

How are Nonprofits Responding to Scrutiny of Executive Compensation by the IRS, Public and Media?

Part II Strategies and Responses

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Wednesday Webinars
February 24, 2010



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& ENGLISH**
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Overview of Webinar

- See www.lawrenceassociates.com for recording of Part I detail on the “basics”.
- Key Concepts
- Case Studies

Lindalee Lawrence and Rick Lucash

Key Concepts

- Why do we care?
- Helpful tools
- What's Excess?
- Case Studies
 - “Arriving in NYC”
 - “Freedom Incentive Plan”
 - “Targeted by the IRS”

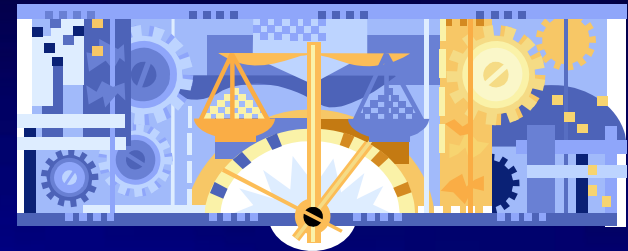
Why Do We Care?



- **Personal Liability** for Executives and Board Members
- IRS Survey of Colleges and Universities – 40 being audited
- IRS Studied Nonprofit Hospitals starting 2006
- IRS examined compliance by 2000 Nonprofits starting 2004
- Public Attention on Executive Compensation in public companies has affected nonprofit sectors
- Local Press Focuses on Local Nonprofits
- Attraction, retention and motivation of needed talent

Accountability and Good Governance

- IRC Section 409A
- Public Availability of Form 990 and **NEW** Disclosures
- Intermediate Sanctions
 - Excess benefit transactions to Disqualified Persons
 - Rebuttable presumption of reasonableness
 - Reasonable compensation



Intermediate Sanctions

- Why “Intermediate”?
 - Gives IRS a remedy between doing nothing and revoking Exempt status
- Rule: *Cannot provide “Excess Benefit” to “Disqualified Person”*
- HR and Compensation professionals can assist the Board and senior management in complying

Intermediate Sanctions

- Special Rules for Smaller Organizations and Lower Paid Executives
 - Organizations with less than \$1 million annual gross receipts may use compensation data from just three comparable organizations in the same or similar communities for similar services.
 - Lower-paid executives are not “disqualified” if they receive economic benefits from the organization, directly or indirectly, of less than \$110,000. (Not available for CEO and other senior officials, or controlling parties.)

Rebuttable Presumption of Reasonableness (Safe Harbor)

Payments are considered reasonable IF

1. Advance approval by an authorized, disinterested group of the organization.
2. Appropriate comparability data is used.
3. The decision is documented by the later of 60 days or before the next meeting of the group.



Note – new Form 990 asks if this process is used

Total Compensation Means All Elements of Pay

- Base Salary
- Short-term Incentives
- Long-term Incentives
- Deferred Compensation/Capital Accumulation (457(b), 457(f), split dollar, trusts, Professional Roth)
- Perquisites (contract, severance, auto)
- Non-monetary



Helpful Tools for Compliance

- SalaryExpert's "Preliminary Tax-Exempt Executive Compensation Report", and notice that use of comparables alone is not protective www.salaryexpert.com/index.cfm?Fuseaction=Products.SafeHarbor
- GuideStar's "CEO Compensation Checkpoint"
- Tally Sheet
- Analysis of IRS Forms 990
- Analysis of Surveys
- Pay Compared to Policy
- Media Checklist

What's a Tally Sheet?

- A detailed list and values of all compensation provided by the organization and related organizations to disqualified executives
- Transparency and documentation
- Made available to key decision-makers
- Responds to historical cases where aspects of compensation were not fully disclosed to Trustees



IRS Form 990 Focus on Governance

What's on an IRS Form 990?

Policy Questions

- ✔ Used compensation committee?
- ✔ Used independent compensation consultant?
- ✔ Used Forms 990s of other organizations?
- ✔ Have written employment contract?
- ✔ Used compensation survey or study?
- ✔ Met safe harbor?

IRS Form 990 Focus on Governance

What's on an IRS Form 990?

Part I Summary

Organization Size

- Line 12: Total Revenue
- Line 18: Total Expenses
- Line 20: Total Assets

IRS Form 990 Focus on Governance

Who's Reported on an IRS Form 990?

