, and Smith 2007, 3).

The totality of Small’s compensation was not transparent to the public because while his salary was reportable on the Smithsonian’s tax forms, Small “was allowed to claim reimbursement of up to 50 percent of his actual housing costs, up to $150,000 per year” which he took great advantage of and which could not readily be seen as benefitting Small on those tax forms (Grimaldi 2007). If Small had actually used his residence often for Smithsonian purposes, such as hosting donor events, the payment of his housing expenses would have been much more palatable and less likely to give the appearance of a hidden salary. In fact, “Small rarely used his house for entertaining Smithsonian donors or potential donors . . . In his seven years as Secretary, Mr. Small held 23 Smithsonian events at his house or gallery, five of which were ‘staff development’ events for a very small number of Small’s senior staff” (Bowsher, Potts, and Smith 2007, 46).

Small’s initial employment agreement and compensation package was negotiated between Small and only a few Smithsonian board members. During its investigation, the IRC found that Small fought for a high salary and then additional housing payments in order to raise his total compensation to what he believed was an acceptable level. The IRC “was told by individuals directly involved in negotiating Mr. Small’s initial compensation that there was concern, among the limited number of former Regents involved in setting Mr. Small’s compensation, that there would be adverse publicity if the
Smithsonian announced that Mr. Small was being hired at a salary in excess of $500,000 a year” (Bowsher, Potts, and Smith 2007, 36). That being said, the small number of board members agreed to the compensation, as well as the additional raises without fully involving the entire board of regents. Indeed, the “full board did not formally approve the terms of Mr. Small’s annual total compensation until 2004, and some [board members] did not learn all the details of Mr. Small’s compensation until they read about it in . . . press accounts” (Bowsher, Potts, and Smith 2007, 5).

The case becomes even more egregious when one juxtaposes Small’s compensation and benefits, and that of his executives, against those of the Smithsonian staff. In looking at how compensation was meted out at the Smithsonian, the IRC found that the scientist and museum directors who carried out the mission of the Smithsonian were generally compensated below average as compared to staff at comparable institutions while Small and his management team were compensated far above average (Bowsher, Potts, and Smith 2007). Furthermore, Small padded his personal bank account by flouting the travel and expense reimbursement policies of the institution.

From the start, Mr. Small articulated to the Smithsonian Executive Committee that he expected to be compensated well for his service to the institution both in terms of his salary as well as his benefits. For example, “Small made perfectly clear in 1999 to the [board members] working out the terms of his employment agreement that it was absolutely necessary that he travel first class” (Bowsher, Potts, and Smith 2007, 57). Neither Small nor the board members involved appear to have considered or discussed
whether or not benefits, such as first class travel, were appropriate for the leader of a nonprofit organization. In addition, the requirement to travel in first class was interpreted by Small, and subsequently approved by the Smithsonian board, to apply to all of his travel accommodations (Bowsher, Potts, and Smith 2007).

In February 2007, the Washington Post reported that the Smithsonian inspector general found that “Small accumulated expenses from 2000 to 2005, [which included] charges for chartered jet travel, his wife’s trip to Cambodia, hotel rooms, luxury car service, catered staff meals and expensive gifts” (Trescott and Grimaldi 2007). Having the Smithsonian pay for these expenses was easily facilitated during the time that Small was Secretary because when he first stepped into office, “Small was given by his chief of staff signed blank expense authorizations . . . [and thereafter], while the Smithsonian had detailed guidelines and policies for business expenses, Mr. Small exempted himself from these policies” (Bowsher, Potts, and Smith 2007, 7).

Despite his best efforts to obscure evidence of such expenses, there are a number of clear examples of Small misusing his status as Secretary. This includes an instance when Small disregarded the Smithsonian’s more modest travel policy, and even his own negotiated “first class travel” rule when he chartered a private jet, costing more than $14,000, to fly to Texas to receive an award and then return to Washington DC the following day for a Smithsonian board meeting. The IRC found that Small did not pay for the use of the jet, despite reports to the contrary in the Washington Post, and the jet was paid for out of several different Smithsonian accounts (Bowsher, Potts, and Smith
In total, the IRC reported that an independent accounting of Small’s reimbursed expenses showed that approximately $210,000 of his expenses were either unallowable, not supported or inadequately supported by appropriate documentation (Bowsher, Potts, and Smith 2007, 60). These expenses included the Smithsonian covering travel by Small’s wife. While the IRC did not look deeply into this issue, it did report out that “[w]hen an employer pays the travel expenses of an employee’s spouse who travels with the employee on official business, this benefit is excludable from tax only if the spouse performs a bona fide business function on the trip” (Bowsher, Potts, and Smith 2007, 65). As such, the IRC recommended that the payment of Mrs. Small’s travel expenses should be reviewed to see whether or not tax requirements were violated making these payments taxable “excess benefit transactions” for Small (Bowsher, Potts, and Smith 2007, 65).

This type of greed and mismanagement at the Smithsonian resulted in increased congressional interest in nonprofit governance. In June 2006, the Washington Post reported that Senate Finance Committee Chairman Grassley questioned the lack of stewardship at the Smithsonian. But while it is clear that Senator Grassley was skeptical about Small being an appropriate steward for the institution, it was also clear that Grassley believed these issues touched on a much larger governance problem (Quilan 2006). It is not difficult to understand that connection given that, for example, during most of his tenure as Secretary, the “busy Smithsonian [board of] regents trusted Small to oversee his own audit, and then passed resolutions that retroactively approved his spending” (Smith 2009, 65).
As articulated by the IRC in its report, the Smithsonian’s supporting documents clearly outline the role and responsibilities of the Board of Regents and make clear “that the Regents are fiduciaries of the Smithsonian” because they are trustees of the Smithsonian trust, and have the duty of managing this money for the “benefit of the American people” and the board members are “analogous to directors of [other] nonprofit organization[s]” (Bowsher, Potts, and Smith 2007, 29). Furthermore, the IRC noted that the standard fiduciary duties of care and loyalty “are heightened for the Regents due to their status as trustees of the Smithsonian trust. In short, Regents owe the highest possible fiduciary duty to the Smithsonian and the American people” (Bowsher, Potts, and Smith 2007, 31).

Following press reports and the investigation of the IRC, the failures of both management and the governing board became apparent. Some of the governance failures could be attributed to the passivity of its members, but two other key contributing factors were Small’s control of information to the board and the insistence by Chief Justice Renquist, the chair of the board, that the board’s quarterly meetings run no longer than 90 minutes (Bowsher, Potts, and Smith 2007, ). The IRC found that the board failed to “look behind the tightly controlled data provided by Mr. Small . . . [and it did not] engage in the active inquiry of Mr. Small and Smithsonian management that would have alerted the Board to problems” (Bowsher, Potts, and Smith 2007, 2). The board “rarely met without Small present” which made it almost impossible for the board members to discuss Small’s performance or any concerns they might have with his leadership (Smith 2009, 67).
During most of his tenure, the Smithsonian inspector general reported to Small. As such, Small was able to prohibit the inspector general’s office from performing any independent audits or investigations (Bowsher, Potts, and Smith 2007). It was only after public rumblings and accusations began that the reporting structure was changed in 2006 so that the inspector general’s office reported directly to the board. Shortly before that transition, the sitting inspector general, Debra Ritt, complained that she was pressured by Small to curtail her office’s audit of Smithsonian expenses. Ritt eventually left the Smithsonian, arguing that her independence had been compromised by Small, and evidence collected by the IRC indicated that her predecessor had been instructed by Small not to have any direct communication with the board. In addition, Small also isolated the Smithsonian’s General Counsel and Chief Financial Officer from the board and reduced the accounting staff at the Smithsonian by half (Bowsher, Potts, and Smith 2007).

Both with respect to his outsized compensation and benefits, as well as his extravagant travel expenses, the Smithsonian board did little to question their chief executive officer. Although some leeway could be granted with respect to his compensation, because not all of the board was aware of the totality of Small’s compensation, it is much harder to excuse their lack of oversight of his expense abuses. Even after ordering an external audit “which identified nearly $500,000 of questionable expenses, which included first-class travel and repairs to Small’s home,” the board’s response was not to hold Small accountable but to instead pass two resolutions, drafted by Small’s office, retroactively approving the expenses (Smith 2009, 67).
One final example of this disturbing governance failure and the lack of oversight by the Smithsonian board is exemplified by the extent to which Secretary Small and his Deputy Secretary were involved in activities outside of the Smithsonian. These activities not only took them both away from their Smithsonian duties for significant periods but also presented significant conflicts of interest for the institution (Bowsher, Potts, and Smith 2007). Through its investigation, the IRC found that Small served on the boards of directors of a number of for-profit companies and received compensation for such service. With the exception of one year during his tenure, Small took more than 10 weeks of vacation every year and he was absent for more than 64 days from the Smithsonian for his for-profit board service (Bowsher, Potts, and Smith 2007, 74). One such board upon which Small served was the board of directors for the insurance brokerage company through which the Smithsonian purchased its insurance coverages. While it appears as though Small did report to the Smithsonian ethics structure this potential conflict, the IRC found no evidence that the Smithsonian board was notified of Small’s service on the company’s board or the potential conflict of interest that his service posed (Bowsher, Potts, and Smith 2007).

Furthermore, the Smithsonian’s second-in-command during Small’s tenure, Deputy Secretary Sheila Burke, had even more for-profit board service commitments. As such, the IRC found that from 2000 through 2006, Burke was absent from the Smithsonian for more than 400 work days performing non-Smithsonian activities and was compensated for some of these activities in an amount that totaled approximately $9 million in cash, stocks and stock options. An amount that far exceeded her annual salary
of $400,000 provided by the Smithsonian. As noted by the IRC, “[i]f one’s income from outside sources far exceeds the income from his or her main employment, it is difficult to believe that the primary employer is getting the full attention it deserves” (Bowsher, Potts, and Smith 2007, 79).

The combined service time and compensation for Small and Burke outside of their employment is uncommon and the IRC alleges that the “Board’s failure to uncover such a significant issue highlights the extent to which the Board was kept in the dark and failed to ask very basic questions about the Smithsonian’s operations” (Bowsher, Potts, and Smith 2007, 79-80). It appears as though it was only the growing negative publicity about the Smithsonian that woke the board up, but when finally awoken the board did take some decisive steps. These steps included forming a “special ad hoc governance committee to review the structure and processes of the board and to recommend changes”… the board also established the IRC to “conduct a separate review of the crisis, as well as of the governance problems that led to its development” . . . and, finally, the board asked Small to step down from his position (Smith 2009, 67). Unlike other executives asked to leave their leadership roles, “Small received no severance payment” (Smith 2009, 67).

