F: AU/CM

Smith Consulting

September 27, 2005

Ms. Leslie Bains
Chair, American University Board of Trustees
Ratcliff Capital
5 East 59th Street, Third Floor
New York, NY 10022

Dear Leslie:

As you can imagine, I have been watching the publicity concerning Ben Ladner's compensation and expenses with great interest.

Of particular concern to me is Ben's statement in the September 24th Washington Post denying that he had asked the Board to raise his compensation. Also, I noted in this morning's Post coverage that Ben and some of his supporters on the Board felt the faculty no confidence votes would have been different if they had had access to more complete information.

The attached memorandum, faxed from Ben to George Collins on February 19, 2004, provides that information and thoroughly refutes Ben's contention that he did not ask for a raise in his compensation. In fact, the memo specifically requests amounts totaling anywhere from $2 to $3 million or more of extra compensation over the next five years (depending on the amount of his requested "much larger" percentage increase in his base salary), on top of his already very generous compensation.

Although George referred to this memo in his prior discussions with the Board, I know that he was reluctant to release its specifics in the intention of protecting Ben from the negative backlash that was likely to occur. Given the situation, it may be appropriate for you to share this with the full Board and possibly the AU faculty, so that they have a better understanding of issues with which the Compensation Committee was dealing.

Sincerely,

Pete

A.W. (Pete) Smith, Jr.

CONFIDENTIAL

File

Areas of Consideration for Ben Ladner's Compensation

February 19, 2004

1. Annual Salary and Merit Increases
   - A few years ago the Compensation Committee adopted a compensation approach that keeps annual salary increases for AU executives low, and gives a larger percentage for performance increases. The rationale was to keep AU executive salary increases in line with those of faculty and staff, while awarding the bulk of increases solely on merit. The last two years, for example, executive salary increases were set at 4%, in line with AU staff and faculty— except for my own, which last year was set at only 3% -- while merit awards ranged from 10% - 42%.
   - This approach creates several problems. First, in all published compensation reports, the total amount of compensation is reported, making the distinction between salary and bonuses irrelevant, at least from the standpoint of public perception. No one notices the fact that part of the compensation is designated as salary and part as merit. In the public mind, only the total amount matters.
   - Second, for me it is a serious penalty to continue to reduce the percentage increases for my annual salary, especially when they are lower for me than for my Cabinet executives. Because my deferred compensation is calculated as a pre-set percentage of my annual base salary, a lower base salary automatically lowers my deferred compensation. Moreover, my contract stipulates that upon retirement I will receive a year's sabbatical plus a year's salary at my then base salary. Therefore, with a lower base salary each year, I will have a significantly lower income when I retire. Furthermore, I am now falling behind the salary levels of president's at peer competitor schools.
   - It is unclear why I was given a smaller percentage salary increase than other AU executives or why my salary level is kept low, which creates a negative impact on my deferred compensation and pay at retirement. I would prefer to be rewarded in larger salary percentages than in the past in order to be in a better financial position at retirement.
   - At the November 2003 Compensation Committee meeting, the Committee approved my recommendations for merit increases for Cabinet executives, with various percentage increases above their last year's compensation. In my case, however, the Committee decided not to give me a percentage increase and to hold this year's merit increase to the same as last year's. In the last eighteen months, I have received a lower percentage salary increase than my Cabinet and no percentage increase in my merit award, compared to significant increases in the Cabinet merit awards. Since these decisions are tied to the Committee's evaluation of my performance, it would be helpful for me to have a clearer understanding of how to interpret the import of these decisions.
2. Retention Incentive
   - Five years ago, the Board approved a retention incentive of $500,000 for me to stay at AU as president for five years. I received a $100,000 cash payment in the first year of the five years, and the remaining $400,000 would have vested on June 30, 2004.

However, I [illegible]ected to place the $400,000 at risk of forfeiture until 2010, which I can withdraw e[illegible]ier if I decide to retire before then.

