

The Brave New World of Not-for-Profit *Governance and Compensation*

By Thomas P. Flannery and Clark Bell

The Scenario

It started with a telephone call to Frank Falls, the president of our fictitious River Branch College (RBC), a small but comfortably endowed college in western Virginia. Francine Farrell, a highly regarded community leader and influential board member of RBC, was very upset as she spoke with Falls.

“I’m tired of the newspaper stories, the mudslinging and the finger-pointing about us,” she told Mr. Falls. “They say we pay you too much. They insinuate we have conflicts of interest. They say the local population feels there’s a noticeable social and financial gap between most townspeople and those associated with the College.”

Mrs. Farrell is just one of many outstanding leaders who help manage and preserve the colleges, cultural institutions and social services organizations that have always been among any community’s most prized assets. However, the responsibilities associated with board membership have increased. While it’s still an honor to serve on a college’s board, the work has become much more sophisticated and demanding.

Moreover, a series of highly publicized scandals, media exposes, government investigations and lawsuits have added new elements of risk to board service. While most of the outrageous activity involves publicly traded

companies, the backlash also has had great impact on the not-for-profit sector and increased the risk factor for those serving on boards.

In response to this scrutiny, a number of proactive boards have undertaken thorough audits of their practices and procedures. In some cases, these governance audits have sparked long overdue board changes in policies and procedures. Although Mr. Falls reminded Mrs. Farrell that the College was not the target of any government investigation nor had anyone suggested there was a pattern of board malfeasance, he agreed the time was right for RBC to embark on such an audit. After acknowledging that the media and community activists had questioned certain board policies and management decisions, he and Mrs. Farrell agreed that at its next meeting, the board would address the need for a governance audit and the parameters that could help shape reform efforts.

At the end of nearly two hours of frank and, sometimes, heated discussion, the board did agree to review, evaluate and possibly alter its governance practices. The members unanimously agreed that the board would pursue a path designed to make it more accountable to the public. A governance development committee was formed to study best practices in decision-making structure and communication that had helped other boards cope with intensified demands and challenges.

Felix Franklin, a RBC board member and a top executive of the fictitious National Dredging Corp. (NDC), was selected to chair the governance development committee. At the first meeting of the committee, Franklin told its members that NDC had learned a great deal about its own organizational and governance practices as the company worked to comply with the much discussed and often stringent governance and reporting regulations recently imposed on publicly traded companies by Sarbanes-Oxley.

Introduction

It's the way you do the things you do.

In the current turbulent environment, college boards are increasingly expected to be independent, transparent and ethically grounded enough to avoid conflicts of interest.

The turbulence arises from a "perfect storm" of factors that have put the governance practices of colleges and other not-for-profit boards under such scrutiny. These factors include:

- State attorneys general focusing on compliance with applicable not-for-profit laws;
- The seemingly runaway cost of college tuition when compared to general cost-of-living increases;
- Media and Congressional scrutiny of board governance as it impacts executive compensation packages (e.g., American University); and
- The Internal Revenue Service's ongoing probe of "the seemingly high compensation" paid to officers of tax-exempt organizations, such as college presidents

While the IRS wields the biggest stick in overseeing college fiduciary matters, a number of other critics and

watchdogs also carefully monitor the activities of not-for-profit boards. As noted above, the media, state attorneys general, state legislators, and Congress are among those keeping a close eye on colleges and other tax-exempt organizations. They are all looking for greater transparency and more accountability from those expected to manage and preserve charitable assets.

The push for accountability is perhaps even more intense in the for-profit sector where highly noted corporate disasters are said to have cost investors billions of dollars.

Compensation Committee Challenges

- Scrutiny of executive pay practices from internal and external forces
- Attracting, retaining and developing executive talent
- Fluid legal/regulatory environment
- Disclosure issues

The outcry from these scandals produced much stiffer reporting and governance regulations designed to protect the interests of investors and the public at large. Specifically, the Sarbanes-Oxley Act, which Congress passed in 2002, was crafted to thwart questionable, misleading and possibly fraudulent practices of for-profit companies.

Although many of the Sarbanes-Oxley requirements that cover accounting rules, audit reports and financial statements are not directly relevant to colleges, their board members can discover a treasure trove of good ideas by studying how companies are complying with the law.

This paper examines how college boards can benefit by utilizing applicable principles of the Sarbanes-Oxley Act to evaluate and improve their governance practices. Some of Buck Consultants' clients have used the relevant parts of Sarbanes-Oxley to develop a "best practices" strategy in such areas as board independence, composition and compensation procedures.

