NONPROFIT GOVERNANCE: ISSUES AND CHALLENGES IN EXECUTIVE COMPENSATION
OBJECTIVES OF PRESENTATION

- To underscore the importance of taking all benefits into account in assessing and supporting the reasonableness of total compensation
- To explore the many types of potential risk that boards and compensation committees should take into account in reviewing and approving executive benefits
- To illustrate various ways to determine the value of benefits, depending on the types of risk being assessed
- To show how the value of benefits, particularly supplemental retirement benefits, can be determined and communicated to the executives to whom the benefits are provided
- In short, to prepare boards and compensation committees to be more effective in meeting the objectives of these important benefit programs, and to be more effective in meeting their governance oversight responsibilities
Payment of unreasonable compensation or benefits can jeopardize the exempt status of the organization, can lead to significant excise taxes on the recipient and on organization managers, or both.

The legal risk framework consists of these key statutes:
- Section 501(c) private inurement and excessive private benefit prohibitions
- Section 4958 intermediate sanctions excise taxes
- Similar penalty structure for private foundations under section 4941
- “Rebuttable presumption of reasonableness” under the intermediate sanctions regulations
- State statutes prohibiting waste of charitable assets
- State rules or statutes limiting executive pay and benefits (such as New York State Executive Order 38)
- Form 990 (and similar state reporting requirements) disclosure of executive compensation and benefits
The legal risks apply to all forms of compensation, including benefits.

For example, Section 4958 applies to deferred compensation, noncash compensation, and all other compensatory benefits whether or not included in income.

- Severance benefits expressly included
- Fringe benefits excluded from income under Section 132 expressly excluded
- All other fringe benefits expressly included
- Expense reimbursements under a nonaccountable plan expressly included
- Economic benefit of a below market loan expressly included
THE LEGAL FRAMEWORK: REBUTTABLE PRESUMPTION

- Note the role of benefits in qualifying for the rebuttable presumption of reasonableness.
- The approval body has to rely on appropriate comparability data to determine that “the compensation arrangement in its entirety” is reasonable – this includes benefits.
- The approval body has to prepare a contemporaneous written record of its deliberations and decisions, and this record must include the terms of the transaction that were approved. To be assured that the rebuttable presumption applies to total numeration (i.e., all compensation and benefits), all elements of compensation and benefits should be included in the written record.
THE LEGAL FRAMEWORK: AUTOMATIC EXCESS BENEFIT TRANSACTION TREATMENT

• If a disqualified person (under Section 4958) receives an economic benefit, and the exempt organization has not clearly indicated in writing its intent to treat the benefit as compensation for services when the benefit was paid or provided, then the Service will treat the benefit as an automatic excess benefit transaction.

• This treatment applies regardless of whether the benefit would be considered reasonable for the services provided, and regardless of whether all other compensation provided is reasonable.

• In effect, by not treating the benefit as compensatory, the organization has forgone the ability to show that the benefits is reasonable for the services provided.

• Compensatory intent is demonstrated by employment contract, evidence of approval (as compensation) by the approval body, a tax filing (on Form 990, W-2, 1099 or 1040), or other written evidence of intent at the time the benefit was paid or provided.
THE LEGAL FRAMEWORK: FORM 990 DISCLOSURE

- Form 990 disclosure of benefits applies to current and former officers, directors, trustees, key employees and the five highest paid other employees.
- Certain benefits must be expressly disclosed and explained (e.g., first class travel, spouse travel, gross-ups, nonaccountable spending account, housing and/or allowance, club dues, and personal services).
- Most benefits are disclosed at their annual incremental cost to the organization, whether or not taxable to the recipient.
- Nonqualified deferred compensation is disclosed when it is accrued (whether or not vested/taxable), and again when it is included in income (with a separate disclosure of the amount previously reported).
- Valuation of deferred compensation for purposes of 990 disclosure can be challenging.
THE LEGAL FRAMEWORK: ENFORCEMENT

- Benefits can be the easier enforcement route for a regulator.
- The position of the Service on automatic excess benefit transactions is an example.
- It may be easier to show, for example, that the personal use of employer property is an excess benefit transaction than to show that a very large salary or total cash compensation is unreasonable.
- Notable executive compensation scandals have often turned more on executive benefits than on the level of salary or incentive compensation.
BROADER VIEW OF ASSESSING RISK

