Spotlight on Executive Compensation

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Regulators continue to challenge executive compensation paid by nonprofit organizations. Indeed, even the commercial sector saw an outcry against executive compensation levels in the context of the recent bank bailout program, resulting in some limitations. State regulators are questioning the amount of compensation paid to nonprofit executives and the governing boards' methods of setting the compensation. Recent examples in Maryland, Massachusetts, and New Jersey illustrate their displeasure and willingness to charge nonprofit organizations with a failure to properly justify compensation levels and poor governance practices. On occasion, the regulators discount reliance on comparability data - a key component in the IRS "rebuttable presumption" procedures for determining reasonable compensation. Through the questions addressing executive compensation on the revised Form 990 and recent compliance initiatives in the healthcare and education sectors, the IRS has also signaled its concerns about executive compensation.

In Massachusetts, the Attorney General announced a compensation initiative in September 2009 that included an examination of executive compensation practices at certain health care organizations, the development of new reporting requirements for health care organizations, and an examination of director compensation by nonprofit health care insurers. Yesterday, David Spackman, Assistant Attorney General and Chief of the Non-Profit Organizations/Public Charities Division, indicated that the executive compensation portions of the initiative are temporarily on hold until the Fall. Nonetheless, organizations are well-advised to consider the Division's stated views on how it would evaluate executive compensation in a particular context.

Mr. Spackman elaborated at conferences held in recent months on the goals of the Division's compensation initiative. Most clearly, the Division wants to encourage boards of directors to engage in more deliberative processes for establishing compensation rather than simply or primarily relying on comparability studies. The Division is focusing first on the health care sector, but the very fact of this initiative, as well as the findings and new reporting obligations to be issued by the Division, should be instructive for charitable organizations in other sectors as well.

In his remarks, Mr. Spackman identified both procedural and substantive factors the Division is interested in examining when assessing whether a governing board executed its fiduciary obligations to the organization.

The procedural considerations include the following:

- Did a market compensation comparability study represent the sole or primary element in setting compensation?

- If a study was used, who conducted the study and why? How were the comparable organizations selected and why?
- Does the record reflect a deliberative and reasoned decision-making process on the part of the board of directors? Is compensation set by a formula?
- Did the board of directors and the executive negotiate the amount and nature of the compensation?
- How did the board of directors address any conflicts of interest when determining the compensation?

The substantive considerations include the following:

- What are the organization's goals and accomplishments?
- What are the executive's goals and accomplishments?
- In reviewing data from the health care sector and from each institution in particular, the Division will be interested in examining certain trends such as the following:
    - How many times higher is the CEO's compensation compared to the institution's lowest paid employee?
    - How do premium costs, labor costs, and access costs compare across institutions and within the industry? Is the institution controlling its costs?
    - What and how do incentive plans reward people? Is improved access to health care one of the elements?
    - Do the institution's strategy and compensation system reflect mission-driven or market-driven goals?

The Division is relying on governing boards and their committees to exercise judgment and care in establishing executive compensation and preventing charitable organizations from applying their funds toward unreasonable, excessive executive compensation.

We are available to assist organizations and executives navigate the requirements and best practices for establishing compensation in today's regulatory climate.