Board Improvement Initiatives

Although Sarbanes-Oxley is intended to enlighten the public about the financial performance of investor-owned companies, it also has created an accountability mold for not-for-profit organizations.

We fully expect that state governments will begin adopting provisions of the federal law to help define the oversight and fiduciary responsibilities of not-for-profit boards. Already, state attorneys general are using charitable trust laws to probe governance of not-for-profit organizations. The most visible battleground is in Minnesota, where the Attorney General's clamp down on wasteful spending centers on boards failing to exercise proper oversight on executive compensation, perks and other questionable business expenditures.

Consider this a wakeup call for colleges interested in avoiding legal problems, public relations nightmares and board bashing.

Jack Welch, former CEO and Board Chair of General Electric Co., is convinced that all boards need occasional prods. He believes, "the higher the voltage, the better to stop doing what they are doing and start doing what they should do. Unvarnished facts, liberally dosed with dispassionate assessment and rigorous discussion/deliberation, are the best stimulant for improving an organization's governance."

The most challenging time to begin such a process is when an organization is being prodded in this way. That's why proactive boards are not waiting for another "perfect storm" to hit before taking steps to counter potentially devastating consequences.

The truth is that Sarbanes-Oxley is more about auditing than it is about governance. And it's ironic that this 2002 law has gained more attention than the IRS' intermediate sanctions regulations, which have been in effect for not-for-profits far longer and with far more direct impact on college governance.

Nevertheless, the one-two punch of Sarbanes-Oxley and intermediate sanctions has produced a "high-voltage prod" strong enough for some college boards to take a hard look in the mirror.

A good way to gain insight into the new governance environment is to review the new rules for companies listed on the New York Stock Exchange, NASDAQ and the American Sock Exchange. The Securities and Exchange Commission approved rules outlining how boards of publicly traded companies deal with selection of members, independence, decision-making, audit and compensation.

In addition, the Panel on the Nonprofit Sector and the National Association of College and University Business Officers has issued guidance on board accountability, including how Sarbanes-Oxley can be applied to enhance governance.

We strongly advocate that every board form compensation, audit and nominating committees composed entirely of independent directors.

Compensation Committee Best Practices

The formation and behavior of the Compensation Committee of a not-for-profit's board can set the tone for the entire governance improvement process. Moreover, the responsibilities and crucial issues faced by members of the Compensation Committee make it vital that procedures are clearly defined and closely followed. In fact, the inner workings of a Compensation Committee are at the epicenter of governance process improvement efforts adopted in response to Sarbanes-Oxley.

A list of Compensation Committee Best Practices that have evolved from the Sarbanes-Oxley yardstick include:

- Forming an independent Compensation Committee that meets in executive session to approve pay packages for the CEO and other top executives. Independent board members are defined as having no affiliation with the organization and its subsidiaries. They also have no consulting, advisory or other compensatory fee arrangements with the organization, other than in the capacity as a member of the board or a board committee.
- Developing a written charter that defines the scope of Compensation Committee activities, including structure, code of conduct and compliance methodology.
- Forging an executive compensation strategy that articulates how to evaluate top management's performance. The strategic plan also should outline how the committee will report to the full board and evaluate its own performance.
- Assigning to the Compensation Committee the responsibility for all facets of executive compensation, including salary, fringe benefits,

severance agreements and supplemental retirement plans. The committee also should guide management succession planning.

- Encouraging committee members to take advantage of continuing education opportunities.
- Giving the committee the ability to directly hire and supervise outside advisors, with no interference from management.

Process Improvement

Establishing an independent Compensation Committee that understands its role in college governance is an important first step in the accountability process. But it's only the first step. Once the committee becomes comfortable with its responsibilities, the next step is to identify ways to enhance its level of performance.

Buck surveyed 50 Compensation Committees in multiple industries to determine:

- What Compensation Committees want and
- How management can help meet their needs.

The findings should provide college organizations with food for thought. For example, the surveyed Compensation Committee members reported sometimes feeling constrained by an annual calendar of events. At about the same time each year, they deal with salary increases, target bonuses, performance goals, bonus payments and other standard fare. That routine prompts the committee to make decisions on how to deal with unanticipated challenges partly based on when they surface.