The IRC concluded its report with a series of recommendations which it noted would preserve the Smithsonian’s “unique historical structure” while addressing the need for active oversight. A significant component of these recommendations included the “establishment of a Governing Board what would take on the fiduciary responsibility for
overseeing the operations and management of the Smithsonian” (Bowsher, Potts, and Smith 2007, 101). The establishment of such a board would formalize a process for ensuring it would be “responsible for the oversight of the Smithsonian and its management” in a manner that the Smithsonian board had attempted to address informally (Bowsher, Potts, and Smith 2007, 17). The IRC also emphasized that the Smithsonian could only move forward in a healthy manner if the relationship between the Board of Regents and the Secretary was clear and correct. As it stated, “[t]he Secretary must work for the Board . . . The operations of the Smithsonian, especially the Secretary’s office, should be open and transparent” (Bowsher, Potts, and Smith 2007, 107).

American University

American University was founded in 1893 as a private university with ties to the Methodist Church. It is one of only a few universities to be chartered by Congress. Over the course of more than 100 years, American University has developed into a respected mid-range university with a law school (Jaffe 2006). The university hired Benjamin Ladner in August 1994 after a period of almost a decade of instability within the President’s office, including having one former president pleading guilty for making obscene phone calls from his office on campus. Although Ladner was an academic and had held led a nonprofit education related organization, he had no previous experience as a college or university president when he was hired by American University (Jaffe 2006).
Ladner was welcomed by the university and city of Washington DC and started his tenure with high expectations. “At his inauguration in November 1994, Ladner came off as a heavy hitter with high ethical standards . . . [and] talked of bridging ‘the traditional gap between private interest and public responsibilities’” (Jaffe 2006). Under his leadership, the university seemed to blossom. Ladner oversaw major renovations to the university’s main campus, applications almost doubled while he was in office as president, and the test scores for incoming students increased. In addition, the university’s endowment “bloomed from $29 million to $281 million” (Jaffe 2006).

Although the university appeared to thrive while Ladner was President, there were early signs that he came into the position with a goal of improving his own financial status as much or more than that of the university.

Shortly after taking office, Ladner asked the board to obtain a house off-campus where he created “lavish living quarters” and separated himself from the campus community (Jaffe 2006). The Washingtonian Magazine reported one dean as proclaiming that the ‘extravagance started from day one. It was an imperial lifestyle’” (Jaffe 2006). Similarly, a student was said to note that Ladner gradually withdrew from campus and that the students and faculty were only aware that Ladner was on campus “if his car, with driver, was idling in front of the president’s building” (Jaffe 2006).

The apparent dichotomy between the success of the university and Ladner’s growing separation from it began to raise questions about Ladner’s management style. These questions included a heightened concern about the extravagant way in which
Ladner and his wife appeared to live—beyond the means of a normal university president. More than 11 years after becoming president of American University, Ladner was asked to step down from his position and the university announced that there was a pending investigation. In response to questions raised about the impetus for an investigation into the activities of the former president, acting president Cornelius Kerwin stated that “[t]he board received an anonymous letter alleging concerns about personal and travel expenditures of the AU president” (Kerwin 2005).

Ladner came into his position as president of American University with what appeared to be a predetermined plan to make a considerable amount of money and to enjoy the “perks” of his position. From the beginning, Ladner established a pattern where he renegotiated his contract and salary often. Those contract negotiations occurred primarily between Ladner and the chair of the board of trustees with the full board rarely being informed of the details. The board chairman at the time that Ladner was hired and throughout much of the time he was president, William I. Jacobs, acknowledged that many of Ladner’s contracts were open-ended with no termination date (Jaffe 2006). In addition, Jacobs’ also admitted that while board members may have been notified when Ladner received a new contract, the board members were not told the details of those contracts. (Strauss and Kinzie 2005) Jacobs reported that he and the executive committee “‘did not want the contract to be in the newspaper the next day, and if anybody wanted to know specifics about the contract, they could find out whatever they wanted.’ Nobody asked, he said” (Strauss and Kinzie 2005).
Overtime, however, some board members started to become uncomfortable with the amount of money that Ladner was receiving because the salaries of “university presidents are reported to the Internal Revenue Service on Form 990 each year, and the Chronicle of Higher Education publishes [an annual] list of the top ten . . . By 2002 Ladner had begun making the list” (Jaffe 2006). Finally, in late 2003, Pete Smith, a member of the American University board of trustees compensation committee “began looking into Ladner’s compensation . . . Smith engaged a new set of compensation consultants to review Ladner’s salary package and compare it with those at other institutions” (Jaffe 2006). Unfortunately, that independent review did not slow down the trajectory of Ladner’s salary increases and by 2004, his “total compensation . . . was more than $800,000, well above that of presidents at comparable schools, according to outside analysts” (Kinzie and Strauss 2005).

An ad hoc Governance Committee of the Faculty Senate noted in 2006 that the “above-market salary paid to President Ladner generated a corrosive cynicism that disillusioned and demoralized many faculty and students” (Faculty Senate ad hoc Governance Committee 2006). At this point, the board started to consider taking action to cut Ladner’s salary but these discussions caused dissent among some board members. On the one hand, there were board members who expressed concern about Ladner’s salary. On the other hand, there were board members, such as David Carmen, a member of the American University board and a federal lobbyist, who vociferously came to Ladner’s defense. It is reported that Carmen “scoffed at the IRS regulations” limiting the compensation of nonprofit executives and “called potential financial penalties [for
disregarding those regulations as] ‘de minimis’” or not enough to be concerned over (Jaffe 2006). The dissent among the board quickly grew and one of the university’s board members, Pete Smith, admitted that he resigned from the board because he was “[f]rustrated with Ladner’s arrogant defense of his compensation” (Jaffe 2006).

The Washington Post reported that in 2004, Ladner’s compensation package, when compared to that of the presidents of six other universities of “roughly equal size and reputation as American . . . found Ladner's more than $100,000 higher than the next highest” (Kinzie and Strauss 2005). Ladner’s high salary, however, was not the only evidence of his greed and desire for excess. As was acknowledged by acting university president Kerwin, American University’s executive committee of the board of trustees received an anonymous letter accusing Ladner and his wife of “‘SEVERE expense account violations’” (Jaffe 2006).

Questions about Ladner’s spending had been raised in the past but the chair of the board’s audit committee during most of Ladner’s presidency, John Petty, repeatedly told others that “it was an insignificant sum, perhaps $8,000 a year” (Jaffe 2006). In reality, the board’s audit committee had never examined Landner’s spending over a period of more than ten years. David Ward, president of the nonprofit American Council on Education, told reporters of the Washington Post that the “expenses of university presidents are not routinely audited by trustee boards . . . although it is somewhat unusual for a decade to pass without such a review” (Kinzie and Strauss 2005). Following the
an anonymous whistleblower letter, however, the board of American University decided it had to act.

The job of conducting an investigation into the spending of Ladner and his wife fell to Leonard Jaskol, “the recently appointed chair of the board’s audit committee . . . Jaskol contacted [a private law firm], who teamed up with AU’s internal auditor, Protiviti, to conduct a forensic audit” (Jaffe 2006). In reviewing documents related to the audit, Jaskol and his wife discovered a record “for a first-class plane ticket to Nigeria for $22,345” (Jaffe 2006). After confirming that the amount was accurate, Jaskol compared it to the price for a business-class elite ticket, which was $8,000, making the difference in the two prices approximately $14,000, nearly equal to the cost of one semester of tuition for a student at the university (Jaffe 2006).

Jaskol worked with the private law firm and the university’s internal auditor to come up with a final investigative forensic report. Among the investigative findings from the forensic audit, the report concluded that “[t]here was a lack of documentation [for expenses]; the Ladners had not abided by AU’s travel and entertainment policies; [and] the ‘expenses were rather extraordinary’” (Jaffe 2006). In total, the report concluded that Ladner and his wife had spent more than a half-million dollars over a three year period in a questionable manner. The expenses included a family engagement party, “travel expenses, more than $6,000 in club dues, nearly $54,000 in driver’s costs, more than $220,000 in chef services, more than $100,000 in services from the social secretary and nearly $44,000 in alcohol” (Kinzie and Strauss 2005).
After seeing the forensic accounting report, Paul M. Wolff, a senior partner in the Williams & Connolly law firm in Washington, wrote in a letter to his fellow board members stating, among other things, “‘[w]e do not have enough financial aid to help every student,’ . . . [and we] have held our faculty to small, single digit salary increases’ . . . [but] Ladner gave his personal chef raises that averaged 11 percent over the past five years” (Kinzie and Strauss 2005). Although there was considerable disagreement amongst the sitting board members, acting university President Kerwin confirmed that during its October 10, 2005 meeting the American University board agreed to adopt “the findings of its audit committee and authorized the university to report additional taxable income for Dr. Ladner for the years 2002-2005 and to seek reimbursement from Dr. Ladner for certain personal expenses” (Kerwin 2005). In accepting this report, the board agreed that Ladner “should reimburse the university for more than $115,000 for personal expenses and that he should have reported more than $350,000 in additional taxable income over three years” (Strauss and Kinzie 2005).

No one involved in the situation disputes that the “responsibility for overseeing President Ladner belonged to the American University board of trustees” (Jaffe 2006). At the time that Ladner was hired, in 1994, the university board was “packed with names from local real estate like Edward Carr, Stuart Bernstein and Gary Abramson and with such heavy hitters as prosecutors Kenneth Starr and General Motors executive Thomas Gottschalk” (Jaffe 2006). Unfortunately, the board “met just three times a year . . . [and a] board member who joined in 1999 called it “a cocktail board”” (Jaffe 2006).
Presumably, one that was more concerned with appearance than with performing its fiduciary role.