Part VII Compensation of Officers, Directors, Trustees, Key Employees, Highest Compensated Employees, and Independent Contractors

Section A. Officers, Directors, Trustees, Key Employees, and Highest Compensated Employees

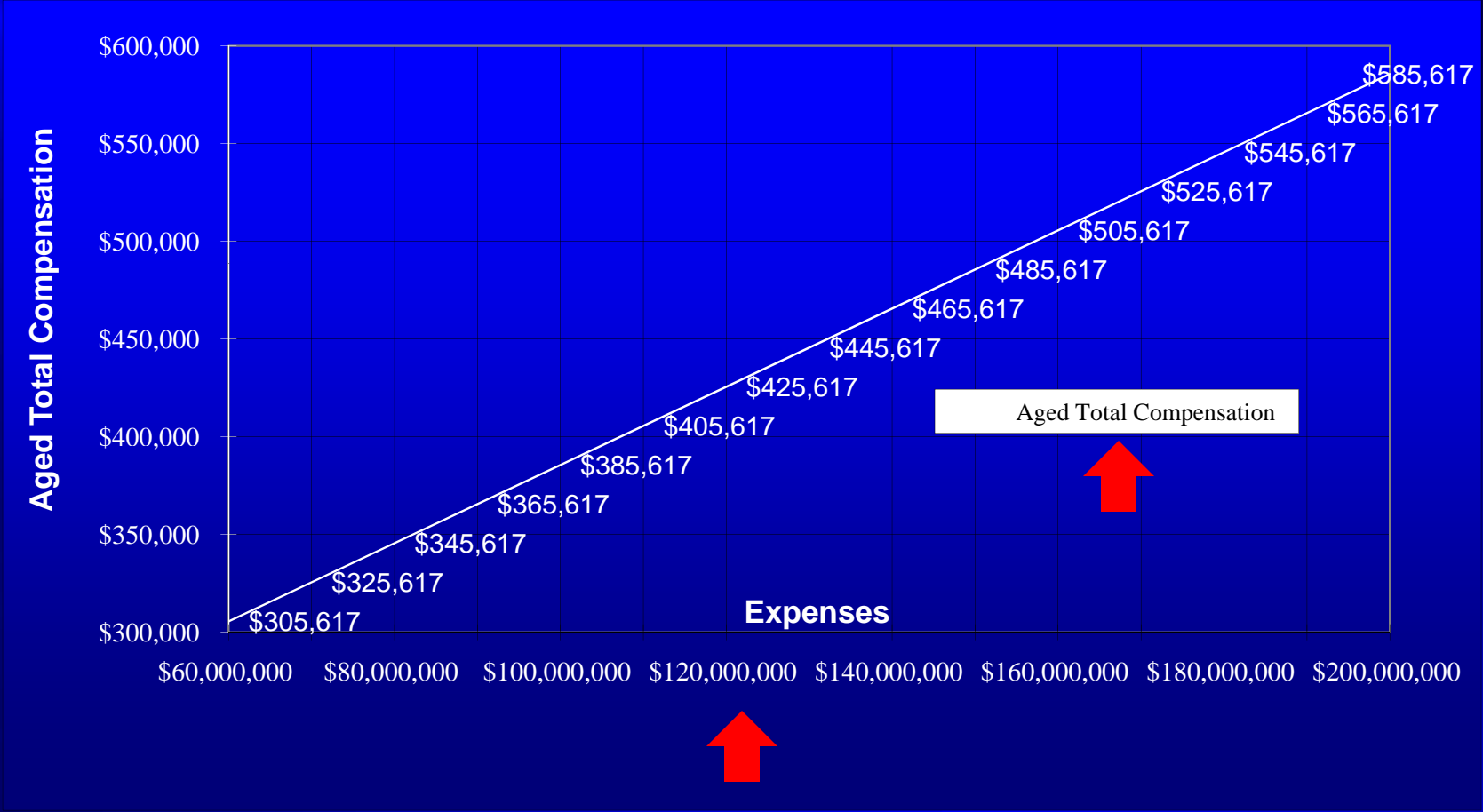
- List all of the organization's current officers, directors, trustees (whether individuals or organizations), regardless of amount of compensation.
- List all of the organization's current key employees. See definition.
- List the organization's five current highest compensated employees (other than an officer, director, trustee, or key employee) who received reportable compensation of more than \$100,000 from the organization and any related organizations.
- List all of the organization's former officers, key employees, and highest compensated employees who received more than \$100,000 of reportable compensation from the organization and any related organizations.
- List all of the organization's former directors or trustees that received, in the capacity as a former director or trustee of the organization, more than \$10,000 of reportable compensation from the organization and any related organizations.