- In anticipa[illegible]n of the completion of the five-year retention incentive on June 30, 2004, I be[illegible]ve it is appropriate for the Committee to consider whether it wishes to provide an[illegible]her retention incentive, at what level, and for how long. From my standpoint based upon previous performance reviews, university improvements, and length of [illegible]rvice, I assume that my value to the institution has increased significantly compared [illegible]o five years ago.
- If the Co[illegible]mittee would like to establish another retention incentive, I propose that the amou[illegible] increase to $225,000 annually, beginning July 1, 2004 and vesting June 30, 2009 [illegible]t would be deferred and placed at risk of forfeiture. The pay-out could be either a [illegible]mp-sum payment in 2009, after a total of 15 years' service, or annual payment[illegible] beginning after my sabbatical, to be determined at my discretion. With such an [illegible]centive, I would commit to staying at AU for another five years.

3. Failure of S[illegible]t Dollar Insurance to Provide Adequate Retirement Security
   - In 1997 [illegible]he university took out a split dollar insurance policy that was projected to be worth [illegible]$2.9 million in ten years, which would secure my retirement at my 1997 level of [illegible]ving. Unfortunately, the policy is currently worth only $650,000 and is not likely to [illegible]mprove enough over the next three years to approach original projections.
   - With th[illegible]failure of this financial vehicle to provide for my retirement future, my Ernst & [illegible]Young financial advisor has calculated that the gap between where I am present[illegible] and where I should be at retirement to maintain my current living level is approx[illegible]ately $3.7 million after taxes, or $5 million pre-tax. I would like the Comm[illegible]ee to consider establishing a viable financial approach to closing this gap as much a[illegible]s reasonably possible prior to my retirement. Possible options might be:
     a) a f[illegible]-year retention incentive bonus, described above, totaling $1,125,000;
     b) a m[illegible]ch larger percentage increase in my annual base salary;
     c) an [illegible]crease in the percentage of my annual deferred compensation from 25% to 35[illegible] of my annual base salary;
     c) a c[illegible]n bonus of $200,000 this year for completing ten years as AU president, and def[illegible]red bonuses of $200,000 at the completion of my second and fourth years of [illegible] five-year commitment. These bonuses would be in addition to my annual bas[illegible] salary, annual merit awards, and the retention incentive.

4. Top Ten L[illegible]ing
   - Althou[illegible] I am aware of the public attention given to the annual top ten listing of compe[illegible]ation for university presidents, the wide variation of circumstances for any preside[illegible] in a given year makes this an unreliable comparative listing. While it is good to [illegible]e out of the glare of publicity with respect to compensation, it may be increas[illegible]gly difficult for the Committee to assure that I do not appear on the list. Last ye[illegible] I was #11, but this year, for example, due to the delay in the Committee's review, [illegible] will receive both my as-yet-undetermined increased compensation for last year an[illegible]he increased compensation for this year, all in the same year.
   - Moreo[illegible], because my length of service as president is more than double the nation[illegible]verage, comparing me with presidents with only a few years service is apt to be a [illegible]s reliable comparative indicator the longer I remain at AU.

September 28, 2005

Good morning Leslie and Paul!

Leslie, attached are some other documents from my AU compensation committee file that might be of interest. They also give a pretty good picture of the time line we were discussing yesterday.

The draft Board minutes were written after my last AU Board meeting – I don't know if they were adopted or revised – but they accurately reflect the extensive discussion the Board had on November 5, 2004 about Ben's compensation, and the motions passed.

Good luck today Paul, I'll see you at lunch on Friday.

Pete

DRAFT

Minutes of November 5, 2004 AU Compensation Committee Discussion

The Board held an extensive two-hour discussion on the issues pertaining to the compensation of the President and his Cabinet.

Pete Smith provided the Board a background review of the situation. At last November's Board meeting (AU executive compensation is typically reviewed in November), questions were raised about the quality and accuracy of the compensation data being provided the Compensation Committee by PricewaterhouseCoopers, AU's consultant.

