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Best Practices for Board Oversight of Executive Compensation

By Barry S. Bader
and Elaine Zablocki

**It's 7:30 am,
and your board's
executive
compensation
committee is
meeting.
Do you know what
they're doing?**

In the past, most directors who weren't on the compensation committee knew little or nothing about the committee's work or how much the CEO earned. Boards believed executive compensation was best treated confidentially, and they entrusted a few board members with the responsibility. Asking too many questions was frowned upon.

That's history. In an era of heightened accountability and transparency, executive pay has become a high visibility issue:

- Some newspapers publish hospital CEOs' salaries using publicly available data from a hospital's own Form 990.
- The Internal Revenue Service (IRS) is ramping up its scrutiny of executive compensation at tax-exempt organizations and plans to broaden disclosures required on the Form 990. Last summer IRS sent a 9-page, 80-item "Compliance Check" survey focusing on executive compensation to 550 organizations.

- The General Accounting Office (GAO), at the request of the chairman of the House Ways and Means Committee, sent a survey asking about executive compensation practices to 100 not-for-profit health systems.
- Outgoing Senate Finance Committee Chairman Charles Grassley criticized the independence of hospitals' board compensation committees, their lax oversight of personal entertainment expenses, and their use of supplemental executive retirement plans (SERPs).
- The new Democratic majority in Congress is unlikely to reverse course on increased scrutiny of tax-exempt organizations, Washington observers say.

"From a public policy perspective, effective board oversight of executive compensation is increasingly viewed as fundamental to non-profit, exempt organization status," concludes a new White Paper from The Governance Institute, co-authored by lawyers from McDermott Will & Emery and compensation experts from Sullivan, Cotter and Associates.

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The Board's Responsibility

A board is responsible for attracting and retaining a highly qualified chief executive and senior management team to carry out the mission of the organization. Under IRS regulations, the board is responsible for seeing that executive pay and benefits are consistent with the organization's charitable mission and are reasonable compared with fair market value in the industry.

The central regulatory guidance for oversight of executive compensation is Section 4958 of the IRS Code. On one hand, it authorizes "intermediate sanctions" in the form of penalties and excise taxes if IRS finds excessive compensation or self-dealing and misuse of charitable resources by trustees or officers.

On the other hand, Section 4958 describes three conditions for boards to create a "rebuttable presumption" that executive pay is reasonable:

- Compensation is reviewed and approved in advance by a board or committee of "disinterested" board members, i.e., members who are not in a position to benefit personally from compensation decisions.
- The board or committee relies on independent sources (not management) for information on compensation at comparable organizations in the industry
- The board or committee makes a contemporaneous, written record that clearly documents its thoroughness and the rationale for its decisions.

Achieving these conditions is getting harder. Paper compliance won't do. Boards need to tune-up the practices of their executive compensation committees and increase the transparency of the committee's work with the full board – and to a lesser but critical extent, with the public.

Recommended Practices

Here are the practices compensation and legal experts are recommending:

1 Basic education. The full board should be educated and updated annually about its executive compensation responsibilities, including IRS Section 4958.

2 Independent committee mechanism. The board should have a committee comprised of "disinterested" directors to oversee executive compensation. Who is disinterested? At best, committee members would have no conflicts of interest. At a minimum, they should meet a "de minimis" definition for director independence, meaning they or their families or businesses may provide a small amount of goods or services, but they have no "material" economic relationship with the organization.

3 Charter and delegation of authority. The board should approve a charter specifying the responsibilities of the executive compensation committee and require an annual report to the board, so that all board members are aware of the committee's work. The charter or a separate policy should specify the commit-

tee's authority, including which decisions must be approved by the board and which can be made by the committee.

4 CEO's role. The CEO should be a non-voting member or attend compensation committee meetings only to provide and discuss information concerning the senior management team. The CEO should be excused when his or her evaluation or compensation are discussed.

5 Independent advice. The committee should engage an independent compensation consultant or firm to provide education, advice, and comparability data. The committee also needs access to legal counsel, as necessary.

6 Executive sessions. The compensation committee should meet periodically in executive session with its independent advisers.

7 Engagement. The committee should not be a rubber stamp; members should be informed and engaged, raising tough questions and exercising rigorous oversight.

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Compensation philosophy and incentive compensation plan.

The committee should recommend a compensation philosophy and incentive plan to the full board for approval. This philosophy and plan provide a framework for determining executives' base pay, incentives and benefits (see box for key provisions). Without this context, salary figures are orphan data that leave the board ill-equipped to assess whether compensation is reasonable and competitive.

Benefits. The compensation committee should seek independent, expert assurance that deferred compensation arrangements, other benefit programs, and any "executive perks" such as automobiles, spouse travel reimbursement, and country club memberships, are consistent with current IRS rules. The committee also should require an audit of executive travel and other expenses to ensure that executives are acting appropriately.

