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Office of the President

TO MEMBERS OF THE COMMITTEE ON FINANCE:[1]

ACTION ITEM

For Meeting of November 15, 2012

PARTICIPATION IN A SEPARATE 501(C)(3) ENTITY, TRANSFER OF THE CENTER FOR EXECUTIVE EDUCATION AT THE HAAS SCHOOL OF BUSINESS TO THE ENTITY, AND EXTENSION OF LOAN TO ENTITY, BERKELEY CAMPUS

EXECUTIVE SUMMARY

This item proposes approval of University participation in a separate 501(c)(3) non-profit entity that will own and operate the Center for Executive Education (CEE) which is currently at the Haas School of Business, Berkeley (Haas); transfer of the CEE program to the entity; and a $500,000 interest-free loan to the entity from Haas with repayment within six months after the transfer of the CEE program to the entity.

As a provider of non-degree, executive education, CEE is outside the traditional mission of the University. The transfer of CEE to a separate 501(c)(3) supports the University's mission by providing an increased revenue stream that will help achieve the University's financial sustainability objective and fund core functions.

The executive education market, a subset of the $280 billion corporate training market, is evolving and top executive education providers have the operating independence and flexibility to attract top talent and be more responsive to client needs. As a preeminent global brand, Haas is not getting its fair share of the market: while CEE has grown significantly over the past ten years, from $2 million to $16 million in revenue, it has not reached its true potential in growth, revenue, and stature. Numerous other top business schools have recently formed separate 501(c)(3) entities to grow their executive education programs, including Duke University's Fuqua School, University of Virginia's Darden School, University of North Carolina's Kenan-Flagler School, and Indiana University's Kelley School.

The business plan for the entity projects a revenue goal of $50 million in seven years, which would result in a projected cash flow to Haas of $7.5-$10 million annually and $3.5 million in revenue to the Berkeley campus (based on the current campus prevailing administrative full costing fee). Transferring CEE to a separate 501(c)(3) entity is a necessary step in creating the operating freedom to achieve its financial and industry leadership goals.

[1] Of interest to the Committee on Educational Policy.

RECOMMENDATION

The President recommends that the Committee on Finance recommend that the Regents:

1. Approve the University participating in a separate non-profit entity ("Entity") that shall own and operate the Haas School of Business ("Haas") Center for Executive Education ("CEE"), subject to the following terms and conditions:

   A. The Entity shall be organized exclusively for charitable, scientific, and educational purposes within the meaning of Section 501(c)(3) of the Internal Revenue Code of 1986 (the "Tax Code"), or corresponding section of any future federal tax code, and shall apply for, and maintain, tax exempt status under Section 501(c)(3) of the Tax Code. Should the Entity be dissolved, all assets shall revert back to the University.

   B. The Entity shall be governed by a seven-person Board of Directors ("Board") including the Dean of Haas, the University of California Berkeley ("Berkeley") Vice Chancellor of Administration and Finance (or a designee), and a member of the Haas or Berkeley Ladder Faculty as well as four independent Directors. The Chairman of the Board will be the Dean of Haas. The Directors shall receive no payments from the Entity other than reimbursement for travel expenses.

   C. The Entity's organizational documents shall require a supermajority (at least five out of seven) of the Board to approve any of the following actions by the Entity:

      (1) Any change in the affiliation agreement between the Entity and the University

      (2) Any change in the distribution of the net earnings of the Entity

      (3) Any change in the composition of the Board

      (4) Any amendment to the bylaws or articles of incorporation of the Entity

      (5) Dissolution of the Entity

2. Approve the transfer of the CEE program to the Entity, including assets (and corresponding liabilities) such as client contracts, accounts receivable, revenue accounts, client relationships, know-how, and good-will, subject to the following conditions:

   A. The Entity shall enter into an affiliation agreement with the University, detailing the respective rights, duties, obligations, and economic terms of the parties in connection with the affiliation, including the Entity's use of the

University's name and intellectual property. The affiliation agreement shall require the Entity to pay, on an annual basis, (i) the prevailing administrative full costing fee, which is currently set at seven percent of gross revenue, to Berkeley, and (ii) all of the Entity's net earnings to Haas. The affiliation agreement shall also provide that, in continuation of CEE's current practice, educational content will be reviewed and approved by a member of the Haas Ladder Faculty to ensure that the University and Berkeley's brand and reputation are protected. The University and the Board of the Entity shall receive an overview report on educational content at least annually. Amendments to the affiliation agreement shall require the consent of the University and the Entity.

