COLUMBIA LAW SCHOOL

Executive Compensation Webinar

NATIONAL STATE ATTORNEYS GENERAL PROGRAM
CHARITIES OVERSIGHT AND REGULATION PROJECT

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Summary of Contents

Scrutiny of executive compensation programs is high; reactions to Wall Street abuses will affect the nonprofit sector in the near term.

Regulators

- State A.G.s
- Insurance commissioners
- IRS studies healthcare and universities

Financial Pressure

- Expense constraints
- Demand for services
- Soft economy

Congress

- Senator Grassley
- Dodd Frank WSR Act
- Deferred compensation restrictions

Current NFP Environment

Stakeholders

- Donors/ members
- Community at large
- Service recipients
- Employees/retirees

Media

- Heightened vigilance
- 24-7 news cycles

Private Inurement / Private Benefit

- No part of a 501(c)(3) organization's net earnings may inure to the benefit of any private shareholder or individual.

- Exempt organizations are prohibited from using their income for the benefit of "insiders" and private individuals; exception for the payment of reasonable compensation.

- In prior years, violation of the "private inurement / private benefit rule" resulted in loss of the organization's tax-exempt status. Thus the IRS sought legislation providing for a less onerous "intermediate sanction."

- The "Intermediate Sanctions legislation enacted new penalty taxes applicable to Section 501(c)(3) or 501(c)(4) organizations that engage in "excess benefit transactions" with "disqualified persons." Penalties include:

  - A tax on a recipient equal to 25% of the excess benefit, which increases to 200% if the violation is not corrected by repaying the excess to the organization.

  - Penalty taxes can also be imposed on the organization's trustees, directors or officers (the "Organization Managers") who approved the arrangement, if they did so knowing it to be excessive.

  - The tax on Organization Managers is 10% of the excess benefit up to a maximum of $20,000 per transaction on a joint and several basis.

Rebuttable Presumption of Reasonableness

- IRC Section 4958 contains an important protective provision, referred to as the "rebuttable presumption" of reasonableness. If certain requirements are satisfied, the compensation paid is presumed to be reasonable, unless the IRS can demonstrate it to be unreasonable on the basis of "sufficient contrary evidence."

- The following steps are required to establish this presumption:

  - The compensation arrangement is approved by the independent members of the board (or a committee comprised entirely of independent directors) who are free of any conflict of interest.

  - The board or committee obtains and relies upon "appropriate data as to comparability", e.g., compensation paid by similarly-situated organizations (both taxable and tax-exempt) for positions of similar scope of responsibility, <u>prior</u> to making its determination.

  - The board or committee adequately documents the basis for its determination (e.g., the record includes the elements of compensation considered, the decisions made and the rationale for the decision) at the time the decision is made or prior to the next scheduled meeting.

➔ ***<u>Best Practice:</u>*** Always ensure that steps are taken to establish the rebuttable presumption.

Adjust Approach for Level of Risk

- Scope of study should be adjusted to each unique situation
- The higher the potential risk, the more in depth the study should be
- Third party reasonableness opinion may not be required in all cases

Higher Risk	Lower Risk
➢ Above average pay	➢ Average to low salaries
➢ Use of incentives	➢ No bonus plan
➢ Generous retirement or pension plans	➢ Limited or no perks
➢ Supplemental deferred compensation	➢ 403(b) TDA and 401(a) savings plan
➢ Generous perks	
➢ Individual plans or programs for top officers	