IRS Form 990 Focus on Governance

What data is on an IRS Form 990?

- (A) Name and Title
- (B) Average hours per week
- (C) Position (check all that apply): Former, Highest compensated employee, Key employee, Officer, Institutional trustee, Individual trustee or director
- (D) Reportable Compensation from the organization (W-2/1099-MISC)
- (E) Reportable compensation from related organizations (W-2/1099-MISC)
- (F) Estimated amount of other compensation from the organization and related organizations

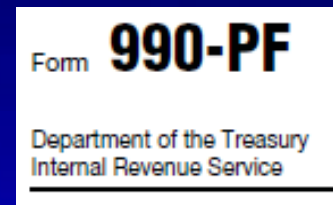
Form 990 Comparability Data Shows Total Compensation Not Just Base and Bonus



Foundations

What's different about foundations?

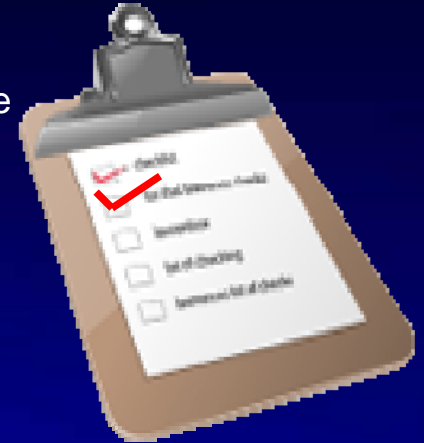
- More likely to pay trustee/board compensation
- May lack disinterested board
- File Form 990-PF
- May not be required to comply with Intermediate Sanctions, but should follow Best Practices
- Compensation may be based on asset size, level and complexity of grant-making and giving
- High expectation of integrity by grantees and public



Responding to the Media

Establish Compliant Policies and Procedures

- ✓ Review provisions of Intermediate Sanctions , IRS Form 990 and Performance Evaluation with key board members and meet the “safe harbor”. process. Notify individuals of the public disclosure of their compensation.
- ✓ Determine what scope of information will be provided when speaking with the media or others.
- ✓ Identify a spokesperson from the Board who can speak knowledgeably about executive compensation policy. Should not be the CEO.
- ✓ Maintain a compliant compensation program for all employees.



Collect and Update Internal Information Prior to Responding

- ✓ Develop, review and update “Media Talking Points.” Update market comparisons. Update resumes and operational background on the organization. Document community benefits. Know administrative costs as a percent of expenses.
- ✓ Prepare a list of specialists (compensation consultants, executive search, association and community members) who can respond to specific media concerns.
- ✓ Prepare to address internal audience issues regarding the inquiry- executives disclosed on the 990, employee perceptions, labor relations.

Responding to the Media



Talking with the Media

- ✓ Learn about the nature of the inquiry or media attention. Who? (union, media, other) Why? (prompted by merger, labor relations, community or internal issues) Focus? (inequitable or unusual compensation)
- ✓ Prepare spokesperson to address compensation, financial and performance-related issues. Familiarize the person with overall compensation policy so that they will be comfortable addressing executive compensation in light of other wage and salary practices.
- ✓ Review organization Form 990 with spokesperson. Identify any unusual areas of compensation. Calculate and review percents of increase and other changes from prior three-year period.
- ✓ Return calls. Be open and cooperative. State policies and put executive compensation into context, rather than defending compensation levels.
- ✓ Alert third parties that they may be asked to respond on the organization's behalf.

