

Walking the Walk and Talking the Talk on Executive Compensation

By Thomas P. Flannery

A CAUTIONARY TALE*

Nowadays, many believe that Panelvale Hospital in Erehwon, a 300-bed not-for-profit facility and the area's largest employer, has gotten itself into a real hole. At one time, though, it commanded the high ground. A decade ago, the medical profession and the community hailed its new state-of-the-art pediatrics unit. Erehwon had generously supported the hospital for years as it, in turn, had served the community. For instance, once a year, the hospital provided free blood pressure, diabetes and cholesterol screening to anyone over 40 who requested it. The uninsured were always treated in its emergency room and its labor and management relations were a textbook case of harmony.

That was all before double-digit medical inflation returned for an extended stay, before Medicare cutbacks, before nurses threatened a walkout after working for a year without a contract and before a 10 percent staff layoff with rumors of more to come. It was also before Dr. Brian G. Britany took over as Panelvale's new CEO.

A reporter from The Metro Times phoned Mr. Mark Down, chairman of Panelvale's Board of Trustees, for a comment on the progress — or lack thereof — of the contract talks between the hospital and the nurses' union. Down was about to refer her to the Media Relations department per established procedure when she said, "I guess the union shouldn't expect the same level of cooperation that Dr. Britany received when the board considered his compensation package?"

At first Down said nothing but then concluded he was obliged to set the record straight. "The hospital has had a difficult few years financially and we were lucky to get Dr. Britany. His willingness to make some very difficult decisions has helped the hospital get better control of its expenses. Therefore, I think any attempt to compare our efforts in coming to an understanding with Dr. Britany and with the nurses' union does a disservice to the hospital,

its patients and our community. We know we can count on our nurses to act like professionals for the good of the patients."

The reporter's article ran in the following day's paper under the headline, Panelvale's Double Standard for Compensation. It used Down's quotes to imply that he thought any comparisons between the trustees' salary negotiations with Dr. Britany and the hospital's ongoing attempts to reach an agreement with the nurses were unfair. The article then valued Dr. Britany's total compensation for his three-year contract at more than \$3 million and reminded readers that nurses had been working without a contract for a year with no new talks currently scheduled.

WHAT'S WRONG WITH THIS PICTURE?

How did this happen? Why do comments like Mr. Down's manage to create so much unfavorable publicity?

The short answer is, such comments — and the controversies they cause — sell papers. Those comments are presented as "evidence" of financial favoritism, greed, abuse of power or all three. Reporters look for such evidence to tell a controversial story.

The fuller answer tells us why executive compensation is such a big news issue. Those rank and file employees and investors who read newspapers or listen to news programs and talk shows are inclined to contrast the greed and alleged crimes of C-suite executives with the "jobless" recovery and their experience of decreasing or stagnating real income over the last 15 years. This contrast tends to make some stakeholders suspicious of the compensation of all CEOs, even high performing ones, if the earnings per share (EPS) number is not continually on the rise.

When it comes to not-for-profit hospital trustees and executives, the factors mentioned above apply, and then some. It's true that, unlike for-profit enterprises, not-for-profits have no investors to satisfy with ever more impressive quarterly earnings reports.

**This is a fictionalized account designed to illustrate the issues presented herein.*

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However, they do have sponsors and communities who expect a very different kind of "ROI" for their voluntary financial support. The return these sponsors and communities expect is an ongoing assurance that the trustees and senior executives are not "in it primarily for the money." When trustees and executives oversee and manage the hospital in a way that leads sponsors and communities to conclude otherwise, look out.

This paper looks at the trustees' responsibility for setting the CEO's compensation and for avoiding any conflicts of interest that would compromise their ability to carry out that responsibility. It also looks at how a not-for-profit hospital CEO and trustees should communicate responses to a reporter's questions about compensation and what the media relations department can do to facilitate that exchange.

IN SPRING, A REPORTER TURNS TO THOUGHTS OF...