B. The termination of the affiliation agreement shall result in the automatic dissolution of the Entity.

C. The University shall have the right to conduct a periodic review of the Entity's programs to ensure that the Entity is operating at a level consistent with the University's standards of excellence.

D. The Entity may act as a service organization to other University campuses, schools, and units interested in leveraging the Entity's executive education infrastructure and capabilities on a fee-for-service basis or through the application of a sharing model when conducting joint programs.

3. Approve an interest-free loan from Haas to the Entity for up to $500,000, with repayment required within six months after the transfer of the CEE program to the Entity.

4. Authorize the President, after consultation with the General Counsel, to approve and to execute (a) any documents reasonably required to accomplish the above; and (b) any modifications, addenda, or amendments (collectively, "amendments") thereto, provided that such amendments do not materially increase the obligations of the University or materially decrease the payments to the University from the Entity; provided, however, that the authority to approve and to execute the affiliation agreement and any amendments thereto may not be delegated by the President.

BACKGROUND

1. Summary

The market for executive education, a subset of the $280 billion corporate training market,[2] is growing globally. The largest segment of executive education, Custom Programs, increased 15 percent in 2011, with the top 70 Business Schools accounting for 6200 programs,[3] or

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[2] Trainingindustry.com, 12/9/11

[3] Financial Times Executive Education 2012 Rankings

$600-900 million in revenue. As a preeminent global brand, The Haas School of Business, Berkeley (Haas) is not getting its fair share of the market: while the Haas Center for Executive Education (CEE) has grown significantly over the past 10 years, from $2 million to $16 million in revenue, it has not reached its true potential in growth, revenue, and stature.

The executive education market is evolving, with the top executive education providers having operating independence and flexibility, allowing them to attract top talent and be more responsive to client needs. Specifically, several schools have successfully formed separate 501(c)(3)s to grow their executive education businesses, including Duke University's Fuqua School, University of Virginia's Darden School, University of North Carolina's Kenan-Flagler School, Indiana University's Kelley School, and University of Texas' McCombs School. As other entities recognize the attractiveness of the executive education market, there is also increasing competition from international schools, for-profit companies, and online training providers.

The Berkeley campus believes it is time for CEE to shift its approach to be a leader in executive education. The Entity's goals are to represent 25 percent of Haas gross revenue (vs. 16 percent now), reach $50 million in revenue within seven years, and be a top-ten-ranked provider of custom programs.

Transferring CEE to a separate 501(c)(3) entity is a necessary first step in creating the operating freedom to achieve these revenue and industry leadership goals. Such transfer includes the transfer of assets (and corresponding liabilities) such as client contracts, accounts receivable, revenue accounts, client relationships, know-how, and good-will. The transfer of the revenue accounts will enable the Entity to fulfill obligations and provide services under the client contracts to be transferred. After the transfer, the Entity will have the ability to provide its employees with appropriate performance-based incentives, scale up or down based on market demand, and streamline back office processes such as contracting to match the service expectations of corporate clients. Delays in action will leave room for current competition and new entrants. (Wharton West is aggressively expanding its West Coast presence.)

As a provider of non-degree, executive education, CEE is outside the traditional mission of the University. Housing CEE in a separate entity will enable growth that will create a larger revenue stream for Haas and UCB, supporting the campus' financial sustainability objective.

2. Relationship to the University's Mission

The mission of the University is focused on providing undergraduate and graduate degree programs and research.[4] Executive education falls outside of the University's traditional mission as it provides professional education that is non-degree in nature. The majority of CEE's programs are designed for corporate or institutional clients seeking professional development and training. In fiscal year 2010-11, approximately 65 percent of CEE's revenue was derived from custom educational programs and the remaining 35 percent was generated from programs that have open enrollment. The vast majority of participants in CEE programs are employees or individuals sponsored by private sector, for-profit firms and corporations.