Comparability Data

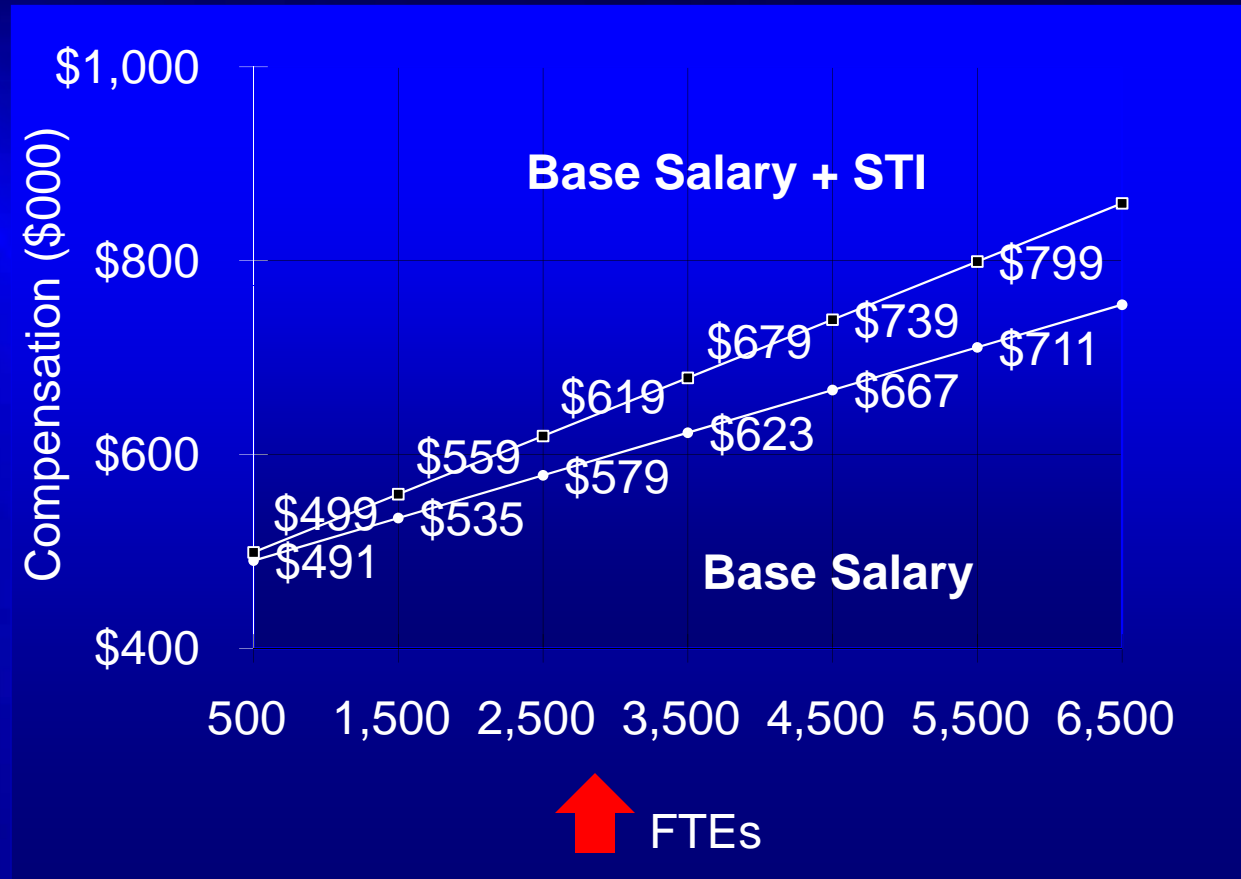
What's Excess?

Factors Affecting Base Salary and Total Comp

- ➔ Reasonableness factors from case law, IRS opinions and letters
- ➔ Organization Size
- Competitive Market
- ➔ Geographic Region
- Performance
- Scope of Work

