NONPROFIT GOVERNANCE: ISSUES AND CHALLENGES IN EXECUTIVE COMPENSATION
DEVELOPING A COMPLIANT COMPENSATION PROCESS

April 22, 2015

LaVerne Woods  
Co-Chair Tax-Exempt Organizations Practice Group  
Davis Wright Tremaine LLP

Nanci Hibschman  
Principal and National Practice Director  
Sullivan, Cotter and Associates, Inc.
AGENDA

• Key Components of a Compliant Compensation Process
• Role of the Board or Compensation Committee
• Common Problems and Challenges (and Solutions)
KEY COMPONENTS OF THE PROCESS

- Board or Committee Charter
- Compensation Philosophy
- Steps to establish the federal tax law “rebuttable presumption” of reasonableness for Section 501(c)(3) public charities and Section 501(c)(4) organizations:
  - Approval by Independent Authorized Body
  - Appropriate Comparability Data
  - Adequate Concurrent Documentation
- Special Issues for Private Foundations
• Sets out procedure to follow in approving executive compensation
  • Identify who has approval authority (Board or committee)
  • Identify frequency of compensation reviews
    • Executive retention
    • Duty of care
  • Identify whose compensation is covered by procedures:
    • CEO, COO, CFO, voting members of governing board who are compensated
    • Persons with “substantial influence” over the organization: when in doubt, include position
• Identify how comparability data will be obtained

• If independent compensation consultant will be engaged, who will engage the consultant (hint: not the executive or a subordinate to the executive)

• Require that compensation arrangements be approved before compensation is paid

• Require that any modifications to compensation be subject to approval

• Require separate approval of any discretionary payments (e.g., incentive payments that require subjective evaluation of satisfaction of goals where the authorized body has not previously approved a cap)
• Identify roles for Legal and Human Resources
• Legal is sometimes excluded from the process, or HR fails to communicate with legal
• Lack of involvement by legal often results in failure to satisfy the federal tax law “rebuttable presumption” (e.g., executive board or committee sessions with no minutes documenting compensation approval)
COMPENSATION PHILOSOPHY

• Purpose: transparency, consistency and fairness
  • Overview
  • Objectives, e.g., alignment of compensation with mission and goals
  • Total compensation offering and pay mix
  • Market definition and rationale
  • Target position of pay relative to the market, e.g., 50th percentile
• Appropriate level of detail
• Keeping it current
Establishing a Rebuttable Presumption Step #1: Independent Authorized Body

- Authorized under State Law (Treas. Reg. § 53.4958-6(c)(1)(i))
  - Board or committee, if corporation
  - Trustee(s), if trust
  - Permitted composition, e.g., some states require committees to be composed solely of directors
  - Creation of committee: most states require a committee with board-delegated authority to be appointed by Board, not the Chair
- Authorized under authorizing documents
  - Bylaws, Trust Agreement, etc.
  - E.g., Bylaws may create a compensation committee to make recommendation to Board, but require that compensation be approved by Board
• Authorized Board or committee under Section 4958 “rebuttable presumption” rules
  • No participating member may have a “conflict of interest” as defined in federal tax law (Treas. Reg. § 53.4958-6(c)(1)(ii)):
    • Not a “disqualified person” who is economically benefitting from the compensation arrangement, or a family member
    • Not in an employment relationship subject to direction and control of the person to be compensated
    • Not receiving compensation subject to approval of the person to be compensated or economically benefitting from the arrangement
    • No material financial interest affected by the compensation arrangement
    • Does not approve a transaction that provides economic benefits to the person to be compensated who in turn has approved or will approve economic benefits to the Board or committee member
INDEPENDENT AUTHORIZED BODY

• Ensure compliance with applicable State statutes regarding executive compensation, e.g., Cal. Gov. Code § 12586 (g):

  The board of directors of a charitable corporation or unincorporated association, or an authorized committee of the board, and the trustee or trustees of a charitable trust shall review and approve the compensation, including benefits, of the president or chief executive officer and the treasurer or chief financial officer to assure that it is just and reasonable. This review and approval shall occur initially upon the hiring of the officer, whenever the term of employment, if any, of the officer is renewed or extended, and whenever the officer’s compensation is modified.
ESTABLISHING A REBUTTABLE PRESUMPTION STEP #2: APPROPRIATE COMPARABILITY DATA

- Appropriate data as to comparability under federal tax law (Treas. Reg. § 53.4958-6(c)(2)) includes:
  - Compensation levels paid by similarly-situated organizations, both taxable and tax-exempt, for functionally comparable positions
  - Availability of similar services in the geographic area
  - Current compensation surveys compiled by independent firms
  - Actual written offers from similar institutions
  - Authorized body has appropriate comparability data if, given knowledge and expertise of its members, it has sufficient information to determine whether the compensation arrangement in its entirety is reasonable
APPROPRIATE COMPARABILITY DATA