After the scandal erupted, an ad hoc faculty committee argued that the board’s lack of oversight of the president and the subsequent internal fighting was “symptomatic of governance issues that had been present for decades. Inadequacies in transparency, accountability, effectiveness, and representation laid the foundation for the events of 2005” (Faculty Senate ad hoc Governance Committee 2006). It also noted that “the [university’s] repeated bouts of financial distress had an unfortunate result on governance at the university. The board of trustees has at times sought out and supported presidents who promised to remedy the university’s financial problems without always exercising sufficient oversight of the methods used in their efforts, or indeed of other crucial aspects of university administration” (Faculty Senate ad hoc Governance Committee 2006).

Despite acting university President Kerwin’s assurances that the board was taking its “fiduciary responsibilities very seriously” in “responding to this complex matter and considerable pressures,” the internal picture was not so promising (Kerwin 2005). The board of trustees for American University quickly fractured following the independent investigation with the resulting factions acting at cross-purposes. On October 11, 2005, one small group hired its own attorney and pressured the board chair, Leslie Bains, to resign. This occurred the day after a board meeting she did not attend because of her concern that an attempt to unseat her would distract the board from addressing the finding of the audit investigation. In her resignation letter, Ms. Bains wrote that “‘a very small,
yet mean-spirited group of trustees on this board has disregarded their fiduciary obligations to be stewards of the university”’ (Jaffe 2006). In addition, a number of board members who were sympathetic to Ladner sought to change the audit investigation report but this action was stopped by the chair of the audit committee, Mr. Jaskol, who refused to sign the audit letter stating that he would “not be party to a lie” (Jaffe 2006).

Ultimately, Ladner lost his job as president of American University. Unfortunately, he walked out of the university doors with additional personal benefits. Although the board voted to terminate his employment, it remained divided on whether or not to provide him with a severance package. As Paul Wolff publicly stated, he did not support doing so because he could not support “compensat[ing] ethical blindness” (Jaffe 2006). In the end, however, the board of trustees, minus numerous board members, including Wolff, Smith and Bains, who had resigned over the period of the investigation and termination debates, voted to provide Ladner with a $3.75 million severance package and allowed him to resign instead of being terminated for cause (Jaffe 2006).
CHAPTER 3
CORPORATE GOVERNANCE

As mentioned in the introduction, this paper focuses on for-profit corporations that are publicly traded and nonprofit organizations that fall into a specific IRS classification which includes the majority of large organizations that the public would recognize as being nonprofit (public charities, private foundations, colleges and universities, and religious congregations). Most people in the U.S. view for-profit corporations and nonprofit organizations as being quite different. In reality, these two types of entities are more similar than they are different with respect to how they are organized and operated. Both are required to incorporate under state law and every state requires such corporations to have a board of directors or board of trustees that is imbued with the responsibility for overseeing the operation of the entity.

It is appropriate to acknowledge that the purposes of for-profit and nonprofit entities are different and that means that the purposes of their respective boards may be somewhat different. According to Professor Zabihollah Rezaee, the primary purpose of a for-profit board of directors is to “create and enhance sustainable shareholder value while also protecting the interests of other stakeholders” (Rezaee 2007, 63) and the primary purpose of a nonprofit board is “to serve the public rather than to maximize shareholder wealth through earning profits” (Rezaee 2007, 425). It is even more important to emphasize that the duties of the boards of both types of entities are fundamentally the same.
For-profit boards of directors are “the ultimate fiduciary for the interests of shareholders . . . [and, it] has the legal power (and increasingly social duty) to consider the company’s stakeholders—employees, communities, and suppliers” (Ward 2003, 99).

To restate, a for-profit board of directors has the fiduciary duty to care for the money invested by shareholders while also protecting the company and the many stakeholders who rely on the continued operation of the company. And, even though a nonprofit board of directors is not responsible for shareholder investments, they are “are held to the same [fiduciary] duties of care and loyalty as for-profit directors” and they must substitute donated or granted money for that of shareholder investments (Green 2005, 264).

The following summarizes some of the similarities between the structure and legal requirements of both for-profit and nonprofit organizations, including the fiduciary duties by which both types of board members must abide, and the similar roles and responsibilities of the respective boards.

**Incorporation and Boards of Directors/Board of Trustees**

In the U.S., the structure of for-profit companies has evolved over time. As early as the 1600 and 1700s, most businesses were privately owned, and often family owned. Heading into the twentieth century, however, the country saw publicly owned corporations emerging “as the dominant legal form of business enterprises” (Colley and others 2005, 2). The publicly owned corporation “has three distinctive features that make it an attractive form for defining the legal entity of business—its unlimited life, the
limited liability of the owners, and the divisibility of ownership that permits transfer of ownership interests without disrupting the structure of the organization” (Colley and others 2005, 3).

As the Industrial Revolution took hold in the U.S., public shareholders of growing companies needed some structure or mechanism to help “monitor and evaluate managerial performance and to protect their ownership interests in the company” (Kaen 2003, 170). This institution, structure, or mechanism developed into what we now recognize as a board of directors. So, while the concept of a board of directors can be found as early as the colonial days, it did not really come to fruition until the mid-1800’s when companies transitioned from being managed directly by their owners to companies with public shareholders managed by a non-owner (Green 2005, 11).

Legally, corporations “are incorporated in a particular state . . . [and that state] establishes its own corporate laws, and its court system interprets that law” (Rezaee 2007, 23). Every state incorporation law requires “a corporation to have a board of directors” (Nofsinger and Kim 2003, 91). And, most state incorporation statutes “provide that the business of the company shall be managed under the direction of the board” (Brancato and Plath 2003, 10). In addition, state “corporate laws establish a minimum standard of conduct for corporations and their directors, officers, and shareholders; they also specify the fiduciary duties, authorities, and responsibilities of each” (Rezaee 2007, 23).

Although not necessarily parallel to the development of for-profit corporations, nonprofit organizations have existed in this country from almost its inception and they
too have evolved overtime. Nonprofit corporations have been “created and sustained by people who want to give their time and resources to solve problems and enrich their communities” (Panel on the Nonprofit Sector 2005, 9). Similar to for-profit corporations, nonprofit organizations must incorporate in a state and the states “have their own laws governing the creation, operation, and dissolution of charitable organizations . . . [and] attorneys general bear the primary responsibility for enforcing these laws and investigating complaints of fraud or abuse of tax-exempt status” (Panel on the Nonprofit Sector 2005, 13).

In addition, every nonprofit organization in the U.S., “by federal and state law, must have a board of directors or . . . one or more trustees” (Panel on the Nonprofit Sector 2007, 5). The board members, whether termed directors or its equivalent trustees, “represents the members, communities, or constituencies in a [nonprofit]” (Rezaee 2007, 427). Just as with for-profit companies, nonprofit boards are “ultimately responsible for the organizations that they oversee” and service on a nonprofit board is “one of the primary vehicles through which citizens participate in the nonprofit section” (Ostrower 2007, 1).

The nonprofit sector, as a grouping, has historically been concerned about such accountability and stewardship because it recognizes that while “nonprofits serve crucial public functions . . . [they also] enjoy substantial public subsidies (in the form of tax deductions and exemptions)” which requires a certain amount of responsibility to the public (Rhode and Packel 2009, 33). The nonprofit sector’s first major effort to
strengthen its performance and accountability “began in 1918, when a coalition of nonprofits established the National Charities Information Bureau to help the public learn about the ethical and stewardship practices of organizations that raised money” (Panel on the Nonprofit Sector 2005, 14). Indeed, this responsibility to the public has only increased as the size of the nonprofit sector has increased. As of 2005, the U.S. had an “estimated 1.3 million public charities, private foundations and religious congregations” (Panel on the Nonprofit Sector 2005, 10-11). As previously noted, by 2013, the number of registered nonprofits had grown to 1.6 million and those organizations controlled more than $4.5 trillion in assets (Stephens and Flaherty 2013).

Nonprofit organizations, as noted previously, are tax-exempt. This is because both Congress and the various state legislatures have “long recognized [that] by making charitable organizations tax-exempt, [it] enables them to dedicate their funds to fulfilling their missions” (Panel on the Nonprofit Sector 2005, 12). The fact that nonprofit organizations are tax-exempt does not mean, however, that they are not required to abide by other rules, laws and regulations. At the federal level, for example, the IRS is authorized to grant nonprofit tax-exempt status and the IRS “is also authorized to assess fines and penalties and, as a last resort, to revoke tax-exempt status” (Panel on the Nonprofit Sector 2005, 13). The majority of nonprofit organizations incorporated in the U.S. are required to file an annual information return with the IRS, called the Form 990.

The purpose of the Form 990 is to serve “as the primary document providing information about the organization’s finances, governance, operations, and programs for
federal regulators, the public and many state charity officials” (Panel on the Nonprofit Sector 2005, 26). One requirement of the annual IRS Form 990 is that a nonprofit must list all of the members of its board (IRS 2003; IRS 2007; IRS 2014).

**Fiduciary Duties**

When looking at the structure of a for-profit company, the board of directors “sits at the apex of a company’s governing structure” (Permanent Subcommittee on Investigations 2002, 5). In this setting, the “board’s duty is to focus on guidance and strategic oversight, while it is management’s duty to run the company’s business, with the [mutual] goal of increasing shareholder value for the long term” (Brancato and Plath 2003, 10). To encourage or induce board members to govern in a manner that keeps the long-term interest of shareholders and other stakeholders in focus, there are traditionally, three sets of legal rules that apply: “there are the fiduciary duties . . . [then] there are shareholder voting rules . . . [then] there are disclosure rules” (Lorsch, Berlowitz, and Zelleke 2005, 91-92). Although a board of directors must abide by shareholder voting rules and disclosure rules if they are applicable to them, fiduciary duties are fundamental to all boards of directors. Similar to for-profit boards, nonprofit boards have many of the same fiduciary duties that they must uphold. As such, this paper focuses on fiduciary duties because they are applicable to all boards of directors, regardless of the type of entity.

The two fiduciary duties that are most often talked about in both the for-profit and nonprofit sectors are the duty of care and the duty of loyalty. In the for-profit sector, the
board of directors’ fiduciary duty of care requires board members to “be informed and exercise appropriate diligence in making decisions and to oversee the management of the corporation; and, the duty of loyalty to put the interests of the corporation before those of the individual director” (Brancato and Plath 2003, 10).