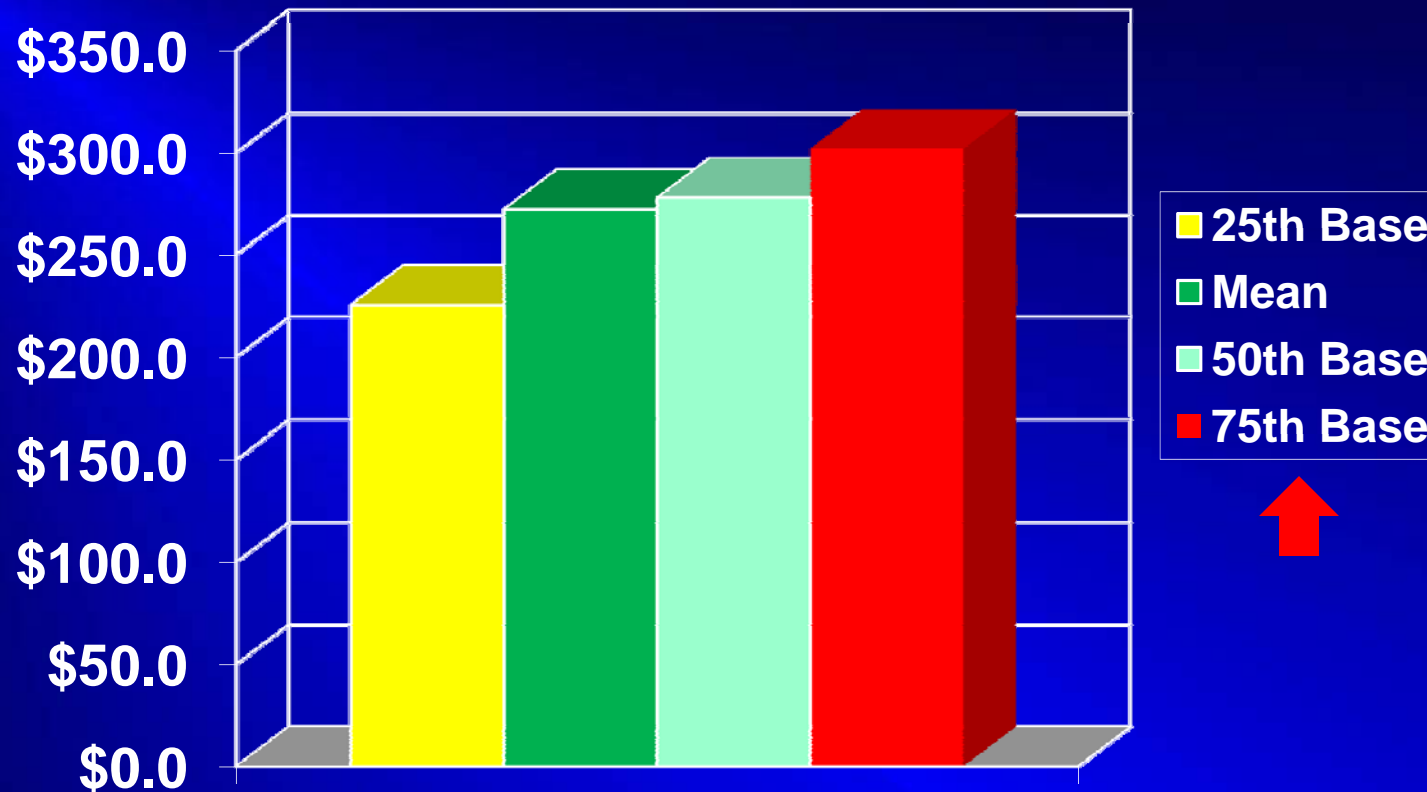


Comparability Data Regression by Size (Base+Bonus)

