



COMPENSATION Insight

New Challenges Create Opportunities for Compensation Committee Action

A Changing Standard

Nonprofit healthcare organizations must adjust to new challenges arising from the intense legislative and media concentration on executive compensation, and the recent release by the IRS of its *Hospitals Report*. These forces combine to suggest that executive compensation decisions of nonprofit healthcare organizations be guided in the future by a common sense approach and proper business judgment reflective of both the current economic circumstances, and increasing taxpayer concerns. A failure to respond to these challenges could expose nonprofit healthcare organizations to reputational damage, decreased community and philanthropic support, and increased regulatory scrutiny.

What's the Big Deal

The need to adjust executive compensation committee practices has emerged forcefully in the last few months. The *new federal stimulus legislation* contains a series of limitations on the compensation payable to executives of companies that receive significant federal "bailout" funds. This legislation has formally introduced into public discourse concepts previously considered too extreme to be seriously considered. Accordingly, it is not improbable that some of those concepts will have a spillover effect onto the nonprofit sector. In addition, the February 12, 2009 release by the IRS of its *Hospitals Report* provides important guidance on legally compliant compensation practices, while focusing a spotlight on the "high" compensation payable to some nonprofit hospital executives.

Opportunities for Action

1 Reassess Executive Compensation Programs Given the Current Economic Environment

The current economic environment suggests that a review of executive compensation programs and planned changes for 2009 would be prudent. Economic conditions are resulting in reduced salary increase budgets, pay freezes, and even pay reductions in selected instances. Although the greatest impact is currently felt among troubled for-profit companies, moderation in pay actions is becoming the norm in the nonprofit sector as well. Thus, it would be prudent to:

- Review compensation adjustment assumptions given current economic data.
- Carefully consider executive salary increases and bonuses when there are either poor financial results, failures in mission or community benefit, and very modest (or no) salary increases for front-line employees, or layoffs.

2 Consider Lessons of Hospitals Report

The *Hospitals Report* reveals some high amounts of compensation payable to nonprofit hospital executives, but also concludes that these amounts “appear supported under current law” (e.g., established pursuant to three-part “Rebuttable Presumption of Reasonableness” safe harbor and within the range of reasonable compensation):

- The IRS recognizes, however, the potential for “disconnect” between public perception of reasonable compensation, and what is permitted under tax law.
- The IRS has also noted that state charity officials are not bound by the “rebuttable presumption” in their examination of nonprofit executive compensation arrangements.
- In addition, the IRS expresses concern in the Report about nonprofit healthcare organizations using or relying on compensation data from for-profit companies in compensation decision-making.

3 Consider the Lessons From Troubled Companies

The executive compensation issues in troubled companies receiving federal economic stimulus dollars suggest that nonprofit healthcare organizations would be well served to:

- Ensure the design of the incentive program does not encourage inappropriate risk-taking.
- Consider the use of “clawback” provisions that allow the nonprofit healthcare organization to recover bonuses and other types of revenue-based incentive pay if financial results are restated.
- Review severance provisions for appropriateness, affordability, and term.
- Assure reasonable internal financial controls on executive and board travel and on other forms of high-profile expense reimbursement (e.g., out-of-town board retreats).
- Reconsider the value and optics of providing perquisites likely to draw disproportionate attention (e.g., spouse travel, club memberships and loans).
- Review supplemental retirement programs for appropriateness and affordability, and ensure the board understands the total liabilities the organization has in this regard.
- Examine and reconsider the use of any type of “tax gross-up” payments.

It is prudent to ensure that executive compensation components properly balance the interests of the executive, and the organization, and are appropriate for the current economic environment.

4 Employ Best Practices That Indicate Proper Business Judgement

Given these new external legislative, regulatory and media challenges, executive compensation committees will want to take steps to assure:

- The independence of both the compensation consultant and of committee members. The committee membership should have experience with executive compensation issues.
- The “apples to apples” nature of data used to compare pay levels and benefits of other organizations with those of the executives being reviewed.
- Careful review of the use of *any* market compensation data from for-profit companies in producing recommended salary ranges based on comparative data.

- The reasonableness of organizational benchmarking for each element of compensation (not just salary).
- The appropriateness, and tax reporting implications, of perquisites.
- Whether pay levels and pay increase rates throughout the organization have been compared for internal equity.
- The consistency of executive compensation decisions with the organization's compensation philosophy.
- The ease with which outsiders can understand the compensation structure and the board-led review and approval process.

Application of these standards will increase the nonprofit organization's ability to withstand regulatory and public review, as such challenges are as likely to focus on process as on the actual compensation levels paid.

5 Move Toward Greater Transparency

There is now consensus that greater transparency surrounding executive compensation strongly contributes to appropriate and defensible compensation programs. Nonprofit healthcare organizations may be well served to:

- Ensure that executive compensation is properly reported on the Form 990 and required governmental filings.
- Provide a report on executive compensation programs and levels to the full governing board on a regular basis.
- Use "tally sheets" to assist committee and board members in understanding the total current and expected cost of all economic benefits provided to each executive.
- Make use of historical and projection data to ensure adequate perspective on high cost items such as severance and supplemental retirement programs.
- Review outside income earned by executives to identify potential conflicts and ensure executives are properly focused on the organization's interests.

6 Prepare For Regulatory, Media Review

Given the intense external focus on executive compensation, the following steps may help to ensure your organization is well positioned to successfully withstand media scrutiny or regulatory review:

- Ensure the decision-making process is free of potential or actual conflicts of interest.
- Ensure that documentation (e.g., compensation philosophy, minutes, reports) is complete and thorough.
- Review expense reimbursement practices for adherence to organization policy and tax regulations.
- Document board adoption of "best governance practices" for executive compensation.

Conclusion

The prudent nonprofit healthcare organization will carefully consider its current approach to executive compensation and adjust its processes as appropriate given these new environmental challenges.

About Sullivan, Cotter and Associates, Inc.

Sullivan, Cotter and Associates, Inc. is an independent consulting firm specializing in the assessment and development of strategic total compensation programs for not-for-profit healthcare clients.

Since 1992, SullivanCotter has worked closely with not-for-profit healthcare organization boards, compensation committees and management to devise innovative compensation solutions that attract and retain leadership and physician talent and that comply with regulatory standards and best corporate governance practices.

A leader in compensation consulting and benchmarking, SullivanCotter annually conducts the most widely recognized healthcare executive, physician and on-call pay compensation surveys in the United States.

SullivanCotter has offices in Atlanta, Boston, Chicago, Dallas, Denver, Detroit, New York, Parsippany, San Francisco and Westport.

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With an over 50-year history of serving the healthcare industry, McDermott Will & Emery has one of the United States' largest and most prestigious health law departments.

McDermott was ranked in the top tier of health law practices in the United States in the most recent rankings by *Chambers USA: America's Leading Lawyers for Business*. Twenty-five of our health lawyers were also ranked individually as national experts in health law by *Chambers USA* in 2008.

McDermott Will & Emery provides advice on all aspects of executive compensation, including benefits, tax, securities, labor and litigation issues. Members of the Executive Compensation Group include former IRS officials who participated in many of the rulings and regulations affecting the executive compensation area and attorneys who have leadership positions within the bar.

McDermott Will & Emery's health lawyers are resident in the firm's Boston, Chicago, Los Angeles, Miami, Munich, New York, Rome and Washington, D.C. offices.

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