Generally speaking, the duty of care in the for-profit sector “requires a director to act in the best interests of the corporation and with the care reasonably expected of ‘an ordinary person’” (Colley and others 2005, 11). Or more specifically, this standard “requires that a director discharge his duties in good faith, with the care of an ordinarily prudent person, and in a manner which he or she reasonably believes to be in the best interest of the corporation” (Byrne 2002). In the nonprofit sector, the duty of care is the same and requires a board member to “exercise due care, diligence, and skill that an ordinary, prudent person would exercise under similar circumstances” (Rezaee 2007, 431).

The duty of loyalty of for-profit board members requires that they must acknowledge and act in manner that shows “that the best interests of the corporation and the shareholders must take precedence over any individual director’s interest” (Colley and others 2005, 11). Similarly, under the duty of loyalty, nonprofit board members are required “to carry out their activities in pursuing the best interests of the organization by avoiding self-dealing and self-serving activities” (Rezaee 2007, 431). The IRS states that a nonprofit board member’s duty of loyalty “requires a director to act in the interest of the
charity rather than in the personal interest of the director or some other person or organization” (IRS 2008, 8).

Central to both the duty of care and the duty of loyalty in a for-profit setting is the concept of “being trustworthy in acting in the best interests of the shareholders whom the directors represent . . . [and] implies everything that contributes to strengthening the economic efforts and value of the corporation” (Colley and others 2005, 10-11). Thus, these duties require more than the mere direct representation of individual owners and is fundamentally about taking action when it is in the best interest of the corporation for the long-term. The focus on the long-term health of the company places pressure from all sides on for-profit boards of directors. They must maintain good oversight over the operation of the company while recognizing the desire of shareholders to see increased values of stock. As such, it is increasingly important for society to be comfortable in relying “on individual board members and the board as a group to be the guarantors of values, balance, judgment and accountability” within the corporation (Lorsch, Berlowitz, and Zelleke 2005, 39).

Stephen B. Young sees both of the duty of care and the duty of loyalty as a mandate that for-profit boards are “ordered by the law to act with self-restraint, with a view towards the advantage and interests of others” (Young 2007, 2). A board’s fiduciary responsibilities, which are grounded in ethical components such as trustworthiness, have a direct impact on the health and well-being of the company. According to John L. Colley and his colleagues, “all business organizations have multiple
stakeholders whose needs must be considered to achieve sustainable success” (Colley and others 2005, 4). And it is when boards serve the needs of all of those stakeholders that “most businesses find their purposes” (Colley and others 2005, 5). Similarly, Rezaee argues that “well-governed companies outperform weak-governed companies over the long-term” (Rezaee 2007, 21).

In the nonprofit sector, these fiduciary duties are emphasized because board members are viewed as “stewards of the public’s trust and the resources invested in the organization, [and, therefore] board members have an obligation to ensure that the organization uses its resources as effectively as possible to advance its charitable mission” (Panel on the Nonprofit Sector 2007, 19). Regardless of whether the nonprofit organization has any paid staff, the board “bears the primary responsibility for ensuring that the organization lives up to its legal and ethical obligations to its donors, consumers, and the public” (Panel on the Nonprofit Sector 2007, 5).

**Board Responsibilities – CEO hiring and compensation**

There are many ways in which for-profit boards follow their fiduciary duties and apply ethical and long-term value promoting focuses in practice. In addition to setting the goals and overall strategy for the company, one principle responsibility of a for-profit board of directors is to hire and monitor the performance of the corporation’s CEO, as well as to plan for CEO succession (Brancato and Plath 2003, 34; Chew and Gillan 2009, 81). Once the CEO has been selected, the board delegates to the CEO the responsibility of the daily management and operation of the company (Colley and others 2005, 53). In
addition to hiring and evaluating the corporation’s CEO, boards are responsible for establishing his or her reasonable and appropriate salary. Starting in the 1980s and gaining momentum in the 1990s, CEO salary and benefits increased exponentially. “The pay of CEOs escalated in the mid-1990s while firms were down-sizing . . . [or better said] CEOs were paid more while rank-and-file employees were laid off” (Nofsinger and Kim 2003, 35-36). In the late 1990s, the “base pay of CEOs was nearly 100 times greater than that of the average production worker . . . [and] if incentive awards like stock options were included, CEO pay was more than 200 times higher” (Nofsinger and Kim 2003, 36).

Many for-profit boards of directors see incentive plans as one tool by which they are able to evaluate and reward a CEO for his or her performance. The case studies of Enron and WorldCom are illustrative of a significant problem that can arise when short-term incentive plans are established for CEOs. In these instances, the interests of shareholders and other stakeholders can be put in conflict with those of company executives who want to take advantage of that incentive plan. As such, CEOs may manipulate performance standards, or engage in questionable accounting practices, or in other ways try to game the system in order to obtain the tangible benefit of a bonus or a significant salary increase (Kaen 2003, 125-128).

In looking at the examples of both Enron and WorldCom, it was not greed in and of itself that was the problem but how that greed motivated the company CEOs and other executives to the extent that they did not question engaging in illegal and unethical actions which led to taking “advantage of shareholders, the capital markets, and the
government” (Nofsinger and Kim 2003, 51-52). Some argue that the boards of both Enron and WorldCom enabled, and perhaps encouraged, the executives to take these advantages by establishing compensation policies focusing on short-term profit instead of establishing “compensation arrangements that link compensation to long-term company performance and strategic goals” (Brancato and Plath 2003, 27).

For nonprofit organizations with paid staff, the board of directors “is responsible for selecting, overseeing and, if necessary, terminating the [CEO or executive director]” (Panel on the Nonprofit Sector 2007, 13). Furthermore, the board is responsible for monitoring the work of the CEO and to determine a compensation package that will “attract and retain a qualified chief executive” (Panel on the Nonprofit Sector 2007, 15).

Compensation of executives in the nonprofit sector may be somewhat more complicated than in the for-profit sector for a couple of reasons. First, “[salaries] that are modest by business standards can cause outrage in the nonprofit sector, particularly when the organization is struggling to address unmet social needs” (Rhode and Packel 2009, 32). Second, by law, nonprofit organizations are prohibited from paying “excessive compensation and other transactions that provide excessive economic benefit to executives and other disqualified persons” and this prohibition also extends to the family members of nonprofit executives (Panel on the Nonprofit Sector 2005, 67).

Nonprofit board members are liable for ensuring that an organizations’ chief executive is reasonably compensated and not provided excessive compensation. If a chief executive is found to have received excessive compensation, the nonprofit board
members may be required to pay an excise tax that is a percentage of the excess transaction (Panel on the Nonprofit Sector 2005, 7). Despite a clear penalty for paying an executive too much money, as in the for-profit sector, the nonprofit sector has faced scandal with media reports regarding “seemingly excessive compensation” for nonprofit executives raising “concern among donors, state and federal regulators, and the public” (Panel on the Nonprofit Sector 2005, 66). In both the Smithsonian and American University examples, the respective boards did not have good control over the process for determining compensation for their CEOs.

**Board Challenges – CEO evaluation, board independence and other concerns**

Monitoring the performance of a company or nonprofit CEO is not an easy task. Boards of directors walk a fine line between micromanaging and being too detached from the organization’s operations. It is important for board members to “strive to find the right balance between the two extremes, staying proactive in carrying out their responsibilities as directors without interfering” (Colley and others 2005, 53). At its best, effective corporate governance “can be described as a vigorous set of checks and balances that establish responsibilities, require accountability, and enforce consequences” at its worst, and as revealed in the previously detailed case studies, for-profit and nonprofit corporate governance be weak, inattentive and destructive (Rezaee 2007, 22).

In finding the right oversight balance, Niskanen argues that “the relation between the board and the management should be one of constructive skepticism” (Niskanen 2005, 14). The IRS has stated that it believes nonprofit boards are successful when they
are “composed of persons who are informed and active in overseeing a charity’s operations and finances” and “include individuals who not only are knowledgeable and engaged, but selected with the organization’s needs in mind (e.g. accounting, finance, compensation, and ethics)” (IRS 2008, 8). Nonprofit board members must ask themselves “whether they are actively serving the organization’s mission and ensuring that the organization is accomplishing its mission” (Ostrower 2007, 1).

Whether for-profit or nonprofit, board members must be able to ask questions and to demand appropriate and relevant information. Again, the IRS has stated that if “a governing board tolerates a climate of secrecy or neglect, we [the IRS] are concerned that charitable assets are more likely to be diverted to benefit the private interests of insiders at the expense of public and charitable interests” (IRS 2008, 8). In the for-profit setting, Ward notes that while board members may be instructed to ask tough questions of the CEO about his or her decision-making, this is something that rarely happens in reality (Ward 2003, 207).

This failure to question or challenge the CEO happens for many reasons. For example, the board many not be aware of what is truly taking place within a company and may have limited access to relevant information (Colley and others 2005). Or, as is often the case, it is because directors are “not picked for their ability to challenge management . . . they are more often chosen for their business or personal ties, or for their ability to add symbolic luster” (Chew and Gillan 2009, 82).
In addition, it is hard for some for-profit boards to evaluate the performance of the company CEO because the board is structured such that the CEO is the chairman of the board. This type of structure, which was seen in the Enron and WorldCom case studies, speaks to a serious lack of independence on the part of the board (Nofsinger and Kim 2003, 98-99). The independence of for-profit board members is very important and directors “must always represent the best interests of the company” (Green 2005, 169). Corporate best practice offers that in order for a corporation’s governance structure to operate effectively and efficiently, board members must be “independent, effective, vigorous, and diligent . . . [with board members acting as] active fiduciaries exercising their oversight responsibility” (Brancato and Plath 2003, 18). Unfortunately, most of the high profile scandals of the 2000s, including Enron and WorldCom, “involved boards comprised principally of directors who, by background and activity, qualified as independent . . . [but] it is clear that some of these boards of directors failed to act as a strong independent check on management leadership” (Brancato and Plath 2003, 18).

In order for a for-profit board of directors to be truly independent, it should be comprised of mostly “outside” directors and the chair of the board should be someone other than the CEO of the company. Generally speaking, for-profit boards include both “inside” and “outside” directors. “Inside members hold management positions in the company, whereas outside members do not” (Kaen 2003, 25). The fact that a board member does not hold a position within the company does not, in and of itself, mean that the board member is truly independent. In fact, most for-profit boards of directors in the U.S. have more “outside” directors than “inside” directors. Unfortunately, “many of
these so-called outside board members have some sort of business or personal tie to the CEO, which is how they became members of the board in the first place” (Nofsinger and Kim 2003, 99). For most for-profit companies, the CEO has “significant influence over the [board] nomination process” and many directors view the “financial and nonfinancial benefits of holding a board seat” as beneficial which drives them to act in a manner that ensures that they maintain their positions on the board (Chew and Gillan 2009, 120).