- Determine data sources, e.g., general published survey data, custom peer group
- Determine criteria for peer group selection
  - Structure and complexity of operations
  - Size
  - Location
  - Tax status
  - Unique organizational characteristics
- Identify where additional custom peer groups may be warranted
- Review and approve data sources in advance of data collection
- Document decisions and rationale
• Best practices to ensure appropriate and defensible comparability data include:
  • Regular review, testing and confirmation of data sources and peer group criteria
  • Balanced input from qualified Board members, independent compensation consultants and executive management
  • Avoidance of aspirational data peer groups or other comparison sets
  • Review and evaluation of all economic benefits, i.e., all elements of compensation
APPROPRIATE COMPARABILITY DATA

- Elements of compensation:
  - Salary
  - Bonus/Incentive Award
  - Other cash compensation
  - Supplemental Executive Retirement Plans (SERPs)
  - Stock in affiliates
  - 403(b), 401(k), 457 plans
  - Severance benefits
  - Spousal travel
  - PTO payouts
  - Sabbaticals
  - Post-retirement compensation and benefit arrangements
• Definition of “adequate” (Treas. Reg. § 53.4958-6(c)(3)):
  • Must be in written or electronic records
    • Documentation must contain all the following to satisfy “rebuttable presumption” rules:
      • Terms of compensation/benefits arrangements approved
      • Date of approval
      • Who was present, who voted
      • Comparability data relied upon and how obtained
      • Actions taken regarding consideration of the transaction by any member of the authorized body who had a conflict of interest
  • If the body decides that reasonable compensation and benefits exceed the data range presented, the basis for the determination of reasonableness
ADEQUATE CONCURRENT DOCUMENTATION

• Definition of “concurrent” (Treas. Reg. § 53.4958-6(c)(3)(ii)):
  • Documentation must be prepared by the later of the date of the next meeting of the authorized body or within 60 days of final action
  • Approved within a reasonable time thereafter
SPECIAL ISSUES FOR SECTION 501(c)(3) PRIVATE FOUNDATIONS

• Federal tax law Section 4958 excess benefit rules / rebuttable presumption procedures do not apply to private foundations

• A private foundation’s payment of compensation to a “disqualified person,” including the CEO, is a prohibited “self-dealing” transaction under Section 4941 unless an exception applies

• Often there are no independent persons on the governing body (e.g., where the compensated person and all directors or trustees are members of the same family)
SPECIAL ISSUES FOR SECTION 501(c)(3) PRIVATE FOUNDATIONS

- Ensure that services performed by a “disqualified person” fit within an exception to Section 4941 self-dealing rules
  - “Personal services” exception
  - Consider obtaining a legal opinion
- Comparability data to ensure that compensation is not “excessive”
  - Comparables?
  - Asset size?
  - Other factors?
SPECIAL ISSUES FOR SECTION 501(c)(3) PRIVATE FOUNDATIONS

- Written documentation of approval
  - Determination of exception to self-dealing rules
  - Determination that services are “reasonable and necessary” to carry out the foundation’s exempt purposes
- Sources of comparability data
- Express intent to comply with private foundation rules
Who should have final approval authority for executive compensation?
- Full Board or delegation to a committee?
- Some state Attorneys General take the position that the full board should approve President/CEO’s compensation
- Delegation to a committee
  - Advisory to Board or authorized to provide final approval?
  - If authority to approve is delegated to a committee, ensure that the committee satisfies state law requirements (e.g., appointed by the Board, not the Chair)
- Recommendation: Committee that reports to and advises the Board; full Board has ultimately approval authority
ROLE OF THE BOARD OR COMPENSATION COMMITTEE

- Develop a Board-approved compensation philosophy
- Approve Board or Compensation Committee Charter setting out approval procedures
- Engage independent compensation consultant
  - Consider having legal counsel engage the consultant for privilege purposes
- Ensure that adequate concurrent documentation of approval process is prepared
- Review Form 990 disclosures regarding compensation and approval process
- Prepare to respond to inquiries from media and the public
Payments begin before compensation arrangement approved
Executive or a subordinate selects and engages the compensation consultant or obtains comparability data
Inappropriate identification of peer group for comparability data
Comparables provided by executive search firm
Some elements of compensation (e.g., severance) not included in the comparability analysis
COMMON PROBLEMS AND CHALLENGES

- Approval not obtained for changes to compensation
- Approval not obtained for discretionary payments where there is no pre-approved cap
- Decisions not documented adequately (e.g., executive sessions of the board with no minutes)
- Legal counsel not involved in review of documentation prepared by HR
Q & A