Executive compensation! By mid May many not-for-profit hospitals have filed their Form 990 with the IRS. Among other things, these filings should disclose all forms of compensation for the five employees with the highest compensation over \$50,000. For instance, the hospital that provides the CEO with a car or car allowance should include the value of such items in its Form 990 filing. Sometimes, such a value is included; sometimes it's not.

In any case, hospital trustees and executives should prepare for questions about their CEO's compensation package from reporters. Before the interview, reporters may consult all Form 990s the hospital has filed in the past for general information and compensation trends. Even so, they certainly will have specific questions on the current year's compensation. But these cannot be answered by consulting Form 990s already filed. Why? Because no Form 990 is available for public inspection until two years after it has been filed.

Executive compensation packages can be very complicated. After all, when these plans need the investigative services of a forensic compensation expert to explain, after the fact, why executive X got so much money under the terms of the plan, that's complicated — probably too complicated for many trustees, or anyone else, to comprehend on their own.

Regardless of the packages' complexity, at a minimum, reporters may ask trustees if they voted for the CEO's most recent compensation package and how the hospital can justify such levels

of executive pay when many Americans face a crisis of rapidly increasing healthcare costs and decreasing coverage. If their responses are complete but succinct, confident but not misleading or defensive and, most of all, honest and informed, the resulting news story is far more likely to be a balanced treatment of a complicated issue.

SETTING CEO COMPENSATION WHILE AVOIDING CONFLICTS OF INTEREST

The board of trustees is responsible for setting the compensation package of the hospital's CEO. Even if the board has a compensation committee, the entire board typically makes the final decision about the amount and terms of the package. In setting compensation, the board considers the CEO's performance in previous and/or current positions as well as the salary scales and fringe benefits of other similarly situated executives.

The public, specifically the hospital's donors, those who use its services and the community at large, will want to know the total amount of the CEO's compensation. In fact, many states require that the compensation for CEOs of not-for-profits be public information.

A trustee's responsibility to set the CEO's compensation is really twofold: to decide on the "right" package and to do so unaffected by conflicts of interest. The second part may be easier said than done. Particularly, when one considers that:

- Trustees have the sole authority to decide the CEO's compensation package.
- Many trustees have business investments or other financial interests that could position them to benefit financially from a business relationship with the hospital.
- From time-to-time any CEO may have a say in deciding which organizations will do business with the hospital.

This combination of factors could create a conflict of interest between a trustee's responsibility to always act in the best interests of the hospital in all matters — including decisions about the CEO's compensation — and his or her personal financial interests.

Clearly, a trustee on the hospital's board may own a business or benefit financially from it when the business has a relationship with the hospital. However, before such an entity enters into a business

relationship with the hospital, the board member must consider the potential conflict of interest.

Because it may look questionable to the public and may result in tax penalties (see Intermediate Sanctions for Tax-Exempt Organizations on page 4), the board member should be cautious about entering into such a relationship and the entire board should be very cautious about allowing it to proceed. Such a transaction should not occur unless the board determines it is clearly in the hospital's best interest.

Prior to the board vote, the board member should fully disclose any personal financial interest to the entire board, and the board member with the financial interest should not vote on any aspect of the arrangement or be present when it is being discussed or voted upon. Because of the sensitivity of conflict-of-interest issues, boards may want to require that transactions involving these issues receive a greater-than-simple approval majority. For instance, some boards — which may have anywhere from 10 to 50 members — are adopting a two-thirds approval majority requirement on conflict-of-interest issues.

The board should have a policy for dealing with potential conflicts of interest. It should include a requirement that all board members disclose in writing any business involvement they have with the hospital and any other board memberships they maintain. The disclosure should be circulated to all board members and updated as necessary.

The policy should also address board members' investment holdings. It should outline procedures for dealing with situations in which board members acquire investments that may affect or be affected by the hospital's investment decisions.

It may be advisable to obtain an outside compensation expert's evaluation of any major business transaction proposed between the hospital and a trustee or an entity in which a trustee has an interest. This evaluation assures that the proposal is feasible, the terms are favorable to the hospital and the potential pitfalls of such a transaction have been considered.