According to Fred R. Kaen, as of 2003, “about 75 percent of U.S. companies [had the CEO acting as] the board chair—a situation that is far less common in other countries” (Kaen 2003, 178). In Europe, for example, “the roles of chair and chief executive are typically divided” (Ward 2003, 17). This divided approach is viewed by many as best practice in corporate governance because “the CEO often is, or should be, the subject of board discussions and will be directly affected by decisions on matters such as who joins the board, management team performance, and compensation” (Green 2005, 37). Having the CEO not just on the board but also acting as the chair for the board “seems an obvious case of being allowed to grade one’s own report card” (Ward 2003, 17).

Unlike for-profit boards, where payment for service on the board is prevalent and where “outside” board members may still have business connections to the corporation, nonprofit boards “are usually much larger than their corporate cousins, and directors are generally not paid, rather they are usually expected to be a source of service, talent, and fundraising” (Green 2005, 263). Although nonprofit board members usually will have
their board related expenses reimbursed (Panel on the Nonprofit Sector 2005, 7) they are not being paid a salary or stipend for their services. Thus, a lack of independence on nonprofit boards usually has nothing to do with a potential monetary benefit but rather a strong connection to the CEO or an inability to separate themselves from the nonprofit’s operations.

Nonprofit board members often “sit on both corporate and nonprofit boards [and] serve as a channel through which corporate practices are brought into the nonprofit world” (Ostrower 2007, 1). Some of those corporate practices can certainly be helpful for the nonprofit sector but others may have a true negative impact on a nonprofit board’s independence. Specifically, the vast majority of nonprofit boards do not have the CEO as a voting member. This fact leads to greater independence of the board and may enable them to ask the tough questions. As such, having the CEO as a voting member does not appear to be a common corporate practice that should be repeated in the nonprofit sector. In fact, the Urban Institute looked at the performance and accountability of nonprofit boards in 2007 and found that while only about a third of nonprofit boards included the CEO as a voting member of the board, a study suggested that by having the executive director serve as a voting board member it “detracts from the board carrying out its stewardship responsibilities, and that nonprofits should think carefully before adopting this corporate practice” (Ostrower 2007, 6).

Finally, boards of directors face other problems beside a lack of independence. These include the fact that the members of the board may only meet and discuss
corporate operations “for a few hours every other month” (Ward 2003, 124). And, especially in the case of large for-profit corporations, the same board members may be found serving on multiple boards. Such service can overextend these board members and make them unable to provide the attention needed to fulfill their fiduciary responsibilities to the shareholders and other stakeholders of each company (Nofsinger and Kim 2003, 102-103; Kaen 2003, 176). Additionally, in both the for-profit and nonprofit sectors, board members with material conflicts of interest should recuse themselves from board discussions and votes concerning the conflict. In the nonprofit sector, this type of recusal is required by law (Panel on the Nonprofit Sector 2007, 9).

Whether and how boards of directors meet their legal responsibilities is important to the long-term health of both for-profit and nonprofit organizations. Colley, et. al. note that the performance of a corporation is inextricably tied to the effectiveness of its corporate governance. Indeed, they report that they “have observed that businesses that have prospered and remained prosperous are those that have found ways to govern their affairs effectively” (Colley and others 2005, 3). For better or worse, boards are the legal and moral compass for the organization of which they are ultimately responsible. Thus, individual board members must remain accountable for their active engagement and oversight because “[moral] blinders are especially likely in contexts where people lack accountability for collective decision making” (Rhode and Packel 2009, 31).
Even as the ripple effects of Enron and WorldCom were coursing through U.S. society, the federal government was looking for ways to enact legislation to prevent similar future corporate scandals. Passed in 2002, the Sarbanes-Oxley Act was intended to address “perceived weaknesses in auditing, reporting, and corporate governance of U.S. public companies and has been hailed as the most dramatic change to federal securities laws in over 50 years” (116 Stat. 745 2002; Colley and others 2005, 79). The new requirements in this law, along with changes regarding listing criteria made almost immediately by stock exchanges in the U.S., such as the NYSE and NASDAQ, were intended to promote transparency of corporate operation, and disincentives, like criminal penalties, for bad behavior by corporate management.

A few years later, as the spotlight shifted to misconduct in the nonprofit sector, the IRS announced the publication of a revised Form 990, the financial reporting form filed annually by nonprofit organizations, with a new section focused on seeking governance related information. In addition, there were significant changes to the section of the form dealing with reporting on the compensation of executives (beyond the CEO), officers and directors (Internal Revenue Service 2007a, 19-20). In 2003, the Form 990 did not require nonprofit organizations to provide much detail about the governance structure of the organization, its policies and practices. The form did require the names of board members to be listed and that expenses for board meetings be included in the
financial report but little else regarding an organization’s governance was required to be disclosed (Internal Revenue Service 2003, 22-23). Although there were no criminal penalties included, as there were with some of the changes proposed by the Sarbanes-Oxley Act and the stock exchange listing requirements, the changes to the IRS Form 990 were intended to increase transparency of nonprofit operations.

In reality, none of the legislative, regulatory or policy changes appear to have resolved the problem of financial misconduct in either sector. In the for-profit world, some view the efforts as not addressing “the real problem with corporate governance—boards of directors” (Rogers 2012), and others argue that the changes have had a negative effect on corporate governance. For example, Niskanen proposes that overall, “Sarbanes-Oxley is making it more difficult, and therefore more costly, to attract and retain qualified directors” (Niskanen 2005, 34). Indeed, it is important to recognize that these responses were reactionary in nature and do not get at the heart of the changes necessary to see real ethical practice take hold in corporate governance. As Richard Breeden, the Corporate Monitor in the WorldCom bankruptcy case notes, the government “will rarely be in a position to stop abuses before they occur, or before it is too late to protect shareholders, bondholders, employees and other interested parties from serious economic losses” (Breeden 2003, 25).

**Congress, the SEC and the Stock Exchanges**

The passage of the Sabanes-Oxley Act, the enactment of several new SEC regulations, and changes made to the governing rules of some U.S. stock exchanges, all
of which occurred in the early 2000s, helped put in place a number of new requirements for what was perceived as good corporate governance. Collectively, these changes included, among other things: requiring that listed companies must have a majority of their directors be independent; mandating that independent directors meet without the CEO and other senior management in regularly scheduled executive sessions; making it explicitly illegal for corporate officers and directors to fraudulently influence independent auditors; and, demanding that boards of directors ensure that companies have a stated code of ethical conduct that must be followed by all—from the board members down through individual company employees (Colley and others 2005, 80-85).

According to Corporate Monitor Breeden, “[m]any provisions of the Sarbanes-Oxley Act—such as officer certifications, bans on loans to officers, mandated audits or internal controls and others—have substantially improved the regulatory structure in areas where too many boards historically failed to act” (Breeden 2003, 25). Most of the legislative, regulatory and policy changes, however, focus heavily on how corporate governance interplays with the financial operations of a company as opposed to concentrating on overall healthy corporate governance practices. Under these new laws and new rules, it has been made clear that boards of directors are responsible for gathering information and for investigating financial issues if there is ever a whiff of something to be concerned about (Ward 2003, 12). The first four substantive sections of the Sarbanes-Oxley Act—Public Company Accounting Oversight Board; Auditor Independence; Corporate Responsibility; and, Financial Disclosures—emphasize the
responsibility and accountability of financial employees and board audit committee members of public corporations (116 Stat. 745 2002).

Unfortunately, the legislative, regulatory and policy efforts made in the early to mid-2000s were reactionary and do not appear to have been coordinated in any manner, although some changes followed up on those started by the passage of the Sarbanes-Oxley Act. For example, the “Sarbanes-Oxley Act requires each public company to disclose whether it has adopted a code of ethics for senior financial officers . . . [t]he NYSE raises the bar by requiring listed companies to go beyond financial officers by making publicly available a code of business conduct and ethics for the company’s directors . . . [and] the NASD has similar requirements” (Green 2005, 142). Similarly, the Sarbanes-Oxley Act, often touted as the “most comprehensive public company legislation since the 1930s . . . left undone one of the most contentious issues of our day: the problem of a single individual holding the conflicting roles of CEO and Chairperson of the Board of a public company or what many refer to as the ‘imperial CEO’” (Green 2005, 36). When it passed the law, Congress limited the independence requirements in the Sarbanes-Oxley Act to only a board’s audit committee (Green 2005, 29). Seeing this as a deficit, several stock exchanges have expanded upon the independence mandate by now requiring “that a majority of [a] company’s board of directors must be independent and that the independent directors meet regularly without any insiders in attendance” (Skeel 2005, 179).
It is clear that the SEC and the stock exchanges have tried to flesh out the regulation of some areas of corporate governance left untouched or incomplete by the passage of the Sarbanes-Oxley Act. Some argue that by not trying to look at and improve corporate governance requirements holistically, the body missed a significant opportunity to improve the operation of public companies in the U.S. Mark Rogers, a corporate lawyer in Massachusetts and the founder and CEO of BoardProspects.Com, wrote in Forbes magazine in 2012 that Congress failed to address the underlying governance structure problems that led to for-profit implosions like Enron and WorldCom when it passed Sarbanes-Oxley. Furthermore, he believes they lost an opportunity to effect change which they could have achieved if they had focused on three specific governance areas: 1) requiring term limits for boards of directors; 2) limiting the number of public company boards that an individual can serve upon at any given time; and 3) requiring continuing education programs for board members (Rogers 2012).

It is easy to agree with Rogers’ statements concerning the missed opportunity when it can be noted that at the time “Enron declared bankruptcy . . . it was in full compliance with the corporate governance provisions of [Sarbanes-Oxley], with the exception of loans to some officers” (Niskanen 2005, 340). Furthermore, when WorldCom was imploding its board also, “at least in form, appeared to satisfy many [best practice] checklists of the time, it [just] did not exhibit the energy, judgment, leadership or courage that WorldCom needed” (Beresford, Katzenbach, and Rogers 2003, 29). Indeed, “all of the other major firms charged with accounting scandals through 2002 were
also in full compliance, at least formally, with the standards for boards and audit committee independence [outlined in Sarbanes-Oxley]” (Niskanen 2005, 340).