Importantly, the transfer of CEE to the separate Entity supports the University's mission by providing an increased revenue stream that will help achieve the University's financial sustainability objective and fund core functions.

3. Financial Impact

CEE is currently a significant financial contributor to Haas' operating budget, contributing $16.6 million in revenue for 2011-12 (16 percent of Haas' revenue) and generating cash flow of $3.5 million. In addition, CEE generates approximately $4 million in payments to Haas and Berkeley faculty members annually. The Berkeley campus receives a set share of CEE's gross revenue equal to seven percent, or approximately $1.2 million in 2011-12. Seven percent of gross revenue represents roughly 25 percent of current revenue net of expenses.

CEE's seven-year business plan is built on a revenue goal of $50 million, or approximately 25 percent of Haas' total revenue target. If the Entity pays Berkeley seven percent of its gross revenue, and pays Haas all of its net earnings, this would generate projected cash flow to Haas of $7.5-$10 million annually, and $3.5 million in revenue to the Berkeley campus.

With business schools including those at Duke, Wharton, and Harvard generating $75-100 million in executive education revenue, it is not inconceivable that CEE could approach this size long-term. (Berkeley's brand globally certainly has the stature and awareness that few schools possess.) At $75 million in revenue, if the Entity pays the Berkeley campus seven percent of its gross revenue, and pays Haas all of its net earnings, the Entity would contribute a projected $11-15 million in cash flow to Haas and $5+ million to the Berkeley campus annually.

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[4]The mission of the University is set forth in California's Master Plan for Higher Education. EducationCode Section 66010.4(c) provides:

The University of California may provide undergraduate and graduate instruction in the liberal arts and sciences and in the professions, including the teaching professions. It shall have exclusive jurisdiction in public higher education over instruction in the profession of law and over graduate instruction in the professions of medicine, dentistry, and veterinary medicine. It has the sole authority in public higher education to award the doctoral degree in all fields of learning, except that it may agree with the California State University to award joint doctoral degrees in selected fields. The University of California shall be the primary state-supported academic agency for research.

Importantly, transferring CEE to a separate entity will require little upfront capital and poses minimal financial risk. Because CEE already generates significant cash flow, the Entity can be funded from operations quickly. It is anticipated that start-up costs (legal, hiring, HR/admin set-up, benefits, etc.) may require up to $500,000 in the first several months. Subject to the Regents' approval, Haas will loan CEE this requisite funding on an interest-free basis, requiring repayment in full within six months after the transfer of the CEE program to the Entity. From that point forward, all growth for the Entity should be self-funded.

4. Benchmarking

Haas engaged an independent consultant to benchmark the activities of other business schools that have created separate 501(c)(3) entities to operate their executive education programs, including Duke University's Fuqua School, University of Virginia's Darden School, University of North Carolina's Kenan-Flagler School, and Indiana University's Kelley School. In short, the universities who have chosen to create separate entities have done so for several key reasons: greater operating flexibility, hiring and compensation flexibility, and a need to meet the service expectations of corporate clients. All have cited this move to a separate entity structure as critical to their future growth. In all cases, the net earnings of the separate entities flow directly to the business schools, without additional fees paid to the broader university campus.

5. Strategic Advantages of Separate Entity

The University system is not designed to serve and target clients for executive education. Clients for executive education need highly customized programming and high levels of customer service. Additionally, CEE partners with outside firms as clients and sponsors, requiring contracts and program delivery timelines and requirements that fall outside the normal operating timeframes and standards of the University. Targeting corporate clients to engage in premium programming (that can cost in the hundreds of thousands or millions of dollars) also requires a strategic, consultative sales process. University constraints on hiring and incentive-based compensation do not align well with the goal of growing an executive education business. The chart below shows a comparison of several key strategic levers in the executive education business, and how those levers would operate under a separate entity (vs. within the UC Berkeley system).