The policy can require each board member to disclose annually to the entire board the total amount the trustee received as a vendor of goods or for services rendered from the hospital during the previous year.

YOU'RE ON!

Following up on our cautionary tale, Dr. Brittany, Panelvale's CEO, has just signed his second three-year contract that is valued at up to \$3 million, including bonuses. Although Mark Down is chairman of Panelvale's Board of Trustees, you, as the newly appointed Chairman of the Board's Compensation Committee, are the trustee who played a leading role in determining the contract provisions. Also, as a principal in an investment management firm that manages the hospital's \$100 million endowment, you recently disclosed your 10-year business relationship in a written statement to the board as required by policy.

You're waiting in your office for the reporter's 10:00 a.m. call. She's new at The Metro Times, but has written a series of generally thorough and balanced articles on executive compensation for another newspaper. However, this is her first article that will feature a not-for-profit hospital and this is your first interview on the subject of executive compensation. You've prepared yourself to seize opportunities to use the "do" list to the right. You've also learned all the don'ts. Nevertheless, it's already 10:10 a.m. and you're getting a little edgy. While you wait, you go through the lists one more time.

DO:

1. Prepare for the reporter's worst questions with three positive points you want to make.
2. Practice what you want to say. And remember, talking to a reporter is an opportunity to tell a positive story.
3. Organize your ideas step-by-step, from:
 - general to specific or specific to general,
 - positive to negative or
 - most important to least important.
4. Personalize your information and make it easy to understand. Use:
 - natural expressions and common words so that everyone can understand,
 - popular expressions to illustrate your points,
 - numbers in interesting ways, and
 - charts and videotapes.

5. Stop talking after you've answered a "yes" or "no" question. Elaborate, but keep your response brief and to the point. Don't worry if there is silence. It isn't your job to fill it up.
6. If you must use technical terms or acronyms, explain what they mean.
7. Say "I don't know." If you don't know an answer, refer the reporter to someone who does know the answer or offer to find out who does. If you do know the answer, but are unable to provide it during the interview, tell the reporter when you can give an answer.

DON'T:

1. Talk to a reporter without doing your homework.
2. Say anything to a reporter you don't want to see on TV or in print – nothing is "off the record."
3. Respond with, "No comment." To most people, "No comment" means guilty or that their worst suspicions are justified. If you can't answer a question, say: "That's not the critical issue, this is" Or, "That's currently part of a law suit. Our policy is not to discuss ongoing litigation" Or, "We'll have an announcement about that later this week."
4. Answer hypothetical questions or speculate.
5. Comment on what others have said, particularly if you haven't seen it in writing or heard it.
6. Let the reporter put words in your mouth. If the reporter uses inaccurate facts when asking a question, correct the error.

TYPICAL QUESTIONS POSED BY TRUSTEES

- If we have a compensation committee, do we need to inform our entire board about the executive compensation program?
- Our executives are uncomfortable about their compensation being reported in the media; what should we do?
- Our financial results are awful, but our CEO is doing a great job. How do we justify a "pay for performance" linkage to the press?
- We are a religious organization; will we be criticized for how much we pay our executives?
- Our board is split about the executive compensation issue. What happens if we receive a call from the press?

- Our CEO was terminated. Reporters are asking about the severance package and how much the new CEO will be paid. What should we do?

YOU'RE NOT IN THIS ALONE – THE MEDIA RELATIONS DEPARTMENT'S ROLE

The hospital's Media Relations department should play a significant role in developing and maintaining mutually beneficial relations between the hospital's trustees and executives and the media.

CONCLUSION

The sidebar on this page lists sample questions for those trustees who find themselves in some situations you might recognize. Although black and white answers to these and other such questions are rare, the guidance provided in this article strongly suggests the an effective course of action.

P.S.