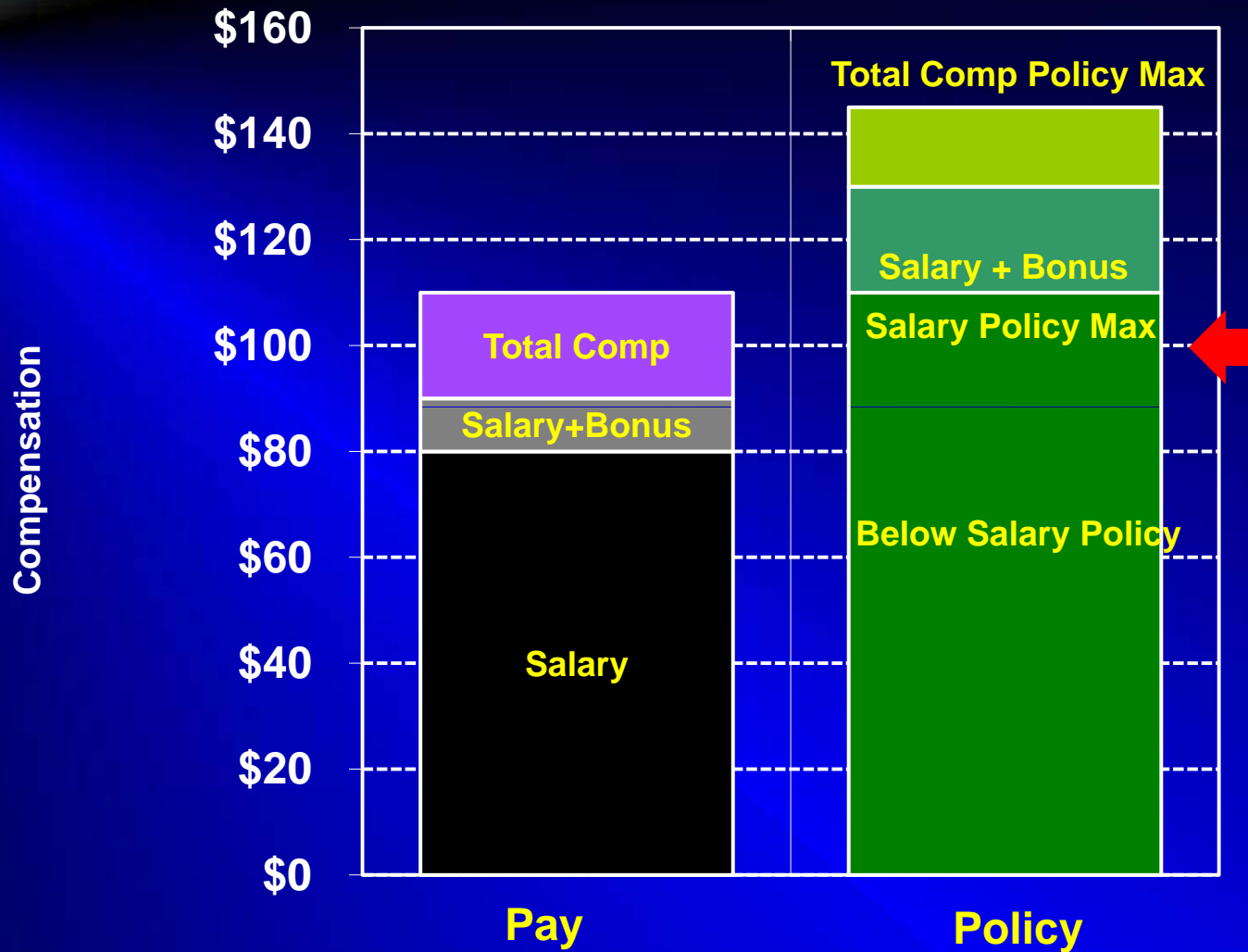


CEO

Statistical Position in Market



CEO Pay Compared to Policy



Three Case Studies

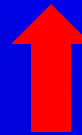
- Presentation Approach
 - Fact Set
 - Analysis
 - Poll Question
 - Poll Answer

Arriving in NYC

- The hospital has net revenues of \$250M, an operating margin of - 3%, and all union contracts are under negotiation.
- The new CEO came from North Dakota to NYC, for a base salary of \$250,000 with an annual incentive, few perquisites and a promised retirement plan. He also has a 30% long-term incentive that will be determined each year and paid out three years later.
- The performance objectives have not been determined, but things seem to be changing at a fierce pace.
- Due to an error in timing the most recently filed Form 990 includes two incentive payments to the prior CEO for reported cash of \$700,000.
- The newly-established Compensation Committee wants HR to assure they are meeting regulatory requirements, and are within the safe harbor.

Arriving in NYC Base Salary Analysis

	Survey	Market Mean Base (1/1/10)	Market 75th Base	Current Client Base
Chief Executive Officer (CEO)				
19 hospitals	Survey 1	\$499,675	\$553,635	\$250,000
Regression \$200M op exp	Survey 2	\$454,780		\$250,000
A, B, C, D, E, F	Survey 3	\$469,291	\$502,257	\$250,000
17 hospitals	Survey 4	\$510,138	\$534,013	\$250,000
Operating Budget \$200M	Survey 5	\$405,227	\$482,270	\$250,000



Arriving in NYC

Regression Analysis of CEO Pay



Arriving in NYC

What do you think this CEO's maximum salary should be?