Board education and approval. The full board should review and approve the committee's recommendations. (Except in rare circumstances, the full board does not rehash or redo the executive compensation committee's work.) To make an informed approval, the full board needs education to understand how the compensation philosophy and incentive plan have been applied. It should understand the process the executive compensation committee conducted. Members should know the CEO's compensation package and the compensation for other members of the executive team. Members should be briefed on and understand the form 990 disclosure statement every year before it is filed.

What's Next? Proxy Statements and Tally Sheets

In July 2006, the U.S. Securities and Exchange Commission (SEC) adopted changes to the rules for publicly owned companies requiring disclosure of executive and director compensation, related person transactions, director independence and other corporate governance matters. The outcome is greater disclosure, and as a result, publicly traded companies such as IBM and Altria are posting complete descriptions of their executive compensation philosophy, oversight process and determinations on their web sites. The SEC requires disclosure of the total value of all elements of compensation, including retirement liabilities and severance, in exhibits that tally everything up.

Not-for-profit organizations face no such mandate – at least not yet – but the SEC's rules are a clear sign of the need for increased rigor and transparency. Members of many boards are already asking for "tally sheets" disclosing all elements of total compensation.

How Much Does the Full Board Need to Know?

In an era of increased accountability and transparency, a fiduciary board is responsible for and should know the compensation of its top executives. The board may delegate the details to an executive compensation committee, but it ultimately must oversee the committee's work and review or approve its recommendations.

"The IRS recently said that while it is okay for the board to delegate oversight of compensation to a committee, it cannot ignore executive compensation," says David Bjork, PhD, Managing Director at Clark Consulting, Minneapolis. "They (directors) can delegate the administrative task; they cannot delegate the responsibility for seeing that it is appropriately performed."

In some states, the board is legally required to approve hospital executives' compensation. However, when possible, Bjork prefers to use language such as "the board accepts the committee's recommendation", or "the board ratifies the committee's decision."

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His argument: the IRS requires that the body approving compensation for top executives must obtain and rely upon appropriate comparability data on total compensation and must articulate the rationale for its decisions. The executive compensation committee takes time to review this data in detail, and debates the issues before making its decision. The Board rarely has the time to review the data in similar detail... and in any case, why should it duplicate the committee's work?

Some boards are concerned that some trustees - especially physicians - would violate confidentiality and leak the CEO's salary, creating misunderstanding and dissension among those who don't understand the rationale for seemingly high salaries. The answer is clear: breaches of confidentiality are grounds for removal, but fear of breaches does not justify keeping the entire board in the dark.

Compensation Philosophy and Incentive Plan Checklist

Does Your Compensation Philosophy:

- Explain how executive compensation is linked to achieving the charitable mission? yes no
- Articulate that executive compensation decisions are made by the board and not management? yes no
- Require and describe the board's executive compensation oversight process for creating a "rebuttable presumption" of reasonableness or at least complying with laws and regulations? yes no
- Define the organization's peer groups for comparison purposes and its targets (e.g., 60th percentile)? yes no

For some boards, openness about executive compensation will be business as usual. For others, it will be a difficult change. Greater transparency does open a cloistered process to the risks of inappropriate tinkering and breaches of confidentiality. Board education, clear policies, and rigorous enforcement of confidentiality can mitigate the risks. Gradual implementation may be appropriate.

- Articulate the underpinnings of the organization's approach to compensation, which may include: pay for performance; percentage of pay at risk; multi-year (as opposed to only annual) goals; and the intent to include a range of mission-based measures (not just financial) in determining compensation? yes no
- Describe benefits and deferred compensation, so the total possible compensation of each executive is clear? yes no

Does Your Incentive Plan:

- Re-articulate the rationale and basis for determining incentive awards and total compensation for the CEO and senior executives? yes no
- Establish incentive award opportunities, often at three levels: minimum threshold, targeted incentive opportunity, and maximum incentive opportunity or "stretch goal"? yes no

A board of directors deserves information that will soon be in the public domain, available to the press and accessible to regulators and legislators.

In an age of accountability and transparency, the board needs to know. With hospitals' charitable tax status on the line, it's time for boards to open a window to all directors on the work of their executive compensation committees.

FOR MORE INFORMATION

Is the Job Getting Harder?

White Paper from The Governance Institute, November 2006

Members: \$19 per copy (download PDF free)

Non-Members: \$76 per copy

Red Flags: When to Probe Deeper on Executive Compensation

What are the red flags that should alert a board or compensation committee to pay closer attention?