### Internal Revenue Service

As scandals were occurring in the for-profit sector in the early 2000s, concerns about governance began to surface in the nonprofit sector. As mentioned previously, nonprofit organizations have looked at ways to self-regulate as far back as the early 1900s. During the late 1990s and early 2000s, the growth of the nonprofit sector, as well as the steady evolution of ways to conduct business started to pressure nonprofits “to be more accountable and transparent, which . . . had a profound impact on discussions of appropriate board roles and policies” (Ostrower 2007, 1). In response to these pressures, a large and representative group of nonprofit organizations took a serious look at the nonprofit governance and accountability. As a result, they published a report in 2005 acknowledging that “[current] methods of self-regulation run along a continuum . . . [from] systems of accreditation that delegate the authority to determine compliance of charitable organizations . . . [to] purely voluntary approaches in which organizations are encouraged, but not required, to follow certain set of standards” (Panel on the Nonprofit Sector 2005, 14). They also recognized that self-regulation may not be enough to prevent bad actors in the nonprofit sector. They theorized that government regulation may be necessary “for those situations where the sector cannot reasonably be expected to deal with those who deliberately abuse the public trust and exploit nonprofit organizations for
personal gain, and new regulation may be needed where current legal standards have proven inadequate” (Panel on the Nonprofit Sector 2005, 21).

The call for new regulation in the nonprofit sector did not result in the passage of new legislation. Instead, the IRS responded by making revisions to its Form 990, the form used annually by nonprofit tax-exempt organizations to submit financial, programmatic and operational information to the agency. In the background paper which accompanied the 2007 announcement of the revisions, the IRS stated that “[t]he Form 990 has not been significantly revised since 1979 and it is universally regarded as needing major revision . . . [because it] has failed to keep pace with changes in the law and with the increasing size, diversity, and complexity of the exempt sector” (Internal Revenue Service 2007b, 1). Many saw these revisions as indicating that the IRS was clearly focusing its resources on trying to strengthen nonprofit governance across the sector (Ostrower 2007, 3-8).

The 2007 revisions to the Form 990 added a number of questions and issue areas for reporting purposes beginning in 2008. For example, the form now requires nonprofit organizations to answer a number of questions about their governance structures and ethical policies which many view as not being directly relevant to the IRS’ financial oversight authority. In addition, the Form 990 requires nonprofit organizations to disclose any grants or loans to its directors or key employees (Internal Revenue Service 2007a, 33-38) and disclose if there has been a significant diversion of the organization’s assets (Internal Revenue Service 2007a, 17).
The IRS’ introduction of a new governance section was viewed as one of the most significant changes to the new Form 990. This section now requires organizations to report on three areas of governance including details about the organizations governing body, the development and implementation of certain governance related policies, such as conflicts of interest, and it requires additional financial disclosures for board members and executives of a nonprofit. The IRS made it clear that some of these reported items were not legally required but the agency also pushed tax exempt organizations to be more forth coming by asking for nonprofit organizations to provide more detailed information to explain responses to the new governance questions (Internal Revenue Service 2008, 5).

The 2008 Form 990 instructions also provided revised governance related definitions so that nonprofit organizations were all playing under the same rules. For example, the form defined a nonprofit’s governing body as “the group of persons authorized under state law to make governance decisions on behalf of the organization and its shareholders or members, if applicable . . . [and this] governing body is, generally speaking, the board of directors (sometimes referred to as board of trustees) of a corporation or association, or the board of trustees of a trust (sometimes referred to simply as the trustees, or trustee, if only one trustee)” (Internal Revenue Service 2007a, 47).

The IRS’ guidance on best practices for governance of nonprofit organizations further emphasizes the importance of board independence by stating that “[irrespective] of size, a governing board should include independent members and should not be
dominated by employees or others who are not, by their very nature, independent individuals because of family or business relationships” (Internal Revenue Service 2008, 3). The 2008 Form 990 clarified the definition of an independent board member explaining that a member of a governing body, regardless of what it is called, will only be considered independent if it meets the following three criteria: “[t]he member was not compensated as an officer or other employee of the organization or of a related organization . . . [t]he member did not receive total compensation or other payments exceeding $10,000 during the organization's tax year as an independent contractor, other than reimbursements of expenses . . . [and neither] the member, nor any family member of the member, was involved in a [financial] transaction with the organization . . . [or a] related organization” (Internal Revenue Service 2007a, 15-16).

The revised Form 990 also requires a nonprofit organization to state whether it had a written conflict of interest and whether it requires annual disclosure by all of the organization's officers, directors, trustees, and key employees (and their family members) of relationships or interests that could give rise to potential conflicts of interest (Internal Revenue Service 2007a, 17-18). Such conflicts are defined as arising “when a person in a position of authority over an organization, such as an officer, director, or manager, may benefit financially from a decision he or she could make in such capacity, including indirect benefits such as to family members or businesses with which the person is closely associated” (Internal Revenue Service 2007a, 18).
One final new area addressed in the 2008 Form 990 is a requirement that nonprofits report on whether or not they have written whistleblower and document retention policies to encourage employees to report wrong-doing and to retain paperwork important for proving such wrongdoing in any given year (Internal Revenue Service 2007a, 18-19). The IRS also emphasized that organizations were expected to make all reasonable efforts to ensure that the information included in the filing of the Form 990 was accurate because “all information the organization reports on or with its Form 990, including schedules and attachments, will be available for public inspection” (Internal Revenue Service 2014, 2). A nonprofit organization is required to make its Form 990 filing “available to the public for a period of three years at the organization’s principal and regional or district offices during regular business hours, and by mail upon personal or written request, or by posting on the organization’s own website or on the internet” (Panel on the Nonprofit Sector 2005, 35).

The revisions made to the Form 990 were viewed by most of the nonprofit sector as requiring significant change. It remained unclear, however, whether these additional questions and the resulting operational detail that was collected, would effect real transformation over time. As noted by Francie Ostrower of the Urban Institute, “it will be of great interest to follow whether the mere inclusion of questions about certain practices (such as the conflict of interest policy) on the annual IRS Form 990 that nonprofits are required to file will promote adoption of those practices – even though these are not mandatory” (Ostrower 2007, 21).
Executive Compensation

One area of corporate governance failure identified in the case studies included in this paper pertains to how and to what extent leading executives are compensated. Excessive compensation has been a topic of concern in both the for-profit and nonprofit sectors, especially since the early 2000s. For example, in 2003, Associate Professor Brian J. Hall, of the Harvard Business School, testified before Congress that he believed the most “crucial problem [with corporate governance] is that boards are often too weak and too cozy with top executives . . . most directors feel pressure to please the CEO and one of the ways that they do this is by providing generous compensation” (U.S. Senate. Committee on Commerce, Science, and Transportation 2003, 9).

Despite being part of the discussion of what helped lead to the failure of Enron, WorldCom and other for-profit entities in the 2000s, excessive executive compensation seems to continue unabated. It was reported in 2009 that for-profit executive compensation “appears to have increased by a factor of six over the last two decades, with a disproportionate increase in equity-based compensation” (Chew and Gillan 2009, 32). These compensation practices continue to reward executives for taking action to grow and expand “through acquisitions or other means, even when that strategy is value-reducing” (Chew and Gillan 2009, 118).

Unfortunately, these practices harken back to the actions leading to the Enron and WorldCom disasters. They also directly contravene recommendations made by corporate and ethical scholars and practitioners such as Professor Hall who proposed that one way
of improving executive accountability was to align “CEO incentives with long-run shareholder value creation” (U.S. Senate. Committee on Commerce, Science, and Transportation 2003, 10). This focus on long-term value creation was also supported by Peter Clapman, Senior Vice President and Chief Counsel, Corporate Governance for TIAA-CREFF, who testified before Congress that “shareholders want future management rewards to be based on real management performance, not short-term share prices” (U.S. Senate. Committee on Commerce, Science, and Transportation 2003, 5).

Unlike the for-profit sector, where there is little regulation of executive compensation, the nonprofit sector must abide by a number of requirements issued by the IRS and which were clarified around the time of the revisions to the Form 990. In 2008, the IRS published guidance for nonprofits on governance and other related topics. In the guidance, the IRS states that a nonprofit organization “may not pay more than reasonable compensation [to CEOs and executive directors] for services rendered” (Internal Revenue Service 2008, 3). It further outlines that while nonprofit organizations are not required to follow a specific process by which they determine how and to what amount to compensate their executive, the IRS does expect these entities to ensure that compensation decisions are made “by persons who are knowledgeable in compensation matters and who have no financial interest in the determination” (Internal Revenue Service 2008, 3). Again, whether or not these requirements and expectations make any measurable difference over time is an issue that remains to be seen.
Financial Industry Implosion and Post 2008 Nonprofit Scandals

There is no doubt that the passage of the Sarbanes-Oxley Act in 2002, the connected SEC rules revisions, the stock exchange listing requirement changes, and the 2008 revisions to the IRS Form 990, all had components targeted at improving corporate governance in an effort to prevent future fraud and abuse in both the for-profit and nonprofit sectors. Unfortunately, none of these efforts have completely won the day. And, in fact, the for-profit sector experienced similar examples of misconduct within only a few years of the passage of the Sarbanes-Oxley Act when the U.S. faced a banking crisis which led to a worldwide recession. It is impossible to provide an in depth review of why the banking crisis occurred, which included the collapse of a number of financial services companies as well as reported misconduct at many others, but the apparent misconduct present during this time reflects back to some of the governance failures in the early 2000s.

According to John Taft, the rise and growth of the financial industry prior to the crisis occurred because financial institutions started to focus on share value and “loaded up their balance sheets with riskier and less liquid assets, supported by less and less capital, pursuing increasingly explicit mandates to make money for their own accounts, [as opposed to acting as an agent for their clients], creating a culture and set of values different from those of [firms] dedicated to helping solve customer problems, facilitate customer orders, or meet customer needs” (Taft 2012, 13-14). Many factors led to the changes in the way financial services firms operated but one significant factor is that
many, if not most, of the large financial services companies became publicly traded on the stock market by the late 2000s. One of the last financial services companies to make that shift in the 2000s was Goldman Sachs.