Lower Pay = Lower Risk

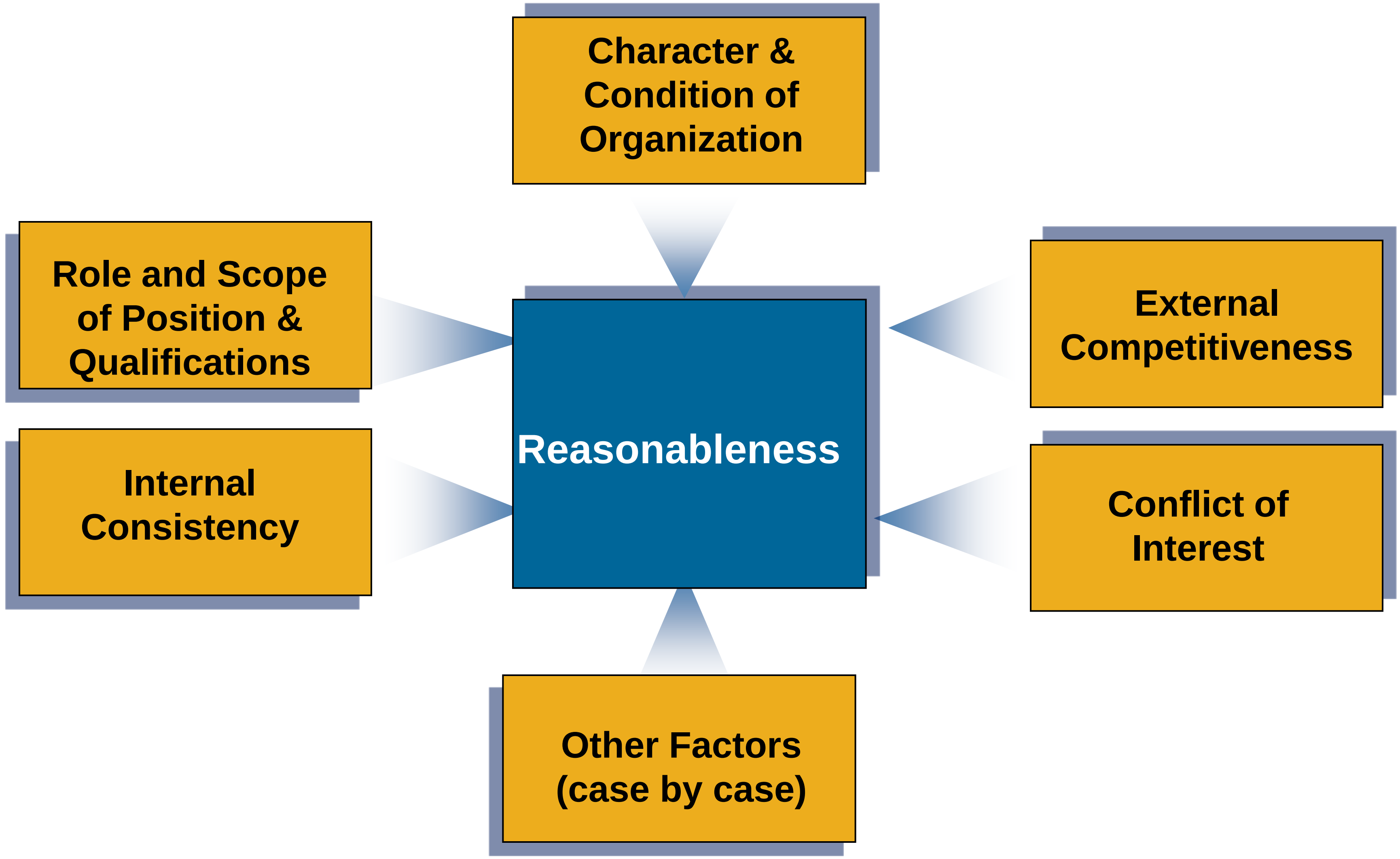
- Smaller agencies with pay that is clearly reasonable can be more practical about the process
- Consider gathering your own data
  - Purchase a good survey from a third party vendor
  - Prepare your own peer group via GuideStar
  - Consult with other social services agencies in your area
- If self-conducted study, be wary of conflict of interest in delivering results to the board
- Outside opinion letter is not required, but the detailed process for establishing the rebuttable presumption is
  - Independent board or committee approves the compensation
  - Appropriate data as to comparability is relied upon before decisions are made
  - Contemporaneous documentation of decisions in the organization's minutes

Higher Pay = Higher Risk

- For higher risk situations, an external consultant should prepare a written opinion letter
  - Consultant should be retained by the board, not the executive
  - Consultant should be independent; provide no other services to the organization
- Sources of market data
  - National published surveys; regional surveys as available
  - Custom peer groups (data by GuideStar)
  - Third-party custom surveys
- Key areas of risk:
  - Bonus plan documentation, including measures and goals
  - Deferred compensation: risk of forfeiture requirements
  - Supplemental pensions and defined contribution plans
  - Excessive perks and unaccountable plans
  - Transaction payments