POLL

- A. \$250,000
- B. \$500,000
- C. \$742,000

Arriving in NYC

Responses to Case Study

- Salary differential North Dakota to NYC of 74.9%
(\$250*1.749=\$437)
- Market competitiveness and rebuttable presumption
- Timing and use of new hire provisions of Int Sanc?
- Discretionary incentives? Approach to performance objectives and structured incentives. 409A?
- Prepare Board Chair to speak to media about Form 990 in response to union and other inquiries, Help Board and CEO address gaps



Arriving in NYC

What do you think this CEO's maximum salary should be?

POLL ANSWER

A. \$250,000

B. \$500,000

C. \$742,000 (example only)

Freedom Incentive Plan



- Plan pays on discretionary basis
- Plan can pay out up to discretionary maximum
- Base plus bonus generally achieve the upper quartile
- Minimal documentation of committee or board actions

Freedom Incentive Plan

What's wrong with this plan?

POLL

- A. Plan pays on discretionary basis
- B. Plan can pay out up to discretionary maximum
- C. Base plus bonus generally achieve the upper quartile
- D. Minimal documentation of committee or board actions
- E. All

Freedom Incentive Plan

What's wrong with this plan?

POLL ANSWER

E. All

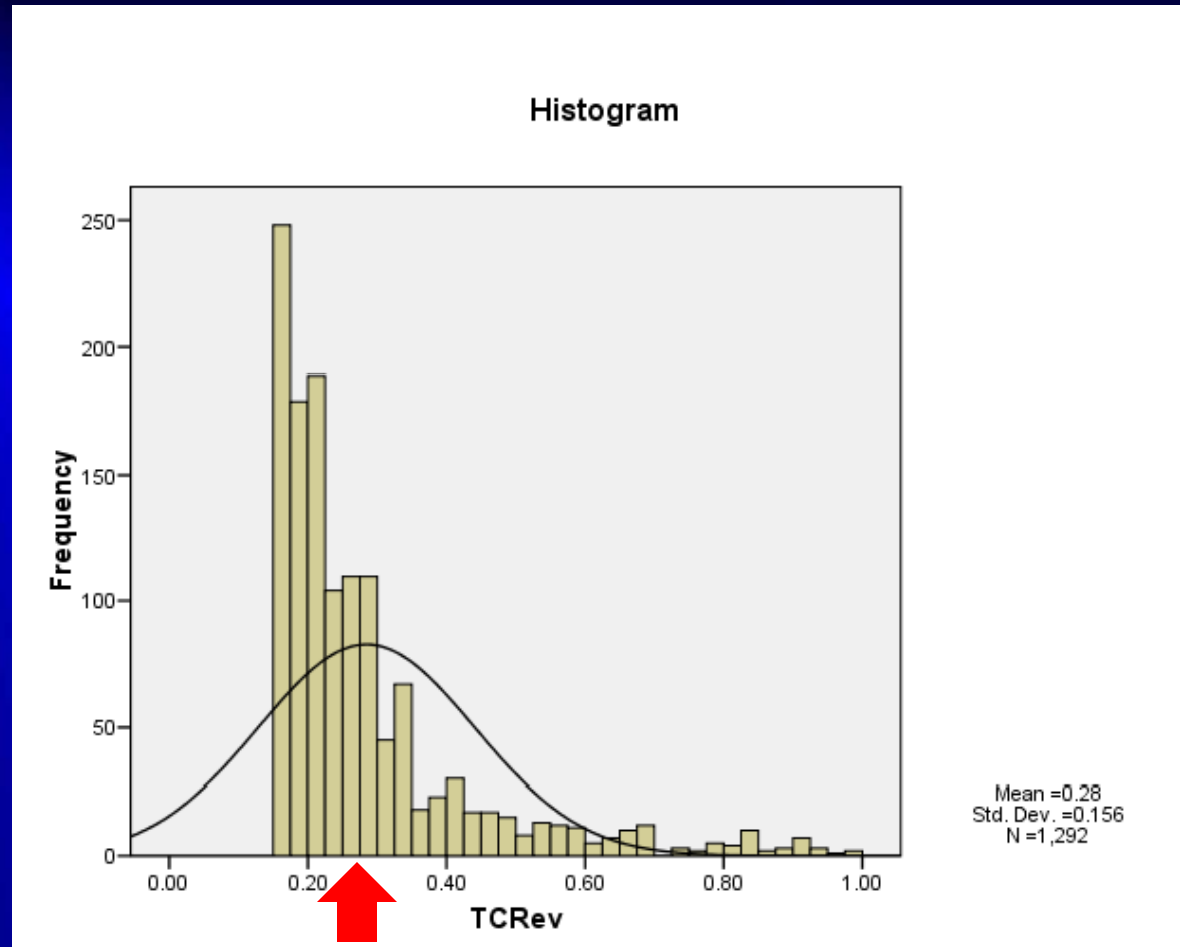
- Avoid discretionary decisions.
- Develop guidelines and link pay to performance.
- Establish plan targets and maximums.
- Test potential payout against policy and the market.
- Document all decisions.