We asked three compensation consultants:

Jim Rohan, Vice President and Managing Director, Sullivan, Cotter and Associates, Chicago, IL;
David Bjork, PhD, Managing Director at Clark Consulting, Minneapolis, MN; and
Lindalee Lawrence, President of Lawrence Associates, Wellesley, MA.

Big Numbers

Executive compensation must be reasonable in relation to market data from appropriate peer groups. “Most organizations carefully manage total compensation to ensure it does not exceed the 75th percentile of market comparability data,” says Rohan. “In some cases hospitals may need to pay above the 75th percentile for a particular business reason, and that’s fine as long as the decision is approved by an independent compensation committee and the rationale is well documented.”

“If they’re paying above the median, then it becomes even more important to state why this is needed for their particular organization and is consistent with their charitable mission,” says Bjork. “Often it comes down to an argument that you need first rate talent to carry out your mission, and top people have many other opportunities elsewhere.”

The higher the compensation, the more a board must be prepared to document its reasonableness. “Boards should be sure

they have satisfied the IRS intermediate sanctions safe harbor, so that the IRS must prove its case, rather than vice versa,” Lawrence says. “An inquisitive press and a state attorney general with strong oversight increase the odds that an organization will be looked at. Behavior that flaunts pay, benefits or perks can prompt outside scrutiny. Substantial year-to-year changes in compensation can also trigger questions.”

Executive pay in healthcare is increasing only four or five percent per year, Bjork points out, not much faster than general inflation in the cost of living. Everyone strives to pay enough to attract talented executives, he says. “A good third of the universe wants to pay at the 75th percentile. More than half want to pay at

median, so everyone is chasing the middle of the market. That contributes to continued growth in compensation levels.”

Rural hospitals and small community hospitals don’t necessarily need to pay at the median to attract executive talent, he says. Surveys show that small rural hospitals tend to pay well below national norms, though they are competitive on a regional basis. “If you can recruit and retain, you are paying enough, even if you are 10 percent below the national median,” Bjork says. But if good CEOs are leaving every few years for greener pastures, or if a hospital can’t recruit top notch chief financial and chief nursing officers because of sub-par pay, a higher percentile may be justified.

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“An incentive plan should be so clear that a board member who sees it once a year can understand it on its face.”

— David Bjork

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Vague or Confusing Explanations

Boards should expect straightforward explanations and clear answers to their questions. Vague or confusing explanations are signs that there is something the board ought to dig into. An incentive plan should be so clear that a board member who sees it once a year can understand it on its face, says Bjork. "If you ever sense that management or your consultant is treating you like an amateur and not giving the board enough information, that would make me suspicious – they could be hiding something."

If a board isn't being educated about current developments in regulation of executive compensation, that itself is a "red flag" for the board, adds Lawrence.

Inappropriate Comparison Group

Make sure you are getting data from comparable organizations. The IRS expects boards to insist on getting data on like jobs, from like organizations, in like circumstances. If you're a children's hospital, define whether your peer group is other children's hospitals, or is a combination of community hospitals and children's hospitals, and explain why.

State explicitly whether you are looking at a national, regional or local peer group, and why. The IRS is beginning to suggest hospitals should use regional or local data. This makes no sense, says Bjork, since the labor market for executive talent isn't local or regional. At present almost all hospitals use national data (with the exception of California and certain large east coast cities) so they should explain why in their compensation philosophy, says Bjork.

Lawrence says looking at regional or local comparisons can be relevant. Although an organization may recruit nationally, the CEO lives locally, and regional or local patterns of compensation differ depending on cost of living and other factors.

Over-reliance on Financial Incentives

Incentive plans should include a balanced set of measures including financial performance, community benefits, strategic growth, patient access, patient satisfaction, and quality of care. The IRS has expressed reservations about too large a share of total incentives being based strictly on financial performance, says Rohan. The incentive plan should set reasonable limits in terms of incentives as well as potential impact on total compensation.

Extras Not Included

Boards should insist on getting full disclosure on all elements of executive compensation, including all perquisites and the ultimate liability for retirement benefits and severance. When determining executive compensation, boards should look at each element in the context of total compensation.

For example, Rohan says, "Let's assume an organization pays its executives total cash compensation at the upper end of the market (i.e., above the 75th percentile). Then based on current market practice, it

adds a rather aggressive supplemental executive retirement plan (SERP). This organization would need to determine if its current cash compensation plus the new SERP results in total compensation that is reasonable."

"Boards should be sure they have satisfied the IRS intermediate sanctions safe harbor, so that the IRS must prove its case, rather than vice versa."

— Lindalee Lawrence

The IRS can fine executives for being paid too much, and require repayment of any amount over fair market value or any amount not disclosed as compensation. Boards should protect executives and themselves by approving total compensation and

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seeing that it is accurately disclosed on form 990. “Make sure you have full disclosure on perquisites and all contractual terms,” says Bjork. “If you are paying for country clubs or an automobile, that should be disclosed to the board every year.”