Strategic Lever	Within UC Berkeley System	Under Separate 501(c)(3)
• **Program Development**	Program design limited by the availability, interest, and skills of a small Haas faculty.	Client-centric design based on client needs. Expand network of faculty/experts outside of Haas to meet client requirements.
• **Sales Strategy**	Reactive and ad-hoc. Non-commission based so dependent on sales team good will. Assistant Dean and faculty involvement when available. Mostly targeting smaller engagements with average program size of $250k.	Proactive long-term client relationship building through consultative selling. Larger, dedicated professional sales team with incentives. Ability to target multi-national companies with multi-million dollar programs.
• **Marketing**	Basic in skills and limited in budget, mostly focused on local market.	Ability to staff and compensate staff with deep marketing experience and expertise in lead generation, direct marketing, database marketing, Web marketing. Will allow for expansion of marketing strategies and implementation of sophisticated targeting.
• **Client Services**	Difficult to deal with. Constrained by UCB systems with limited control over service levels.	High quality and efficient service. Disconnect contracts, accounts and service processes from UCB systems.

6. Benefit to Faculty

CEE has proven to be a powerful tool for faculty recruitment and retention through the provision of supplemental income. UC Berkeley faculty, who will remain employees of the University, can work for CEE in addition to their normal University workload under the University's Academic Personnel Policy Section 025 (APM - 025), Conflict of Commitment and Outside Activities of Faculty Members, which allows faculty to engage in compensated outside professional activities for a maximum of 39 days per academic year. Supplemental executive education income is a critical element to many faculty hiring packages. At CEE's current small size and administrative structure, executive education teaching opportunities cannot be promised as part of faculty hiring packages. A larger revenue portfolio would enable the Haas Dean as well as other campus Deans to include supplemental income opportunities in coordination with the Entity in their overall faculty offer and retention packages, ultimately diversifying the sources of income for faculty members.

7. Management, Governance and Operations

The Entity will be led by a Chief Executive Officer (CEO), who will be selected by the Board. The Board will include seven members, including the Dean of Haas and the Berkeley Vice Chancellor of Administration and Finance (or a designee), a member of the Haas or Berkeley Ladder Faculty as well as four independent Directors. The independent Directors will likely be industry/corporate leaders, who represent the key client base the Entity will be targeting. The Dean of Haas will be Chairman of the Board.

The Entity's organizational documents shall require a supermajority (at least five out of seven) of the Board of Directors to approve any change in the affiliation agreement between the Entity and the University, any change in the distribution of the net earnings of the Entity, any change in the composition of the Board of Directors, any amendment to the bylaws or articles of incorporation of the Entity, or the dissolution of the Entity.

The Entity will provide a high-level of transparency to the University. In addition to Board meetings, the CEO of the Entity will present to the Berkeley administration quarterly on the Entity's activities and financial plan.

As a separate 501(c)(3), the Entity will need to obtain an array of insurance coverage, including but not limited to: Directors & Officers, General Liability, Auto Liability, Employment Practices Liability, and Worker's Compensation. The affiliation agreement between the University and the Entity shall provide that types of insurance and levels of coverage shall be reviewed and approved by the University's Chief Risk Officer, Office of the President.

8. Growth Goals and Strategy

The Entity's goals are clear:

- Represent 25 percent of Haas gross revenue (vs. 16 percent now), as Haas grows towards $200 million
- $50 million in revenue within seven years
- Top 10 ranking in Custom Programs within 5 years (*Financial Times* or equivalent)

The strategy to achieve those goals has several core operational and sales components:

- Significantly increase sales capacity
    - Hire high-level sales resources, capable of consultative selling
    - Provide appropriate incentives
    - Increase new custom business (currently, 90 percent of business is renewal, 10 percent new; industry average for new business is 25 percent, Wharton is 50 percent)

- Build the "client-centric" model and expand delivery capacity
    - Design programs based on client needs
    - Leverage Haas faculty where possible; create network of outside faculty and domain experts

- Grow internationally, where Berkeley brand has incredible weight
    - Look at more in-country programs
    - Diversify client base (3 clients account for almost 50 percent of custom business)
    - Further strengthen the Berkeley-Haas brand worldwide
    - Explore hybrid delivery to create more scalable open enrollment business