At the same time, President Ladner had approached George Collins requesting a substantial increase in his compensation between now and his projected retirement date. While the Board universally recognized that Dr. Ladner's performance has been exceptional, concerns had already been expressed about the current level of his total compensation package.

Accordingly, the Committee decided to engage a new compensation consultant to get an accurate perspective of the competitive situation. Dr. Ladner and Mr. Smith interviewed three consultants and jointly chose Richard Meischeid of Towers Perrin, one of the world's leading compensation consulting firms.

Towers Perrin conducted a special survey of the twelve-university comparison group that the Compensation Committee had previously determined was appropriate for comparing AU executive pay. While these universities are larger than AU, the philosophy was that we need the kind of leadership that could successfully bring AU close to the first tier of American universities, and that Dr. Ladner and his cabinet represented that team. This justified paying compensation substantially higher than that paid by universities of American's size.

Working with Towers Perrin, it soon became apparent that the Intermediate Sanctions regulations could cause problems for us. In the past, PricewaterhouseCoopers had based its comparison on base salary and annual incentive bonus only, with the assumption that many competing universities paid annual incentives. In fact, very few universities pay annual incentives, and the few that do pay much smaller amounts than American has paid, and primarily to the President. Further, American's Cabinet officials have two incentives – an annual incentive and a deferred incentive. In addition, the Board had approved a special five-year retention incentive for Dr. Ladner, in effect adding $100,000 per year to his compensation over the past five years.

Mr. Smith provided a brief summary of the Intermediate Sanctions and their effect: if the Board were found to be paying excessive compensation to AU's cabinet, there could be serious financial penalties for the executives involved and for the Board members who approved the compensation arrangements. There was strong agreement among the Board that we should ensure that the President's compensation and that of his cabinet was at a level where we would be able to get a "safe harbor" or comfort letter from Towers Perrin.[1]

The Towers Perrin consultants indicated that they could provide this letter if AU's compensation levels were under the 90th percentile of the survey comparison group. However, Dr. Ladner's compensation and that of many of his direct reports is well above the 90th percentile of the

[1] The Compensation Committee had been led to believe that PricewaterhouseCoopers had been providing comfort letters annually in the past, but it turned out that they had not been requested to do so.

comparison group. Accordingly, we will need to reduce compensation opportunity going forward to be able to get the comfort letter.

Mr. Collins reported that the Compensation Committee felt the best way to achieve this would be to eliminate the annual incentive for Dr. Ladner and his cabinet, while possibly raising their base salaries to offset the loss to some degree.

Leslie Bains emphasized that this reduction was in no way a reflection of Dr. Ladner's or his cabinet's performance. The recommendation was being made to reflect the risk of coming under the sanctions and in light of the new information showing that AU executive compensation was much higher relative to market than the Board had previously been led to believe.

Mr. Collins pointed out that Dr. Ladner had reviewed the Towers Perrin survey and questioned its accuracy and validity. Having access to a broad array of survey information, including a study of 30 top U.S. colleges and the Chronicle of Higher Education compensation data, the Committee believes that the survey is accurate and that further review would not change the overall results. However, we have agreed to work with Dr. Ladner to answer any questions he has about the data until there is mutual agreement that we have accurate information.

The Board expressed some concern about the significant gap between Ben's compensation expectations and what we would be able to pay under the sanctions. Ben's requests to Mr. Collins had included a significant make-up payment for an underperforming split dollar contract; a substantial recognition bonus for his ten years of service; a new retention incentive payable after five years; and increases in his annual cash compensation. Instead, we were facing a reduction in his pay.

The Board was also very concerned about the effect of this action on the Cabinet. Again, our assessment is that their collective performance has been exceptional, and individually we are highly impressed with the team Dr. Ladner has assembled. A number of Directors strongly recommended that we work with the Cabinet to ensure that our decisions reflect their needs (e.g., perhaps retaining the annual incentive instead of the deferred incentive).