- Leading boards and compensation committees are reviewing key executive benefit arrangements while taking into account an increasingly wider range of potential risks.
- This broader view of “risk” is consistent with the trend of more sophisticated organizations to engage in the discipline of “enterprise risk management.”
- The increasingly accepted view is that limiting risk assessment only to one form of risk is insufficient to guard against potential harm to the organization. Increasingly, organizations recognize that such harm can come from various sources.
BROADER VIEW OF ASSESSING RISK (cont’d)

• The types of risks increasingly being considered include the following:
  o Current and projected cost of the arrangement
  o Projected costs under various forms of sensitivity and probability analysis
  o Internal pay equity (i.e., “fairness” and recognition of relative value when compared to other executives or other employees)
  o Contractual obligations and compliance
  o Affordability (or other measures of “financial stewardship”)
  o Optics of the arrangement (to regulators, to the public, to the media)
  o Impact on reputation (of recipient executives, of the organization, of board members)
TYPES OF BENEFITS THAT TYPICALLY DRAW ADDITIONAL ATTENTION

- Nonqualified deferred compensation arrangements
- Housing/Housing Allowance (business vs. personal use)
- Payments for business use of personal residence
- Health or social club dues/fees (business vs. personal use)
- Travel—first class, charter, spousal
- Auto Allowance (business vs. personal use)
- Tax indemnification and gross-up payments
- Discretionary spending account
- Personal services provided to employee (e.g., chef, maid, nanny, chauffeur, legal, tax, financial, etc.)
- Severance
- Retiree medical
VALUATION OF BENEFITS

- Deferred compensation
  - Defined benefit—in general, the annual increase (or decrease) in actuarial value
  - Defined contribution—in general, the employer contribution credited to the employee’s deferred compensation account in the applicable year
- Housing—fair market value of the use of such property—often substantiated with appraisal or other appropriate documentation of “rental” value. (Note, however, how significantly this can change from one year to another).
- Other benefits—typically the fair market value of such economic benefit to the employee is considered to be the annual cost incurred by the employer
MARKET DATA AVAILABLE FOR ASSESSMENT OF BENEFITS

Form 990
- Total remuneration analysis – total cash compensation received plus the individual values of all benefits received
  - Sample Form 990 data peer analysis

<table>
<thead>
<tr>
<th>Position</th>
<th>Comp Year End</th>
<th>Organization</th>
<th>Cash Compensation [A]</th>
<th>Other Compensation [B]</th>
<th>[A] + [B]</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td></td>
<td></td>
<td>Base Salary</td>
<td>Bonus / Incentive Comp</td>
<td>Total Cash Comp</td>
</tr>
<tr>
<td>Top Executive Officer</td>
<td>12/31/12</td>
<td>Organization 1</td>
<td>337.0</td>
<td>0.0</td>
<td>337.0</td>
</tr>
<tr>
<td>Top Executive Officer</td>
<td>12/31/11</td>
<td>Organization 2</td>
<td>450.0</td>
<td>0.0</td>
<td>450.0</td>
</tr>
<tr>
<td>Top Executive Officer</td>
<td>12/31/12</td>
<td>Organization 3</td>
<td>748.7</td>
<td>0.0</td>
<td>748.7</td>
</tr>
<tr>
<td>Top Executive Officer</td>
<td>12/31/12</td>
<td>Organization 4</td>
<td>481.7</td>
<td>0.0</td>
<td>481.7</td>
</tr>
<tr>
<td>Top Executive Officer</td>
<td>12/31/12</td>
<td>Organization 5</td>
<td>463.1</td>
<td>85.0</td>
<td>548.1</td>
</tr>
<tr>
<td>Top Executive Officer</td>
<td>12/31/11</td>
<td>Organization 6</td>
<td>615.9</td>
<td>0.0</td>
<td>615.9</td>
</tr>
</tbody>
</table>

- Data generally aged to a common point in time (e.g., January 1, 2015)
- Individual benefits and calculated or imported values are generally disclosed in footnotes required by or discretionary narratives included with Schedule J
- Total remuneration reported on calendar year basis
MARKET DATA AVAILABLE FOR ASSESSMENT OF BENEFITS (cont’d)