➔ ***Best Practice:*** **Provide consultant access to the board for Q&A; consider retaining consultant through counsel to retain privilege.**

Consider All Factors Affecting Reasonableness



➔ *Best Practice:* **Reasonableness is determined based on all relevant factors; need to get beyond external market comparisons only.**

Character and Condition of Organization

- Consider the overall financial condition and performance of the organization and its effect on reasonableness.
  - Are the organization making or losing money?
  - Is it outperforming the relevant sector or peer group?
  - Does it compete with for-profits for senior management talent?
  - Is it more complex or "high profile" than peer organizations?
  - Does the organization have substantial or complex operations?
- Organizations that provide upper quartile pay should maintain appropriate documentation in its minutes as to why higher pay is appropriate, e.g., documented compensation policy statement.

<u>Case Example: Regional Health System</u>

Regional health system justified 90th percentile pay for CEO based on superior financial, clinical and operational performance, all while increasing community benefit; pending sale was blocked until after the comp study was reviewed and accepted.

Role, Scope & Qualifications

- Market comparability is determined in terms of competition paid for "functionally comparable" positions in organizations of similar size and scope of operations providing similar services.
  - Comparable duties and responsibilities
  - Similar size and complexity of organization
  - Experience and qualifications of incumbent
  - Geographic market, if applicable
- Functionally comparable positions may be found in other forms of nonprofits and taxable organizations as well.

<u>Case Example</u>: Kamehameha Schools - Bishop Estate

Trustees compared themselves to real estate developers and investment bankers without adequate background or qualifications; used all for-profit data to justify pay, but no large charitable foundations or other not-for-profit organizations.

External Competitiveness

- Compensation should be considered "in its entirety" when making reasonableness determinations; includes salary, bonus, deferred compensation, benefits and perquisites
  - Compare "apples to apples" in terms of job scope, organization size, and geography
  - Data sources should be comprehensive, credible and objective
- Consider all material elements of compensation
- Develop multiple market reference points wherever possible
- Consider pay over time as required to justify
- Need to value SERPs and other significant benefits in addition to cash compensation
- Appropriate data sources:
  - Published surveys by reputable HR firms
  - Association or regional surveys
  - Self constructed peer groups (Form 990 data)
  - Proxy statements for publicly traded companies (where appropriate)

Conflict of Interest

- Individuals in a position to provide "substantial influence "over the organization require higher scrutiny
  - Approval of incentive plans
  - Change in control agreements
  - Sale / disposition incentives
  - Supplemental retirement plans
  - Related party transactions
- The CEO may design and approve a plan for direct reports, but if he / she will participate, then obtain a third-party review

➔ ***Best Practice*****:** Use an independent board or a committee for approval of plans that apply to officers

Internal Consistency

- Other individuals treated similarly within the organization
  - Is there a clear market philosophy adopted by the board?
  - Is eligibility for incentives determined equitably?
  - Any special benefits and programs adopted for a select few?
  - Are benefits and perquisites assigned rationally or at random?
- A board approved compensation philosophy statement reinforces consistency and tends to reduce exceptions
  - Pay positioning by component, e.g., 50th percentile
  - Comparison groups
  - Incentive plans and performance measures
  - Benefits and perquisites policy

Compensation Policy

- A well-designed compensation program should be developed pursuant to a written compensation policy, approved by the board and fully documented including:
  - A clear definition of the labor market or comparables
  - How the organization will position pay compared to the market
  - A description of the market data to be used or the sources of such data
  - Appropriate, documented goals for incentive plans
  - Use of employment agreements where appropriate
  - Alignment with organization mission, values and performance
- Conduct regular compensation reviews for disqualified persons
  - At least every two years; more frequently as needed
- Seek board approval for all major plan or program changes

Top 10 Governance Best Practices

1) Use independent compensation committee reporting to full board.
2) Establish compensation committee charter and adopt sound corporate governance procedures including standing calendar, executive session, CEO performance review.
3) Adopt a comprehensive compensation policy statement that aligns program with organization mission and values, and goals.
4) Develop effective incentive arrangements, aligning pay with organization performance, mission and values.
5) Conduct regular compensation evaluations; establish “rebuttable presumption” of reasonableness.
6) Obtain comparability data from independent sources.
7) Work through counsel where necessary to maintain privilege.
8) Avoid any appearance of conflict of interest.
9) Take advantage of “initial contract” exception where available on new hires.
10) Maintain well documented minutes of all board or committee meetings.