Concerns were also expressed about communications and the impact on morale, retention, public relations, etc. A number of Trustees also strongly suggested that we ask qualified outside legal counsel to review the situation, to ensure that we are taking the right actions and to determine whether other solutions to this issue could be found. The Committee agreed to do this.

The Committee's recommendation to resolve this situation were as follows:

1. Eliminate the annual incentive program for the Cabinet, going forward (beginning with the current 2004-2005 fiscal year).
2. Adjust base pays for Dr. Ladner and his Cabinet (reflecting Dr. Ladner's evaluation) so that they approach the targeted percentile of the survey group.
3. Allow Dr. Ladner to serve on outside Corporate Boards, from which we had prohibited him in the past, subject to Board approval. This would enable him to make up some of the compensation he loses through this adjustment.
4. Encourage Dr. Ladner to accept more outside speaking engagements for fees, again to help offset lost compensation.

5. Pay 100% of his Long Term Disability insurance, as is typical practice in other universities (AU now only pays 50% of this cost).
6. Investigate the feasibility of making a special, one-time contribution of $200,000 to a charity of Ben's choice, in Ben's name.[2]

The Committee also reported that Ben had suggested that paying a salary to Nancy, his wife, for her services on behalf of AU could help the situation. There were serious reservations about this expressed by a few Board members. There was also discussion of possible consulting contracts following retirement but it was understood that any decision on this would be deferred until the time of his retirement.

The Board also discussed what to do with the current annual incentive program, which had been in effect through fiscal 2003-2004 and for which payments are normally approved in the November Board meeting following the fiscal year end. The Committee's recommendation was that these incentives be paid, since the executives had performed throughout the year fully expecting the program to be in effect, and since their performance had once again been outstanding.

Following extensive discussion of these and related concerns, the Board passed the following resolution:

"Be it resolved, that the Compensation Committee will work with Towers Perrin to develop a compensation package for Dr. Ladner comprised of base pay and the deferred incentive compensation, at a level that will reflect his outstanding performance while being in with the guidelines the Committee has proposed.

Be it further resolved that the Committee will work with Towers Perrin and Dr. Ladner to develop similar compensation packages going forward for the Cabinet.

Be it further resolved that the Board will authorize a payment of an annual incentive award for Ben for 2003-2004 performance equal to the same percentage of his base pay that he received for 2002-2003, which is the maximum award under the program. This will be the last annual incentive payment for Dr. Ladner.

Be it further resolved that the Board authorizes Dr. Ladner to distribute annual incentive awards for 2003-2004 performance totaling the same percentage of pay as distributed to his cabinet last year, subject to his evaluation of their individual performance and final Compensation Committee review.

Be it further resolved that Mr. Collins inform Dr. Ladner of the Board's decision to allow him to join up to two outside Boards of Directors, subject to the Board of Trustee's approval as to the boards he will join."

[2] A few Directors expressed serious reservations about diverting moneys contributed to AU to another charity.

PRIVATE SECTOR COUNCIL

1101 16th Street, NW
Suite 300
Washington, DC
20036-4813
[redacted]hone
[redacted]x

www.privsect.org

December 30, 2003

Benjamin Ladner
President
American University
4400 Massachusetts Avenue, NW
Washington, DC 20016-8060

Dear Ben:

This will confirm that on behalf of the Compensation Committee of the Board of Trustees, I have retained Richard Meinheid of Towers Perrin as American University's executive compensation consultant. I have asked Richard to begin his work by giving you any help you need with year-end personal compensation planning, meeting with you and your team to learn your compensation philosophy and how existing programs work, and getting the compensation survey under way so that we can determine appropriate market rates and resolve the deferred salary increase issue.

I have also asked him to schedule an early meeting with the Compensation Committee, so that we can focus more directly on your compensation package.