Targeted by the IRS



- Gross revenues ~\$1M and declining
- Total comp \$500,000 and declining
- IRS Assessed penalties of \$1M+
- Entrepreneurial, founder, working 24/7

Total Compensation as Percent of Revenue (based on 1292 Forms 990)



Targeted by the IRS

What is most persuasive?

POLL

- A. Analysis of Reasonableness Factors
- B. Comparison to for-profits
- C. Comparison to Forms 990
- D. Analysis of upper-quartile compensation
- E. All

Targeted by the IRS

What might be persuasive?

POLL ANSWER

ALL! Try everything you can think of!

- Analysis of Reasonableness Factors –
Organization structure, time devoted, historical under-compensation
- Comparison to for-profits
- Analysis of upper-quartile compensation on Forms 990



Outcome: Reduction to 27% of penalties

Resources

Lawrence Associates has developed online resources to assure that executives and trustees have the most current information on important compensation topics.

These resources can be accessed directly from our [Website](http://www.lawrenceassociates.com) at www.lawrenceassociates.com or by bookmarking the links separately.

- ✓ [Video and slides of Lawrence Associates' webinars on executive compensation](#)
- ✓ Our continually updated [Blog](#) about executive compensation topics.
- ✓ Our executive compensation [NewsFeed](#) selecting articles directly from the news about executive compensation across industries and regions.
- ✓ Our regulatory update [Resources/News](#) page that includes articles, IRS pronouncements and regulatory activity and resource information.

Lawrence Associates Compensation Consultants

Comprehensive compensation consulting solutions for trustees and directors, executives and managers of nonprofit organizations, spanning the continuum of healthcare, foundations, colleges and universities and other nonprofit sectors.

- Executive Compensation – competitive analysis; compensation strategy; incentive plan design; capital accumulation; perquisites; benefits, trustee education and response to media and public disclosure.
- IRS Intermediate Sanctions and Reasonable Compensation Review – analysis and certification under the IRS safe harbor rules.
- Wage and Salary Program Design and Incentive/Bonus Pay – variable pay/incentives, wage and salary program design; performance evaluation and other reward programs.
- Custom Competitive Analysis & Surveys – competitive analysis, custom-designed competitive market surveys and analyses of all sizes.

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Executive Compensation

Recruiting, retaining and motivating executives are essential to any successful enterprise. But that is just the beginning. Heading off litigation, delivering tax effective solutions, implementing succession planning, analyzing and preparing for the effects of business combinations and reorganizations are vital concerns as well. Our attorneys bring practical business sense to bear on the compensation issues that arise in today's highly regulated and competitive marketplace.

Studying each client's unique requirements, we employ an integrated, multidisciplinary approach, considering comparables, competitive market position, public disclosure issues, regulatory and compliance issues, tax concerns, corporate governance, as well as plain old business sense to resolve our client's needs.

Our attorneys assist with every aspect of executive compensation, including negotiating employment agreements, severance agreements, change-in-control agreements, indemnification arrangements, deferred compensation arrangements, long term incentive plans, and advising on retention issues arising out of mergers and acquisitions, and restructurings. Working with our Life Sciences, Corporate, Securities, Financial Institutions, Intellectual Property, Tax, Employee Benefits, Labor & Employment and Litigation practice groups, we tailor solutions that are specific to our client's needs.

Our clients include compensation committees and boards of directors of publicly traded corporations, hedge funds, private equity funds, senior executives, CEO's and leaders of major financial institutions, not for profits, real estate enterprises, family offices, news and entertainment companies.

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Wrap-up

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- Please be sure to visit the links on our site for the upcoming Wednesday Webinars.
- This presentation will be available for download from www.lawrenceassociates.com