

## EXECUTIVE COMPENSATION: IS IT REASONABLE?

By Mike Conover

### THERE SEEMS TO BE NO END TO THE STORIES OF SENSATIONAL EXECUTIVE PAY PRACTICES EXPOSED IN TAX-EXEMPT ORGANIZATIONS.



Rarely is much attention given to the specifics of the organization or the qualifications required of the executive in question. The focus of the story usually rests on the paradox of “not-for-profit” versus an allegedly “outrageous” amount of compensation. As predictable as these stories might appear, they are especially disturbing during difficult economic times. And unfortunately, the stories not only taint the organization who is the subject of the article, but the entire tax-exempt community.

Not all of the bad examples spotlighted in the press are simply misunderstood organizations and the dedicated souls that manage them. There are unfortunately

some bad apples where abuse has occurred. However, there are also some unusual situations where one-of-a-kind or particularly complex organizations or highly specialized positions simply defy a simple explanation of the compensation arrangements in use. These organizations would be well-advised to pay particular attention to the practices used to govern their compensation arrangements. The remainder of this article offers some thoughts on how these organizations might address these issues.

The overriding principle in executive compensation for tax-exempt organizations is reasonableness. The term “executive compensation” used throughout this article

includes the aggregate of all pay, benefits and any perquisites offered to the organization’s policymaking executives. Reasonableness can be assessed from several perspectives, including the following:

- Compensation is set at levels and structured in a manner required to attract, engage and retain qualified personnel needed to fulfill the organization’s mission and should not enrich or inure any individual(s).
- Compensation deliberations and decision making is performed by objective and independent members of the organization’s governing body and should not involve the executive (s) in question.
- Information and/or professional advice about compensation levels and methods offered by other organizations that compete for comparable executive resources is an essential requirement for sound decision making. These decisions should not be based on unsupported hunches or flattering comparisons.
- Adequate documentation of deliberations and decisions made about executive compensation must be kept to support the rationale for compensation levels and methods. An organization should not rely on individuals’ recollections or after-the-fact expression of intentions.

The IRS Intermediate Sanctions offer a “presumption of reasonableness” to those tax-exempt organizations adopting the required practices to ensure that “reasonableness” characterizes the organization’s executive compensation practices. All organizations, especially the unusual and/or unique ones, should pay particular attention to ensure that these practices are effectively implemented and well-suited to their own unique context. Failure to do so inevitably leads to

## Executive Compensation



embarrassment or penalties when compensation practices are exposed or challenged.

The recommended practices associated with the Intermediate Sanctions are outlined in the next section of this article. We have highlighted some points that are particularly applicable to unusual and/or unique organizations. Note that while an organization may not choose to follow all the suggestions, we have noted that there is at least one required item for each of the three major practices to secure the presumption of reasonableness.

### ▶GOVERNANCE

There is a requirement that the organization rely on its independent board members (or designated committee of independent board members) to be formally charged with oversight responsibility for executive compensation arrangements. It would be difficult to overemphasize the importance of this group in an organization's efforts to comply with the Intermediate Sanctions and address the needs of an unusual organization or executive position.

The requirement for a group with the independence and freedom from conflict of interest is nearly self-evident insofar as reasonable executive compensation decision making is concerned. This body can oversee the organization's compensation practices in an objective manner to ensure decisions are made in the best interests of the organization and with complete propriety in terms of the executive(s) in question. Ideally, at least one member of the group should have experience with compensation matters and

be able to provide helpful background information on a topic under consideration or identify the need to call in outside expertise.

The unique and/or unusual situation will gain a particular benefit from members that are thoroughly familiar with the organization and/or position(s) in question. This allows members to understand, consider and decide compensation issues in the context of the organization's special issues. This is especially important for identifying relevant benchmarks for comparisons in the external marketplace that warrant consideration as comparable in some critical characteristic or competing for similar executive expertise. Knowledgeable board members can examine relevant external market data, even from sectors that are not directly comparable to the organization and/or position at hand, and use it as a context for good decision making.

A good compensation governance process would typically have many of the following types of formally adopted policy documents:

- Designation of a responsible party is required and should include the list of independent board and/or committee members currently responsible for oversight and/or governance of executive compensation.
- Formal criteria for determining the independence of the responsible party.
- Conflict of interest policy.
- Specific charter for the group and/or committee charged with responsibility for setting executive compensation

including:

- Roles and authorities for board, committee and management
- Schedule of meeting(s) for compensation matters and decision making

### ▶RELEVANT EXTERNAL INFORMATION

There is a requirement that information about methods and levels of compensation offered by other organizations competing for comparable executive resources is provided to the organization's board or committee charged with responsibility for executive compensation. The primary characteristic sought for this type of external information is that it is reasonable and relevant to the organization and position(s) in question. It need not be limited to tax-exempt organizations or just the most directly comparable organizations, though one would certainly expect them to be represented. In some cases, it might be necessary to incorporate information from multiple sources, where no one source is completely comparable to the organization in question, to arrive at an overall consensus of executive compensation in the competitive market.