9. University Support Functions and Facilities

After a transition period, the Entity does not plan on using University support functions, as it will operate as an independent entity, outside the Berkeley infrastructure. All back-office functions – accounting, legal, payroll, etc. – will also be provided by the Entity. During any transition period, the Entity can contract out to the University to provide any necessary back-office services, with the exception of HR and benefits which will be separate from the University as soon as the CEE program is transferred to the Entity. The Entity will provide Haas all necessary information on University faculty involvement to maintain compliance with the terms of APM - 025 and the maximum time commitment of 39 days.

The affiliation agreement shall address occupancy arrangements between the University and the Entity for administrative, teaching, and other Entity activities.

10. Other Considerations

- **Communications Plan:** Though CEE (as non-degree, executive education) is not core to Berkeley's mission, and although the Entity will be a non-profit corporation that is intended to be tax exempt under the federal income tax laws, there is the potential perception that Berkeley is privatizing core university functions. Haas/Berkeley will implement a proactive external and internal communication plan to mitigate this risk, which will include clear rationale, relevant benchmarking, and a high level of transparency. Other business schools at public universities – UVA, UNC, UT, and Indiana – have also transitioned executive education to separate entities successfully and will be leveraged as resources to understand best practices.

- **Brand:** There are several built-in safeguards in the Entity's design to protect the University and Berkeley brands, most prominently that the Board will include Berkeley administrators and faculty, and Haas or Berkeley faculty will direct all of the programming. In addition, the affiliation agreement will specify that the Entity will appropriately represent the University and Berkeley names and brands. If done well, the Entity can enhance the University and Berkeley brands, as there will be a focus placed on the quality of program delivery and an express goal of being a leader in executive education.

- **Faculty Conflict of Commitment:** CEE currently manages potential conflict of commitment through the application of APM – 025 and the 39-day rule: full time faculty may only work up to 39 days per year in either CEE or outside projects. The Entity would operate under a governance structure that would provide total transparency to the Dean(s) and campus regarding faculty CEE workload and pay. UC faculty have never received credit against their campus teaching loads by doing CEE teaching, and this practice will not change.

- **Human Resources:** Transferring a program that is a part of the University raises personnel issues that carry some potential risk to the University. University HR will work to minimize those risks and manage transitions in accordance with University policies and collective bargaining requirements, and Entity management will work closely with University HR in that regard.

- **Conflict of Interest**: Legal review of conflict of interest issues is ongoing. It is expected that Berkeley will develop the relevant facts needed for this legal advice to be concluded. In the meantime, Berkeley is proactively mitigating known potential conflict of interest risks in a number of ways, including: a) screening off from decision-making related to the Entity current UC officials and CEE staff who could have a financial interest in the Entity, and b) establishing that Entity Board members cannot benefit financially from the Entity in any way. The Entity will also create its own conflict of interest policy.

- **Financial Risks**: The cash flow to Berkeley will remain under the same terms (seven percent of gross revenue) in the affiliation agreement with the Entity as it currently stands between CEE and the campus. The primary financial risks relate to: 1) the transition of CEE's activities to the Entity; and 2) macro-economic changes which could impact the business, which also exist in CEE's current structure. To protect against these risks, the Entity will create a detailed business and financial plan, which will be approved by the Entity's Board. In addition, the Entity will have the flexibility to adjust its resources based on the state of the business. However, Berkeley will not control the Entity's Board and it is possible that the Entity could make business decisions that result in reduced revenue to Berkeley and Haas. From an investment perspective, the $500,000 amount being loaned to the Entity is not significant. CEE is an established business with positive cash flow and earnings, making the risk of non-repayment of the loan very low. Financials will be reviewed regularly by the Entity's management, and will be reported quarterly to the Entity's Board and the University to ensure transparency. All financials will be audited by an outside CPA firm annually.

- **Separate Entity:** Since the Entity will be a separate non-profit corporation, the University will be reducing its risk profile as it will be insulated from legal risk for the activities of the Entity.