As an illustrative example, much like Enron and WorldCom of its day, the $2.6 billion in proceeds gained by Goldman Sachs when it became a publicly traded company allowed it to rapidly grow with only a passing thought about how that would change the culture and operation of the firm (Mandis 2013, 167). Such rapid growth was similar to what appear to have occurred in the scandals of Enron and WorldCom where the desire to grow fast helped to spur the fraudulent practices that occurred. After it became a public company, Goldman Sachs sought to be the best and biggest investment banking corporation in the U.S., if not the world. One former employee of Goldman Sachs, Steven G. Mandis, wrote a book about his experiences at the firm and how the company’s rapid growth after becoming a publicly traded corporation altered the structure and culture of the organization. In his book he notes that in “the early 1980s [Goldman Sachs] had a few thousand employees, with around fifty to sixty partners (all US citizens) . . . [i]n 2012, Goldman [Sachs] had around 450 partners (around 43 percent are partners with non-US citizenship)” (Mandis 2013, 17).

Mantis argues that overtime, Goldman Sachs’ interpretation of its standard that the client always comes first changed from a higher ethical view which went further than current legal protections to one being that “as long as one properly disclosed the risks to clients and followed all the legal rules and regulations, then one was ethically, morally,
and responsibly adhering to the primary business principle” of putting the clients’ interests first (Mandis 2013, 173). As such, it experienced an organizational drift away from strong ethical practice to pure legal compliance which made the firm comfortable in lowering the risks to its shareholders, related to its bad mortgage and credit debt, by selling those risky assets to the firm’s clients. As Taft explains, in the “years leading up to the financial crisis of 2008-2009, financial services firms stopped thinking of themselves as intermediaries whose role was to serve simply as a means to greater ends . . . [and they] started thinking of themselves as ends [or profit making entities] unto themselves” (Taft 2012, 13).

The pressure to seek profits for its shareholders and protect its shareholders from losses due to the bad mortgage debts owned by the company, which also resulted in handsome compensation for its executives, moved Goldman Sachs to seemingly self-deal by selling these bad debts to its financial services clients. Following the height of the banking crisis, Goldman Sachs argued that when it sold “the mortgage securities, it was not acting as an adviser to clients, it was acting as a broker, and its role was simply to sell sophisticated institutional clients whatever they wanted to buy . . . [regardless of the risks, and, as such] it completely fulfilled its legal duties when it acted as a market maker or broker with counterparties” (Mandis 2013, 213). These comments are terribly reminiscent of the actions Enron took in hiding debt within affiliated companies to show continued growth and profit.
Although Goldman Sachs was not alone in its actions it is a prime example of the wide-ranging ripple effect that can be felt when higher ethical principles are abandoned. In early 2010, Congress took many of the large investment banks to task and conducted hearings into their business practices. Taft notes that while those hearings did not reveal a lot of information evidencing overtly criminal behavior, the hearings, including the Goldman Sachs hearing “illuminated behaviors that took place in the gray zone, short of criminality” (Taft 2012, 17). He further reports that “[o]n July 15, 2010, three months after the [Senate] hearings, Goldman Sachs agreed to pay $550 million” and also agreed to revise some of its business practices in order to settle pending SEC charges (Taft 2012, 17).

The nonprofit sector has also still been plagued by financial scandals, even after the IRS Form 990 changes in 2008. Ironically, unlike in the for-profit sector where much of the unethical and illegal practices remain hidden, it is now easier to identify this type of misconduct in the nonprofit sector precisely because the Form 990 revisions require nonprofits to disclose if there has been a significant diversion of the organization’s assets (Internal Revenue Service 2007a, 17).

In light of this forced transparency, in 2013, the Washington Post published an analysis of IRS Form 990 filings from 2008 through 2012 and discovered that diversions reported to the IRS “drained hundreds of millions of dollars from institutions that are underwritten by public donations and government funds” (Stephens and Flaherty 2013). These diversions were attributed to “theft, investment fraud, embezzlement and other
unauthorized uses of funds” (Stephens and Flaherty 2013) and included such organizations as the Legacy Foundation (an estimated $3.4 million loss), the Miami Beach Community Health Center (an estimated $7 million loss to alleged embezzlement by its former chief executive who was later convicted of theft), and the “140-year-old Woodcock Foundation of Kentucky, which awards scholarships to students in need, disclosed that alleged fraud by a former chairman drained more than $1 million from its accounts, leaving the charity with assets totaling just $8” (Stephens and Flaherty 2013).

The 2008-2009 financial crisis and the reported nonprofit losses since 2008 make clear that legislation, regulation and policy guidance alone has not been enough to curb bad behavior. Laws and these other regulatory mechanisms evolve over time and what may be “legally permissible today, but morally questionable, may well become legally proscribed tomorrow” (Petrick and Scherer 2003, 1). As court appointed Corporate Monitor for WorldCom Richard Breeden reported, “[there] is no ‘silver bullet’ that will make governance sound and reliable . . . [there must be] a shared consensus on the importance of responsible and informed governance, and a willingness to act on these principles rather than merely talk about them . . . [without] such a shared determination to live by standards of excellence, then no set of rules can guarantee success” (Breeden 2003, 28). As such, publicly traded corporations and nonprofit organizations must strive to institute a higher ethical standard in corporate practice and make board of directors, those legally responsible for the respective entities, must instill higher ethical standards throughout the corporations’ operations.
CHAPTER 5

STEWARDSHIP: APPLICATION OF THE ETHICAL PRINCIPLE BY CORPORATE BOARDS OF DIRECTORS IMPROVES FOR-PROFIT COMPANIES AND NONPROFIT ORGANIZATIONS

As previously discussed, boards of directors are the pinnacle of any corporation— for-profit or nonprofit—and are therefore responsible for establishing the purpose of the corporation and instituting the culture within the corporation. While boards are clearly not responsible for day-to-day operations, they are responsible for setting the appropriate “tone at the top” to ensure that their respective entities are operated in a manner consistent with the mission or purpose of the entity and which protects the interests of its various stakeholders and constituents. The case studies discussed in this paper exemplify situations where boards of directors were not actively meeting those responsibilities, especially with respect to the responsibility of creating a good moral and ethical culture. I argue that boards of directors can take great strides towards preventing the type of misconduct perpetrated by the executives of those corporations by applying the ethical principle of stewardship to their board service. The responsibility for instituting stewardship practices in any organization starts with the board of directors or boards of trustees who are given the role of oversight through corporate law.

Boards of for-profit and nonprofit corporations must take it upon themselves to apply higher ethical standards to their oversight and decision-making processes. Laws alone cannot ensure such practice. In reality, the specific laws that apply to boards do little to ensure that such board members do the right thing. This is because most “suits
brought [against boards of directors] are commonly dismissed . . . [and those] not dismissed early on, the rules of indemnification and [Directors and Officers liability] insurance, and the incentives for all parties to settle, render the threat of out-of-pocket liability essentially illusory for an outside director” (Lorsch, Berlowitz, and Zelleke 2005, 94). As such, it is important that there be something more than mere compliance with the law. There must be a higher principle at play which influences boards of directors to do what is right for the long-term interests of all stakeholders of a corporation.

**Defining Stewardship**

Sandra Waddock defines stewardship in the Encyclopedia of Business Ethics and Society as when a person places “personal interests below those of other people or below the interests of the collective as a whole” (Waddock 2008). She further elucidates that in “management theory, the concept of stewardship requires managers to subordinate their own personal interests to those of the organization as a whole” (Waddock 2008).

As the for-profit and nonprofit corporate scandals of the 2000s started to unfold, a small number of ethical and business academics began publishing scholarship on the subject of the role of corporate governance in preventing misconduct and specifically in applying the ethical principle of stewardship to such a governance role. I discuss much of that scholarship in this chapter. For example, Cam Caldwell, Linda A. Hayes, and Do Tien Long drew upon previous research by “Davis et al. (1997, p.24) [in defining] stewardship theory as a higher level duty of governance in which the motivations of the manager are based on pro-organizational rather than self-interest behavior” (Caldwell,
Hayes, and Long 2010, 501). These and other scholars spoke of the need for corporate governance to eliminate decision-making based upon personal self-interest and that it should instead foster an environment where the long-term health and success of the corporation is paramount (Colley and others 2005, 69; Petrick and Scherer 2003).

Caldwell and Ranjan Karri, also citing to research by Davis et. al. (1997), argued that the application of the stewardship principle to corporate governance focuses the organization on “sustaining the objectives of the entire organization,” and that the role of stewardship led governance is to “protect and maximize shareholder and organizational wealth and to avoid or prevent substituting individual self-serving behaviors for organizational behaviors” (Caldwell and Karri 2005, 251). Unfortunately, this type of academic research has only been conducted by a small number of scholars. Furthermore, it appears to have mostly stalled with little research having been published since 2010. I am hopeful that more academic research and discussion on this topic occurs in the future.

**Stewardship and Stakeholders**

The ethical principle of stewardship aligns well with the concept of fiduciary duties required of all boards of directors, regardless of whether they are in the for-profit or nonprofit arena. These fiduciary duties are linked to the agency theory of management but should also include concepts from the stakeholder theory of management in that boards of directors are ultimately not just agents of the shareholders but they are responsible for the long-term health and well-being of the entire organization, and thus, all of that entity’s stakeholders. As Taft stated, the “chief attribute of Stewardship, of
servant leadership, and of fiduciary obligation, is a strong and abiding sense of purpose” for the corporation as a whole (Taft 2012, 27).

From a fiduciary perspective, “both the financial interests of shareholders and the vital concerns of stakeholders present themselves to corporate directors and officers in ethical dress” (Young 2007, 14). It is in the mixing of the legal fiduciary duties of shareholders with the moral and ethical responsibilities of all stakeholders that a covenantal relationship is created in corporate governance (Caldwell and Karri 2005, 249-259; Hernandez 2008, 121-128). Under a stewardship theory of corporate governance, the concept of managers as stewards looking at the long-term health of the corporation for all stakeholders replaces the concept of managers as merely agents of shareholders (Karns 2011, 340-342). It also recognizes that a board’s duty to shareholders alone “runs farther than the short-term, materials interest of such owners” (Young 2007, 12) and emphasizes that corporations “cannot create value without good relations” with all stakeholders, be they customers, employees, donors, regulators or the communities in which they operate (Chew and Gillan 2009, 15).

