



The Governance Institute's E-Briefings



Volume 7, No. 6, November 2010

Welcome to The Governance Institute's E-Briefings!

This newsletter is designed to inform you about new research and expert opinions in the area of hospital and health system governance, as well as to update you on services and events at The Governance Institute. Please note that you are receiving this newsletter because you are a Governance Institute member or expressed interest at one of our conferences.

News, Articles, and Updates

The 2011 Agenda for the Executive Compensation Committee

*Michael W. Peregrine and Ralph E. DeJong, Partners, McDermott Will & Emery, LLP
Timothy J. Cotter, Managing Director, Sullivan Cotter & Associates, Inc.*

This article is the second in a series on efficient board committee practices (refer to the September 2010 issue of E-Briefings for the first article on the strategic alignment committee).

Executive compensation remains not only a prominent enforcement priority in the current regulatory environment, but also a sensitive political and employee relations issue given the post-recessionary economy. For these and other reasons, this is no time for the executive compensation committee to let down its guard. The committee would be well advised to address a series of important challenges in 2011. These include the following:

1. **Independence of committee members.** A weakness of many compensation committee structures is the inclusion of members who fail to satisfy the requisite standards of independence—whether as a matter of IRS rules (e.g., the rebuttable presumption of reasonableness safe harbor) or of public perception (e.g., appearing “beholden to” the chief executive). Failing to assure a completely independent committee threatens to compromise the decisions of that committee. Yet, it is an easily solvable problem, which starts by seeking the advice of legal counsel in selecting the committee members.
2. **Reevaluation of the philosophy statement.** It is always important to periodically review the appropriateness of the compensation

philosophy statement, even more so today when many organizations are reevaluating their approach to pay structures. The executive compensation committee should be examining whether the current philosophy statement serves to position the organization at the “right point” in its relevant market, and to strike the proper balance between base salary and incentive compensation.

3. **Supportability of comparables.** Current regulatory oversight emphasis is increasingly on the appropriateness of the comparability data applied by the committee to support the compensation arrangements of base, incentive, and retirement pay. There is greater willingness to “get behind the numbers” (i.e., the written record) and evaluate whether the data is reflective of an apples-to-apples comparison. The compensation committee must be more proactive in its analysis of the comparability recommendations of the compensation consultant.
4. **Future impact of “big ticket” items.** Given the prevailing economic environment, the compensation committee is well advised to consider the risks associated with prominent and controversial benefits such as supplemental executive retirement plans

(SERPs) and severance pay. These risks include the impact of further costs, and the ability to defend the arrangements against regulatory scrutiny and in the court of public opinion. The committee should not be reticent to consider adjustments deemed necessary to reduce exposure to significant risks, even in situations when doing so potentially could create tension between the committee and executive management.

5. **Anticipate future 990 disclosures.** The committee should devote specific attention to identifying and comprehending future compensation and benefits-related Form 990 disclosures, and anticipating the potential internal and external reaction thereto. Such an analysis should take into consideration every type of compensation payment and benefit that will have to be disclosed, along with the timing of the disclosures. If conducted sufficiently in advance, the analysis may provide the committee with the opportunity to recommend revisions to potentially problematic arrangements, or restructure payment schedules where possible to do so, to lessen the possible public and regulatory reaction to the disclosures.
6. **Stick with the tally sheet.** The committee should continue to rely on the tally sheet format as a primary means of providing the full range of compensation information to members. Tally sheets are increasingly recognized as an effective way to report the value of each individual element of an executive compensation package—including potential severance benefits costs—to the committee. Working off tally sheets and similar reports assists the compensation committee in understanding the total value of the compensation package and the proportional relationship of individual elements to the entire package. Moreover, it also could be a useful document to share with government regulators reviewing organizational executive compensation arrangements since it eliminates the guesswork.
7. **Board disclosure.** The committee should adopt a policy that works to assure board awareness of the full compensation and benefits package of the top executives, and confirms board familiarity with the compensation committee's review and approval process. This policy may include an

overview of the underlying philosophy statement, market position, actual compensation amounts, and full potential compensation amounts. While this might seem inconsistent with the efficiencies to be gained by delegating specific responsibilities to a board committee, state regulators in particular are often insistent that the full board possess certain basic knowledge of—if not the responsibility to ratify or approve committee decisions regarding—the key compensation arrangements.

8. **Internal pay equity.** Trends suggest that the compensation committee should become more sensitive to issues relating to internal pay equity. Increasingly, compensation committees are taking into consideration the rate of compensation increase provided generally to the employer's workforce, and a growing public expectation is that the average rate of increase for executives will not significantly exceed the average rate of increase for all other employees. It is possible that reasonableness decisions may appear more appropriate to regulators (and to the media) where the record reflects the committee's consideration of internal pay equity issues.
9. **Compensation consultant independence.** The Dodd-Frank Wall Street Reform and Consumer Protection Act is just the latest legislative or regulatory development to emphasize the importance of relying on a compensation consultant that is truly independent and conducts no other material consulting services on behalf of the organization. In that regard, the committee should work with its counsel to adopt specific independence criteria. A periodic evaluation of consultant independence is particularly important given the rapid consolidation in the human resources area. A consultant who may have been independent when he/she was originally engaged may no longer satisfy independence standards now. Even though not explicitly required for the rebuttable presumption of reasonableness or more generally under tax exemption rules, using an independent consultant carries with it a particularly valuable perception by regulators and the media.
10. **Update communications strategy.** There is great value in the committee working with internal and external media advisors to

develop a compensation-based communications strategy. This is particularly the case as many local and national media outlets closely cover developments regarding non-profit executive compensation, and where valued constituents may react negatively to initial and incomplete, media coverage of compensation arrangements. The compensation committee should ask itself whether there is a coordinated message in place when a donor, a regulator, or a member of the media contacts a board member or member of senior management regarding executive compensation.

Executive compensation issues—and by necessity, the work of the executive compensation committee—remain a high-profile legal feasibility issue for non-profit corporations. This is made

even more so by the twin developments of a recessionary economy that has served to suppress compensation increases, and the spillover effect of legislative developments with strong compensation controls, such as the recent Dodd-Frank law. By focusing on the action items identified above, the prudent compensation committee will remain well prepared for the increasingly skeptical environment.

The Governance Institute thanks Michael W. Peregrine, Ralph E. DeJong, and Timothy J. Cotter for contributing this article. They can be reached at mperegrine@mwe.com, rdejong@mwe.com, and timcotter@sullivanacotter.com.