While Richard is being retained by the Committee and will report directly to George Collins, he understands that to be effective he will have to have a good working relationship with you and your team. I have also indicated that, while we are open to any suggestions he may have, we believe that the current compensation philosophy, program structures, and comparison groups are sound.

Dave Dawson of Price Waterhouse called me last week and offered to make his records available to the new consultant; accordingly, I'll put Richard in touch with him.

Please let me know if you have any questions on this. We should touch base regularly as this progresses during the next few months.

Sincerely,

Pete

A. W. Smith, Jr.
President & CEO

cc. George Collins, Leslie Bains, Bill Jacobs
Richard Meinheid, Towers Perrin

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Compensation Arrangements for Benjamin Ladner

October 31, 2003

2003 COMPENSATION

- FY 2003 Salary ..... $443,000 (3% increase over previous year)
- FY2003 Incentive ..... $175,000 (41% of previous year's salary)
- FY2003 Deferred $107,500

EXECUTIVE COMPENSATION PLAN

- Voluntary Deferred ..... $22,117.01 (market value 9-30-03)
- Supplemental Retirement ..... $92,924.39 (market value 9-30-03)
- Deferred Compensation Plan .... $984,019.60 (market value 9-30-03)

RETENTION INCENTIVE (five years)

$100,000 (paid 1999)
$400,000 (matures July 1, 2004, Rabbi Trust)

INSURANCE

- Travel Insurance $1,000,000
- Term Life Insurance Policy $500,000
- Split-Dollar Insurance Policy .... $651,019.00 (current cash surrender value)
  ($130,000 annual premiums paid by AU)

HOUSE, CAR, CLUBS, ETC.

- Residence ..... $3,500,000 (estimated current market value)
- Automobile ..... $50,000 (current value)
- Automobile (Mrs. Ladner) ..... $3,443.88 (annual cost, 4-year lease)
- Financial Advisor ..... $750 (annual cost)
- Metropolitan Club, Washington... $2,500 (annual dues)
- University Club, Washington..... $- 0 -
- University Club, New York ..... $300 (annual dues)

RETIREMENT ARRANGEMENTS

- One-year sabbatical (with annual salary)
- One additional year of annual salary
- Continued status as AU professor
- Relocation and moving expenses.... $50,000

Draft Minutes of Com
ensation Committee Meetings

American University Board of Trustees

September 8, 20[illegible]

The Compensation Committee met in New York City, at the offices of Towers Perrin, George Collins presiding. Leslie Bains was present; Pete Smith participated by phone; Gary Cohn was unable to attend. Richard Meischeid of Towers Perrin was also there.

Richard reviewed the implications of the Intermediate Sanctions and presented Towers Perrin's survey report comparing AU executive compensation to the special comparison group that AU had been using in previous years. This group is comprised of universities that are generally larger than AU, but representative of the universities with which we compete for students and leaders.

AU's compensation policy has been to target executive compensation at the 75th percentile of the survey comparison group for similar positions. The Towers Perrin survey data showed that for most positions, AU is paying well above this target – in fact, above the 90th percentile for a number of positions.

This is a very different result from the comparative data we had been receiving from Pricewaterhouse Coopers. The primary reason for this is that the PWC data had included only base salary and annual incentive bonus, not counting the deferred incentive element that Dr. Ladner and all of his cabinet members receive. Looking at annual cash compensation alone, the numbers from the two consultants are generally comparable.

Mr. Meischeid also shared verbally the results of Towers Perrin's proprietary study of 30 leading colleges and universities, including all the Ivies. This group is clearly a tier above American University and its primary comparison group, yet in many cases AU executives are compensated well above the 50th percentile of this premier group, and in some cases above the 75th percentile.

The Committee discussed this problem, noting that it was important to get a comfort letter from Towers Perrin or another independent source on the level of compensation for Dr. Ladner and his direct reports. Mr. Meischeid reported that we would be unlikely to get such a letter at AU's current compensation levels.