To be clear, stewardship theory in corporate governance does not ignore the reality of profit-making. Instead, it looks at profit-making in the context of ensuring that the corporation maintains its health for the long-term benefit of all stakeholders involved. Profit is viewed as a “necessary instrumentality” towards the continued existence of the corporation and “provides for [its] continuing and expanding ability to serve humanity” (Karns 2011, 341). Caldwell and his colleagues cite the research conducted by Hosmer,
Manville, Ober, Selznick and others to propose that corporate leaders, such as boards of
directors, have an affirmative duty “to maximize long-term wealth creation to benefit
society and all stakeholders” (Caldwell, Hayes, and Long 2010, 501).

In the for-profit sector, corporations serve the public good by “providing the
goods and services that enable people as consumers to flourish; opportunities for
meaningful and creative work that enable people as workers along the value-chain to
flourish; and, support that enables the communities to flourish” (Karns 2011, 341). In the
nonprofit sector, public charities are expected “to abide by ethical standards that promote
the public good” precisely because their purpose is to serve society at large (Internal
Revenue Service 2008, 6). Taft argues that all of us, including boards of directors, can
leave a stewardship legacy in practice by seeing “ourselves not just as individual actors in
economic or social systems, but that we see ourselves as members of communities” (Taft
2012, xx). Or as Caldwell and his colleagues note, “ethical stewardship incorporates
shared governance, a transformational commitment to the best interests of all
stakeholders, and the application of values that are internally congruent and reflective of
the organization’s mission and purpose” (Caldwell, Hayes, and Long 2010, 502).

**Stewardship Ethics a Higher Standard**

Implementing the ethical principle of stewardship calls for establishing a higher
standard of business practice above and beyond merely following the law. It means that
corporate boards should manage their respective organizations in a manner that promotes
“a spirit of integrity that goes beyond compliance . . . by creating a business culture of
doing what is right” (Rezaee 2007, 445). In order to obtain corporate operation under that higher standard, board of directors or boards of trustee must begin by developing clear code of ethics because the “absence of strong behavioral boundaries enables a fraudulent environment” (Green 2005, 139). As outlined by the IRS for the nonprofit sector, a “code of ethics will serve to communicate and further a strong culture of legal compliance and ethical integrity to all persons associated with the organization” (Internal Revenue Service 2008, 6).

Similarly, for the for-profit sector, a code of ethics or conduct can help for-profit corporations to create an ethical environment that goes beyond a mere “compliance check-box” mentality and, instead, encourages “all corporate governance participants to do the right things and to understand that [ethical practice] is vital to the company’s sustainable financial performance” (Rezaee 2007, 41). As author Ken Silverstein stated in his 2013 Forbes magazine article about the evolution of corporate values after Enron, a corporation must “reward ethical conduct and penalize wrongdoing at every turn” and in order to do so, “a clear-cut mission and a corporate code of ethics is crucial” (Silverstein 2013). It is a corporation’s board of directors that is best situated to establish and then monitor compliance with a code of ethics. As Corporate Monitor Richard Breeden wrote in his examination of WorldCom’s bankruptcy, it is only when a board is strong and willing to act on their principles that problems perceived as governance-related in nature can be prevented (Breeden 2003).
I would like to note that while I argue for the need to implement the ethical principle of stewardship, which is part of virtue ethics theory (or character-oriented ethics), in order to end corporate misconduct, Joseph A. Petrick and Robert F. Scherer theorize that instituting values encompassing four major ethical theories (teleological, deontological, virtue, and system development) may be necessary to help increase the level of integrity of executive management (Petrick and Scherer 2003, 5). They argue that the application of “all four theories are necessary to fully analyze and resolve moral conflicts” occurring within a given corporation at any time (Petrick and Scherer 2003, 5).

**Board of Directors Responsibility – Tone at the Top**

Boards of directors and boards of trustees are the leaders of their respective corporations even if they are not the public faces. In the nonprofit setting, the IRS has made it clear that the “organization’s governing body bears the ultimate responsibility for setting ethical standards and ensuring they permeate the organization and informs its practices” (Internal Revenue Service 2008, 6). Similarly, in the for-profit setting, good ethics practices “originate at the top and flow down through an organization . . . [and] boards have an affirmative requirement to ensure a strong ethics framework is in place” (Brancato and Plath 2003, 63).

In reflecting upon the activities leading to the bankruptcy of WorldCom, Corporate Monitor Breeden discussed the importance of establishing an appropriate ethical “tone at the top” that boards of directors and, by corporate structure, senior executives should establish because setting that tone is “critical in developing and
maintaining a broader framework of internal controls against inappropriate conduct” (Breeden 2003, 106). Once the ethical tone is set, the corporate board is then responsible for making sure that it is applied. There should be zero tolerance for unethical behavior by the executives whom boards oversee because, in the long run, having an ethical code which is unenforced “is worse than having no code at all” (Green 2005, 211). As Taft writes in his book, “[no] amount of legislation, and no amount of regulatory rulemaking, will ultimately be able to overcome or compensate for failures in leadership” (Taft 2012, 139).

Corporate governance systems can only be successful when all related stakeholders believe that the corporate management wants to “do the right thing” (Green 2005, 141). As such, boards, as the corporate leaders, have a responsibility to go beyond being a mere caretaker for the corporation and must also act as role models for executives, employees and future leaders (Hernandez 2008, 121). Caldwell and his colleagues propose that when corporate boards, as the leaders of their respective corporations, adopt an ethical stewardship approach in their governance model, the corporations will have employees who trust their leadership and who will, therefore, “demonstrate greater personal commitment, as measured by a personal willingness in the achievement of organizational goals” (Caldwell and others 2008, 160).

Ultimately, applying the ethical principle of stewardship to corporate governance is not about creating formal rules, although a clear code of ethics is crucial. Rather, it is about leaders taking actions which generate “interpersonal and institutional trust” which
“encourages followers to act with moral courage in service to the organization or cause” (Hernandez 2008, 122). As Stanford University law professors Rhode and Packel theorize, “[virtue] begets virtue, and observing integrity in others promotes similar behavior” (Rhode and Packel 2009, 31). Such stewardship behavior, or service over self, clearly places the long-term best interests of all associated with the corporation ahead of self-interest at any level within the corporation (Hernandez 2008, 121-122).

**Promoting Stewardship Means Promoting Success**

Aspiring to operate under a higher ethical standard that goes above mere legal compliance can and is compatible with a well-run corporation. Scott Green wrote in his book about the Sarbanes-Oxley Act, “those organizations that tolerate moral and ethical ambiguity spend much of their corporate energy defending their actions” to the detriment of their long-term health and sustainability (Green 2005, 139). For example, whereas Enron’s board of directors enabled the company’s executives to run it in a manner which focused on the pursuit of short-term economic returns (Petrick and Scherer 2003, 3), the board of a high performing insurance company made an affirmative decision not to pay incentive compensation to its executives because it believed “that the nuances of their industry make the measure of performance in the short term very difficult” and they were more interested in making sure the company survived for the long-term benefit of all stakeholders (Colley and others 2005, 58).

Although the application of the ethical principle of stewardship by corporate boards in the for-profit sector does shift the focus away from the concept of shareholder
wealth maximization, it does not forgo profit-making, it merely moves the focus towards “profit for purpose over profit for shareholders” (Karns 2011, 341). The profit for purpose being sustaining the long-term health of the corporation for the benefit of all stakeholders. This should be in keeping with the fiduciary duties of board members because “to the extent that directors have authority to allocate corporate resources on any basis other than long-term value enhancement, they are undermining the basis for the grant of power to private entities in a free society” (Chew and Gillan 2009, 87).

Caldwell and his colleagues cite Paine (2003) in concluding that business successes are dependent upon organizations recognizing that their financial performance should be linked with their social performance and that both can be met by integrating effective ethical governance (Caldwell and others 2008, 153). Indeed, Gary L. Karns theorizes in his scholarship that applying stewardship ethics “is very likely to engender trust, organizational commitment, brand loyalty, etc.” which will create an corporate credibility which may help to assure “favorable marketing and financial performance for the long-term” (Karns 2011, 342).

Similarly, nonprofit organizations can benefit from using stewardship ethics to promote a reputation for operating in a manner that shows they are “worthy stewards of the public and private resources entrusted to them” (Panel on the Nonprofit Sector 2005, 22). Those nonprofit boards who seek to truly institute use of the ethical principle of stewardship in their corporate governance can only benefit from the greater transparency
required of the nonprofit sector by the IRS (Internal Revenue Service 2007a; Internal Revenue Service 2007b; Internal Revenue Service 2008).

It is important to note that the benefits of applying the ethical principle of stewardship, while potentially intuitive, have largely not been studied and are mostly discussed in theory. This is an area where more research is necessary.
CONCLUSION

My professional career largely developed over the period of time during which the for-profit and nonprofit scandals discussed in this paper occurred. My observation of and interest in the factors leading to these scandals is what led me to write this paper. I believe that both types of entities—for-profit and nonprofit—can succeed by instituting the ethical principle of stewardship in their corporate decision-making and operational practice at the board of directors or board of trustees level. Those closely connected with the scandals of Enron, WorldCom, the Smithsonian Institution, and American University have all noted failure of corporate governance by the respective boards as a significant contributing factor. Similarly, those closely connected with the subsequent financial industry collapse note the movement by corporate governance towards a model of mere legal compliance, and away from governance under a higher ethical standard, as actions which paved the path to that crisis.

It is imperative to turn the tide back in the other direction. Corporate governance must set an ethical “tone at the top” that establishes compliance with a higher ethical standard for the purpose of ensuring the long-term health of the entire corporation. I believe, as Caldwell and others argue, that using the ethical principle of stewardship in decision-making in a manner which prioritizes “pursuing long-term organizational wealth, multiple stakeholder interests, socially beneficial outcomes, and morally beneficial purposes” (Caldwell and Karri 2005, 257) will lead to successful and sustainable corporations. This theory, however, is still unproven and therefore much
more research must occur because little information currently exists in support of its long-term viability. Ultimately, I agree with John Taft who wrote that the “path forward—to ‘fiscal sustainability’ and ‘planetary sustainability’—requires that not just our leaders, but *all of us*, reconnect with our Stewardship responsibilities” (Taft 2012, 139).
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