It is essential that the IRS form 990 capture all forms of compensation, including perks such as executive expense accounts, personal use of employer-owned cars, cell phones, or home computers. Compensation committee and board decisions about total compensation levels need to match the actual payments reported on the 990. The IRS is looking closely at these forms, and underreporting compensation is a serious violation.

“If you inadvertently pay two bonuses in the same fiscal year, or if severance pay shows up on the form, that can create a problem,” says Lawrence. “Historically there have been a number of cases where the board was not aware of total compensation levels, because an executive was compensated through various subsidiaries, and this has led to regulatory problems.”

Passive Process

“We see executive compensation committees becoming much more careful and deliberate as they carry out their governance responsibilities. They’re asking senior management much tougher questions,” Rohan says.

If board members aren’t asking questions about executive compensation, or if they let the CEO dominate the discussions, be wary, says Bjork. If they don’t “quiz consultants on the reliability of their data, watch out.”

At a minimum, the compensation committee should meet twice a year, says Bjork. First, it reviews and approves incentive plan goals and measures. At the close of the fiscal year, the committee meets again to review performance against goals and determine actual incentive award levels.

Management Influence

The board or compensation committee should choose its executive compensation consultant and directly supervise his or her work. Any evidence that management is excessively involved undermines the credibility of the external advisor, our experts agree.

Management may identify a list of potential firms and draft a request for proposals, but the committee itself needs to listen to presentations, choose the consultant and direct his or her work. Management also may assist with data collection. “The IRS has also said that compensation consultants are supposed to collect all our data through the committee members, but that is almost impossible – it is not an effective use of their time,” says Bjork. “Compensation consultants need direct access to management to gather detailed information

about the hospital’s past compensation practices.”

Outside advisors should be vetted for other business they do with the organization. “If the committee advisor also has a book of business that senior management controls (e.g. an outsourcing contract), the question has to be asked – which master is the advisor serving? Is it the board/committee or senior management?” Rohan says. “Can the advisor be accused of making recommendations to the committee that he/she might not otherwise make to protect the other business?”

Board Conflicts of Interest

Ideally, members of the compensation committee should have no conflicts of interest. At a minimum, they should meet the organization’s definition of an “independent director.”

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— Jim Rohan

David Bjork, PhD
(612) 339-0919
david.bjork@clarkconsulting.com

Jim Rohan
(312) 739-2000
jimrohan@sullivancotter.com

Lindalee A. Lawrence
(781) 237-9044
lal@lawrenceassociates.com

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is published by
Bader & Associates
Governance Consultants,

12225 Seline Way
Potomac, Maryland
20854

Phone: 301-340-0903
Fax: 301-340-1345
E-mail:
bbader@GreatBoards.org
www.GreatBoards.org

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Ruzow Graphics, Inc.
www.ruzowgraphics.com

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"It is often assumed that members of the committee don't have conflicts, but when you go through a formal review process, you do discover potential conflicts," says Rohan. "This committee must be free of conflicts if the organization is to qualify for the "rebuttable presumption" available under intermediate sanctions." That will generally rule out physician board members who serve on the medical staff.

Skimpy Documentation

The compensation committee should keep detailed minutes and records. Several years ago, those minutes might be one or two pages at most; today they tend to be eight or nine pages long. "They should contain enough detail so that a reader can follow the thread of the committee's conversation and decision-making process," says Rohan.

The executive compensation committee also should receive needed data well ahead of decisions. "Getting materials at the last minute on significant issues is a definitely red flag," Rohan says.

Paying too little

Paying too little can be a problem, too. In small communities where the hospital is the largest, most complex enterprise around, the CEO may be paid more than anyone else in the board room. The local farmer, store owner, or teacher may react from a personal viewpoint and question why anyone is worth so much, experts say. On public hospital boards that are appointed or elected, executive pay may acquire political overtones. "Some boards are reluctant to pay competitively, and don't think executives could get better paying jobs. They find out," says Bjork, "when an executive leaves that they generally have to pay more to recruit a replacement."

Education and open discussion can help the board act objectively, not

emotionally. Does the hospital seek an executive from the local community, or does it recruit regionally or nationally for healthcare management professionals? If a hospital wants the best talent, it needs to establish compensation based on regional or national benchmarks.

"This can be a difficult discussion," Rohan says. "It probably takes one or two meetings for the board to come to terms with the compensation levels it needs to pay to attract top talent to its community. After appropriate education and discussion, board members generally reach consensus on appropriate pay levels. This consensus opinion requires a sensitivity to community perceptions and a public communications plan to describe how compensation is set and why executive pay is merited.