Mr. Smith reported that although Dr. Ladner and Don Meyers had both indicated that comfort letters had been secured in past years, no such letters had been requested from Pricewaterhouse Coopers or any other firm and none had been received.

The meeting then focused on Dr. Ladner's compensation package. Dr. Ladner had given Mr. Collins a memorandum requesting a substantial increase in his compensation over the next three to five years. Included in this request was a large cash payment to make up

for an underperforming split dollar insurance contract, an increased retention incentive similar to the $[illegible]0,000 special incentive the Board had granted Dr. Ladner five years ago, and a one-time performance bonus recognizing his ten years of service to AU.

It was clear to the Committee that none of these additional payments would survive the Intermediate Sanctions test of reasonableness, and in fact that we needed to reduce Dr. Ladner's compensation going forward.

With salary, annual bonus, deferred incentive, and retention bonus, Dr. Ladner's effective annual compensation was currently in the $850,000 range. Mr. Meischeid suggested that a more reasonable package going forward would be a salary of $550,000 with a 20% deferred incentive (and no annual incentive) or a salary of $600,000 with a 10% annual incentive. These levels could be considered reasonable in comparison to the Towers survey of the top 30 colleges and universities, although there was some question as to whether the use of the very largest and best colleges would be deemed reasonable.

The Committee also discussed this significant impact this would have on Dr. Ladner and his cabinet, and stressed the need for thoughtful communications on this issue.

November 4, 20[illegible]

The Committee met in Washington, at American University, prior to the November Board meeting. In attendance were Mr. Collins, Ms. Bains, Mr. Smith, Mr. Cohn (by phone), Dr. Ladner, and Richard Meischeid of Towers Perrin.

At Mr. Collins request, Mr. Smith outlined the issues that had been discussed at the September Compensation Committee meeting, noting the importance of the Intermediate Sanctions and the Board's concern about receiving a comfort letter. Mr. Smith also reported that past documentation supporting the use of the special AU survey comparison group made it difficult to justify using any other group, such as Towers Perrin's top 30 survey, to support AU compensation levels. This put somewhat tighter constraints on Dr. Ladner's compensation than we had considered in the September meeting.

All the Committee members emphasized that the situation did not reflect any dissatisfaction with Dr. Ladner's performance or that of his cabinet, which the Board thinks has been outstanding. The problem is the Intermediate Sanctions and the practical limits they impose, a factor that had not received sufficient consideration in the past.

After reviewing the survey report and the recommendations the Committee intended to make to the Board (eliminating the annual incentive going forward, adjusting base pay upward to the degree possible, encouraging Dr. Ladner to join one or two outside Boards, possibly making a substantial charitable contribution in his name), the Committee dismissed Mr. Meischeid and asked for Dr. Ladner's reaction.

Dr. Ladner had prepared a letter for Mr. Collins in which he questioned the accuracy of the compensation survey and the qualifications of Mr. Meischeid. Based on his

significant expertise in executive compensation, Mr. Smith strongly objected to both assertions and suggested that Dr. Ladner, Mr. Meischeid and a Committee member meet to work out any differences and reach agreement on the process going forward. This meeting was scheduled for November 15, 2004. Ms. Bains agreed to represent the Committee at the meeting.

Dr. Ladner also expressed great dissatisfaction with the communications process surrounding his compensation.

The Committee then explored possible ways to keep pay reasonable while lessening the negative impact on Dr. Ladner. These included the possibility of employing Dr. Ladner's wife on behalf of the University, paying 100% of Dr. Ladner's long-term disability insurance (a common practice, while AU pays only 50%), and encouraging Dr. Ladner to do more outside speaking for fees.

Dr. Ladner also raised the possibility of his being appointed Chancellor of the University, with reduced administrative responsibilities but continuing significant compensation. The Committee did not discuss this alternative in any detail, nor was the subject raised at the Board meeting the following day.