Compensation Committee Priorities

- Having board members with proper skill sets assigned to the committee
- Working independently of management and avoiding conflicts of interest
- Developing understanding of best practices
- Being provided with continuing education opportunities to build knowledge base of members
- Accessing relevant data and analysis
- Being able to retain independent consultants
- Having a mechanism to assess its governance and decision-making process

Buck suggests that in the future, Compensation Committees should more proactively manage their calendars in addressing areas requiring attention. In addition, committees should strive to evaluate ways to improve their flexibility, effectiveness and efficiency.

Other methods of improving the Compensation Committee process are to retrospectively study the impact of its decisions and make sure meeting minutes sufficiently minimize the liability risk of the directors.

If a Compensation Committee is to perform optimally and meet compliance requirements, it must have relevant and accurate data.

The organization has a duty to provide the Compensation Committee with the data and analysis necessary to make consistent, defensible decisions.

New York Attorney General Eliot Spitzer has been at the forefront of the accountability movement. In addition to his widely heralded investigations of corporate fraud, Spitzer is an aggressive watchdog of not-for-profit

boards. In a booklet released by his office entitled "Internal Controls and Financial Accountability for Not-for-Profit Boards," Spitzer said it is essential that the organization maintain useful electronic data. The effort to achieve accountability in governance is dependent on "preserving electronic records and ensuring data compatibility when systems change."

The Compensation Committee's acceptance of best practices and access to useful data and analysis can safeguard its ability to make reasonable decisions about executive compensation. Generally, reasonable compensation is defined as what similar persons with similar duties at similar organizations are paid.

The Council on Foundations suggests the best way for boards to avoid IRS challenges to compensation decisions is by conforming to the federal government's Rebuttable Presumption Rules. To take advantage of the defense provided by the Rebuttable Presumption Rules, boards must:

- Secure approval by all board members who have no conflict of interest with respect to the terms of the compensation arrangement. Members with potential conflicts should recuse themselves from voting.
- Demonstrate their reliance on comparable data.
- Provide documentation that explains the basis for compensation arrangements.

A college is more likely to satisfy the requirements if its Compensation Committee consists of independent, knowledgeable board members who understand the process and are able to work in harmony with reputable, seasoned consultants who can provide the committee with balanced reliable, relevant information for their due diligence.

Let The Sunshine In

In today's supercharged environment, the public is demanding more information on the inner workings of not-for-profit organizations.

For example, a special Independent Sector panel recently recommended stricter federal oversight of charitable organizations and harsher penalties against individuals who misrepresent information on not-for-profits' Form 990 filings. It also recommended that audited financial reports should be submitted with Form 990s. This panel, formed at the suggestion of the Senate Finance Committee, which is closely monitoring its findings, represents not-for-profits, foundations and philanthropies.

While no clear-cut method exists for defining the proper level of transparency in executive compensation decisions, college boards may want to consider:

- Developing a report that summarizes the goals and philosophy that guide the decisions made by the Compensation Committee;
- Disclosing more information about executive compensation strategies in the annual IRS Form 990; and
- Arranging briefing sessions with selected media and advocacy group members who take a deep interest in the governance of colleges and other high-profile not-for-profit organizations.

Some Final Thoughts

The aftermath of the "perfect storm" will forever linger

Eliot Spitzer firmly believes that preventive measures are the best safeguard against abuse when he says, "Periodic review of an organization's structure,

procedures and programs will assist board members in determining what is working well and what practices the organization might want to change in order to be more efficient, effective or responsible."

The New York Attorney General pulls no punches in insisting that not-for-profit board members must understand and fulfill their fiduciary responsibilities. Failure to meet those obligations, Spitzer says, can "result in financial and other liability for the board of directors and the officers."

Colleges such as our fictitious RBC acted on the smoldering concerns of Francine Farrell and other members to refine its governance structure. The board decided that some board practices merit updating, others needed a tune-up and a few required a major overhaul.

No matter what the condition of your organization's governance performance, the best practices and other internal controls discussed in this paper can help strengthen overall board performance especially when dealing with sensitive compensation issues.

It's all about having the right set of board members agreeing on the right kind of compensation philosophy and then evaluating the right kind of information before making the right kind of decisions.

Board governance is not a static process. To keep pace with change and to instill a spirit of continuous improvement in the quality of governance, the Compensation Committee should periodically review its results, evaluate its structure and identify areas needing improvement.

None of the recommendations suggested in this paper are overwhelmingly difficult to achieve. However, the level of success will correspond to the commitment, leadership and effort of the board members implementing them.

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