The key point here, particularly for the unique and/or unusual organization, is that there must be a reasonable basis for the data selected and an explanation of its significance from the standpoint of the context of the organization's decision making. The relevance of the information needs to be established ideally, on a business need basis. As mentioned previously, knowledgeable board members can play a critical role to ensure that efforts to fulfill this requirement are as effective as possible by identifying, evaluating and determining information sources.

Relevant external information would typically include at least one (required) or more of the following sources:

- Published compensation surveys from industry groups, and trade or professional organizations that report on pay practices in organizations and/or positions accompanied by a documented explanation of their relevance addressing such questions as "Why was this particular source used?", etc.
- Form 990's from peer and/or competitor organizations and the criteria used to select them.

## Executive Compensation

- Consultant studies performed by qualified professionals to evaluate the organization's executive compensation program.

### ▶DOCUMENTATION

This final requirement involves the maintenance of a thorough and timely record of board deliberations and decisions regarding executive compensation. Of course, this documentation supplies much of the support required to demonstrate the organization's efforts to comply with the two previously described requirements. It details when, how and what has been done (as well as by whom) to arrive at the organization's executive compensation decisions.

This information documents not only the organization's efforts to promote compliance with the Intermediate Sanctions, but also serves as a means for ensuring continuity and consistency in the organization's executive compensation practices over time. With records of past deliberations and decisions and possibly other policy-related information, the organization's executive compensation practices are not redefined every time the board meets or there is a change in the membership of the responsible committee or group. Ideally, it is a clear record of the organization's efforts to ensure its compensation decisions are reasonable and that sincere efforts have been made to comply with the Intermediate Sanctions and standards of good practice.

The importance of this requirement, especially for the unique and/or unusual organization, ought to be obvious. All documentation maintained about the organization's executive compensation practices represent an excellent opportunity to detail the particulars associated with the efforts to: involve the appropriate individuals in the governance process; establish a reasonable basis for evaluating competitive practices; and the rationale for deciding the organization's executive pay practices. The more unusual the organization, the more unique the position, or the greater the compensation,

the more important it is for excellent documentation.

Examples of the types of documentation that would typically support an executive compensation program include one or more of the following:

- Minutes of meetings are required to satisfy the Intermediate Sanctions' presumption of reasonableness.
  - The minutes should be detailed and include dates, people participating in the meeting, reports and documents used, summaries of topics considered, deliberations, decisions made and the rationale for them.
  - The minutes must be prepared on a timely basis which is defined as the earlier of the next meeting date or 60 days, whichever comes first.
- Compensation policy statement or program description containing the following items:
  - Overall compensation philosophy that describes the role of compensation in the management and operation of the organization.
  - Guiding principles that govern the design and administration of the executive compensation program.
  - Calendar showing the schedule of compensation program activities and decisions (e.g. goal setting, performance evaluation, review of competitive data, salary review, etc.).

In summary, there are a couple of final points that need to be made. First, to take advantage of the Intermediate Sanction's presumption of reasonableness, each of the three broad requirements we have covered here must be addressed. Failure to satisfy any one of them puts the burden of proof back on the organization to establish that executive compensation practices are reasonable. It is not too difficult to imagine that responding to a challenge with hastily produced documentation after the fact puts an organization, especially a unique and/or unusual one, at a considerable disadvantage when trying to justify current practices even if they are subsequently found reasonable. Most would agree, it is

One might ask the following question while reviewing the overall program: "Is there anything here that might be difficult to explain to a supporter and/or sponsor of our organization?"

much better to have a well-documented program that could be readily understood by any outsider offered the opportunity to review it.

Finally, it would be a good idea for board members to familiarize themselves with the full range of compensation offered to the organization's policy making positions (e.g. salary, bonus/incentive, benefits – particularly any special retirement or deferred compensation arrangements, perquisites such as automobiles/auto allowances, first class travel, club memberships, etc.). One might ask the following question while reviewing the overall program: "Is there anything here that might be difficult to explain to a supporter and/or sponsor of our organization?" Any aspect of the organization's current compensation practice that seems unusual or out of character for the organization should be reviewed to ensure all the requirements outlined here have been met.

For more information, contact Kelli Boyle, principal, at [kboyle@nathanwechsler.com](mailto:kboyle@nathanwechsler.com)