"Pitfalls for the Unwary"

- Signing bonuses that do not satisfy the "risk of forfeiture" test; justify based on what is being forfeited at the prior employer.
- Supplemental deferred compensation needs to comply with IRC Sec. 457(f) and 409A.
- Incentive compensation should be based on written performance objectives established at the beginning of each year and approved by the board.
- Retirement benefits that accrue too rapidly; market practice is 50 – 60% income replacement benefit accruing over 25 – 30 years.
- Market practices for severance benefits not widely reported; easy to use "market" data that should not apply to nonprofits, e.g., for-profit change in control data.
- Forgivable loans used to buy housing; better to use temporary mortgage allowance to pay additional interest of new residence.
- Minimize "one-off" deals for the CEO to the extent possible; can be an internal consistency problem.
- Beware of big surprises when retirement benefits and/or deferred compensation plans vest and income needs to be reported.

The Bottom Line

- Governance process and documentation are more important than ever
- Committees should periodically review their charter, standing calendar, and written compensation policies to ensure they accurately reflect the current compensation philosophy and external regulatory environment (see Appendix)
- Committees should retain external advisors as needed to assist with market evaluations and more significant transactions
- Compensation programs should be well-balanced, taking into account:
  - Organization mission and values
  - Competitive framework
  - Organization and executive performance
  - Retention of an effective management team

APPENDIX

The Compensation Committee Charter formally outlines the duties of its board members…

The primary objective of the Organization’s compensation policy is to provide a highly competitive and motivating executive total compensation program that will help us attract and retain key leaders possessing the significant skills and experience needed to maintain our stature, advance our mission, and help achieve our long-range goals. This policy covers the Organization’s senior management team, comprising the VP level and above.

Specifically, the Organization’s executive compensation program is designed to:

- Attract, retain, and motivate a world class senior management team;
- Reinforce our mission, strategy, and goals by supporting teamwork, collaboration, and program development across the Organization and its operating units;
- Provide a highly competitive total compensation package, including benefits, tied to performance;
- Ensure that pay is considered as fair and equitable among sponsors and stakeholders;
- Be flexible to reward individual accomplishments as well as organizational success; and
- Ensure that the program complies with all applicable federal, state, and local laws.

The Organization’s executive compensation program is administered by the Executive Committee (“Committee”) of the Board of Trustees (“Trustees”). The Committee is responsible for establishing and maintaining a compensation program for the senior management team that is consistent with our mission and values, and the intent of this policy. The Committee meets as needed to review and evaluate the compensation program, and makes recommendations for any changes, as appropriate, to the Trustees. The Committee also reviews annually the performance and compensation for the President and CEO, and will determine what recommendations are to be made regarding the CEO’s compensation, providing its recommendations to the Trustees for approval.

The Committee may commission and oversee periodic studies of executive compensation policies and practices at its discretion and as it considers appropriate. Such studies shall be conducted from time to time, ensuring that all governance requirements are satisfied, specifically with regard to ensuring that the Organization is operating in compliance with the “Intermediate Sanctions” law under Section 4958 of the Tax Code and applicable regulations.

Sample Compensation Committee Calendar

Q1	Q2	Q3	Q4
▪ Select performance measures and set goals for upcoming year ▪ Approve bonus payouts for prior year ▪ Approve salary adjustments for current year	▪ Conduct periodic review of compensation policy, plan design, and competitiveness ▪ Review compensation committee charter	▪ Approve plan design changes for following year ▪ Review Form 990 disclosure ▪ Monitor performance against peers	▪ Evaluate executive performance against objectives and estimate incentive payouts ▪ Consider base salary adjustments for CEO and direct reports based on market and organization performance