Form 990

- Adjustment considerations to assure (to the extent possible) inclusion of annual benefit values for market assessment purposes
  - Deferred compensation plan benefits vesting during the year (reported under “Other Reportable Compensation”) are generally backed out to avoid double counting (See Schedule J, Part II, Column (F))
  - One-time payments/benefits are often backed out, or spread over applicable service period, to ensure proper annualization of compensation and benefits
  - Peer compensation data for employees who were hired/terminated during the year are adjusted to reflect annualized compensation
MARKET ASSESSMENT OF BENEFITS—GENERAL APPROACHES (cont’d)

Published survey data

- Survey data should be from reputable third-party sources (watch the self-reported surveys sponsored by some affinity groups).
- Some surveys publish values for total remuneration, which includes cash compensation and benefit values.
- As many surveys publish cash information only, benefits data often presented using two approaches
  - Benefit value(s) – individual and/or total benefits calculated
  - Prevalence of all or certain benefits (focus should be on high-value items)
Published survey data

- Sample published survey data – total cash compensation

<table>
<thead>
<tr>
<th>Source</th>
<th>Position Title</th>
<th>Scope</th>
<th>Orgs</th>
<th>Base Salary ($000)</th>
<th>Total Cash Compensation ($000)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Nor-For-Profit Survey 1</td>
<td>CEO - Multi-Unit Organization</td>
<td>All Hospitals; Rev = $150M - $499M (med = $363M)</td>
<td>9</td>
<td>$531 $650 $688</td>
<td>$533 $650 $688</td>
</tr>
<tr>
<td>Nor-For-Profit Survey 2</td>
<td>CEO - Multi-Unit Organization</td>
<td>General Medical &amp; Surgical Hospitals (Non-Teaching) Rev = $150M - $499M (med = $360M)</td>
<td>8</td>
<td>$531 $593 $694</td>
<td>$531 $623 $694</td>
</tr>
</tbody>
</table>

Survey Composite: $531 $621 $691 $532 $637 $691

- Sample published survey data – total benefit value
  - Survey provides average employer-provided benefits as a percentage of base salary, total cash compensation or total remuneration (e.g., 30% of total cash compensation)
MARKET DATA AVAILABLE FOR ASSESSMENT OF BENEFITS (cont’d)

Published survey data
• Sample published survey data - prevalence analysis of certain benefits

<table>
<thead>
<tr>
<th>Benefit</th>
<th>Competitive Data</th>
<th>Organization</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Club Dues</strong></td>
<td>• 4 organizations offer to the Top Executive Officer, ranging from $2,000 to $10,500.</td>
<td>• Not provided by Organization.</td>
</tr>
<tr>
<td></td>
<td>• 1 organization offers to other executives.</td>
<td>-------------------------------------------------------------------------------------------------------</td>
</tr>
<tr>
<td><strong>First-class Travel</strong></td>
<td>• 3 organizations offer to the Top Executive Officer only.</td>
<td>• Not provided by Organization.</td>
</tr>
<tr>
<td><strong>Spousal Travel</strong></td>
<td>• 1 organization covers one round-trip flight per year for the Top Executive Officer only.</td>
<td>• Not provided by Organization.</td>
</tr>
<tr>
<td><strong>Housing / Housing Allowance</strong></td>
<td>• 8 organizations offer to the Top Executive Officer only.</td>
<td>• Organization-owned housing is provided to 2 executives.</td>
</tr>
<tr>
<td></td>
<td>• Of the 6 organizations that provide housing, the average annual employer contribution for the Top Executive Officer is $150,000.</td>
<td>• The benefit is treated as taxable to the Top Executive Officer.</td>
</tr>
<tr>
<td></td>
<td>• 4 organizations offer to other executives.</td>
<td>-------------------------------------------------------------------------------------------------------</td>
</tr>
<tr>
<td><strong>Housekeeping Services</strong></td>
<td>• 1 organization offers to the Top Executive Officer only.</td>
<td>• Not provided by Organization.</td>
</tr>
<tr>
<td><strong>Auto Allowance</strong></td>
<td>• 2 organizations offer to the Top Executive Officer only.</td>
<td>• Organization provides an auto allowance to cover expenses in lieu of reimbursement for the Top Executive Officer. Note the allowance is taxable.</td>
</tr>
</tbody>
</table>

**Things to Ask:**
• Are the participants surveyed appropriate to the organization we’re reviewing?
• Are the findings consistent across a variety of survey sources?
• Do the benefits offered pass the ‘sniff test’?
MARKET DATA AVAILABLE FOR ASSESSMENT OF BENEFITS (cont’d)

- Other sources of data
  - Form 990-PF
  - Custom survey data
  - Proxy data (to the extent for-profit data is relevant and appropriate)
- Where comprehensive, single-source data does not exist or is not sufficiently robust, consider using multiple approaches to corroborate market position.
NONQUALIFIED DEFINED BENEFIT PLAN
SERP – SPECIAL CONSIDERATIONS

- Annual accrual and Form 990 reporting over service period
- Increasing accrual as employee’s compensation increases and employee approaches retirement age
- Funding, regardless of whether or not there is a funding obligation over the service period
- Interest rate volatility and impact
- Projected future value
- Cash impact to the organization
- Taxation upon vesting
- Form 990 reporting upon vesting
- Potential optics and potential public relations issues
Consider the following retirement arrangement included within the remunerative offer for a newly hired 55 year old Chief Executive Officer:

- Base salary of $400,000 per annum – future annual increases to be based upon market, performance and affordability; and
- Lifetime retirement income equal to 50% of final year base salary (benefit vests and is paid at age 65).

<table>
<thead>
<tr>
<th>Age</th>
<th>Base Salary (Assume 3% Increase)</th>
</tr>
</thead>
<tbody>
<tr>
<td>55</td>
<td>$400,000</td>
</tr>
<tr>
<td>56</td>
<td>$412,000</td>
</tr>
<tr>
<td>63</td>
<td>$506,708</td>
</tr>
<tr>
<td>64</td>
<td>$521,909</td>
</tr>
</tbody>
</table>

Benefit Commitment
50% of $521,909
Or
$260,955

Projected Value of Retirement Benefit
$260,955 x Annuity Rate
~ $2.9 Million, which requires an annual contribution of 45% of base salary per year (Assumes 6% annuity rate and 8% rate of return)
Understanding the commitment and the liability. What happens when assumptions aren’t realized?

- Benefit Commitment: 50% of $521,909 = $260,955, or $260,955
- Total Expected Commitment of $2.9M

Projected Liability (Assumes 4% annuity rate):
- $260,955 x Annuity Rate = $3.5 Million, a 19% increase

Projected Liability (Salary actually increased by 4% to $570,000):
- $285,000 x Annuity Rate = $3.9 Million

Projected Liability (Updated Mortality):
- $260,955 x Annuity Rate = $3.6 Million, a 9% increase

Total liability increase of 35%
IMPORTANT ONGOING MAINTENANCE TIPS

- Benefit values can change dramatically over time – values need to be regularly reviewed and periodically updated (e.g., SERPs, housing).
- Determine how to calculate and communicate the value of benefits to the executives who receive them – certain types of benefit values are difficult to understand.
- Be prepared for stories in the media, or for other types of public reactions, and have a response strategy and series of potential messages ready to implement.
- Make sure all benefits are documented and that those documents are up to date, signed, and are in the hands of all individuals and entities responsible for assessing and administering the benefits.
- Understand what the benefit commitments are upon a change in control, or upon various types of termination events. Look for inconsistencies in the treatment of different benefits upon certain events, and consider changes to achieve greater consistency.
- Make sure that full disclosure on material benefit issues is provided to the compensation committee and board.
AT THE END OF DAY...
IT’S ALL ABOUT GOOD GOVERNANCE

• Ask yourselves if what you’re doing passes the ‘Red Face Test’
  • Do your Trustees fully understand the commitments? Are they [sufficiently] comfortable?

• What’s your story?
  • Boards make remunerative decisions with intent. Be prepared to talk about why.
  • Be on the offensive side of the story - it’s far better to have a clear message and communication plan.

• Manage the 3 D’s – get the Data, ensure there’s Dialogue among disinterested Trustees, Document the decisions through meeting minutes.