When the reporter from The Metro Times arrived 20 minutes late for the half-hour interview, you were ready for her. As directed, you had prepared three positive points in response to what you thought might be her "worst" questions. As it happens, she asked two of them. First, she wanted a comment about the 20-percent increase in the total value of Dr. Brittany's new contract over his previous contract. Second, she inquired about any possible business relationship — past, present or future — between your investment management firm and the hospital. In each case, she was nodding in agreement to your comments and was ready to move on to the next question before you finished your second point.

INTERMEDIATE SANCTIONS FOR TAX-EXEMPT ORGANIZATIONS

Section 4958 of the Internal Revenue Code allows the IRS to impose financial penalties on managers of tax-exempt organizations, such as not-for-profit hospitals, that engage in excess benefit transactions. The applicable regulations are called Intermediate Sanctions and apply to excess benefit transactions made after September 14, 1995. A manager is an officer, director, trustee or individual having the power or responsibility similar to those of an officer, director, or trustee regardless of title.

An excess benefit transaction occurs when a not-for-profit organization provides an economic benefit to a disqualified person that exceeds the value of that person's services. The excess benefit

is the difference between the value of what the organization receives and the value of what's been given to the disqualified person. An excess benefit transaction can occur when the disqualified person's compensation is considered above fair market value or is unreasonable. A disqualified person is an executive officer, board member, a family member of a disqualified person or a 35-percent controlled entity who can exercise substantial influence over the organization at any time during the five-year period ending on the date of the transaction.

As they determine fair market value and reasonableness of compensation, those managers setting the CEO's compensation may assert that the total amount is reasonable if their decisions regarding it meet the following three criteria:

1. An authorized body of the organization (e.g., board of directors or board of trustees) composed of individuals without a conflict of interest approved it. A conflict of interest would exist if the member of the authorized body is related to, has an employment relationship subject to control by, or receives compensation subject to the approval of the disqualified person. One would also exist if the member benefited economically from the CEO's compensation package.
2. The Board relied on competitive compensation data to determine appropriate CEO pay levels including CEO compensation levels from other health care institutions (not-for-profit or otherwise), current compensation surveys by independent firms and actual written offers of compensation from similar organizations made to the CEO.
3. The Board should adequately document the process for approving the compensation. Adequate documentation includes:
 - Terms and approval date of the compensation package, the names of those authorized persons who approved it as well as the actions of those with a conflict of interest;
 - Competitive compensation data used and how it was obtained; and
 - Explanation of why the compensation levels approved may be higher or lower than the competitive data.

What Compensation Elements Are Included?

- Salary, fees and bonuses
- Severance payments and deferred and non-cash compensation at the time it vests or when it is no longer subject to a substantial risk of forfeiture
- All other benefits (whether or not they are included in the gross income for income tax purposes) including:
 - Payments to medical welfare benefit plans (e.g., medical, dental, life insurance)
 - Expense allowances (except for an accountable plan)
 - Fringe benefits (except some nontaxable fringe benefits)
 - Economic benefit of a below-market loan

Penalties Imposed by IRC Section 4958

The disqualified person must repay the excess benefit plus interest. In addition, there are two tiers of excise taxes. The first equals 25 percent of the amount of the excess benefit (e.g., the amount above the fair market value). If the excess benefit transaction is not corrected, a second tax of 200 percent of the excess portion may be imposed on the disqualified person. Once the IRS mails the notice of deficiency for the 200 percent tax, the disqualified person has 90 days to correct the transaction before the 200 percent tax is imposed.

Any organization managers who approve a transaction they know constitutes an excess benefit are also subject to a penalty of up to 10 percent of the excess portion of the excess benefit (up to \$10,000 per transaction). If the disqualified person is also an organization manager, the 25, 200 and 10 percent taxes could be imposed.

Intermediate Sanctions do not apply to a fixed payment made to a disqualified person under an initial contract; that is, a binding written contract between the organization and a person who did not become a disqualified person until after entering into the contract. A fixed payment is the amount of cash or property specified in the contract or determined by a fixed formula (e.g., a base salary of \$200,000), but a discretionary bonus up to \$100,000 determined by the board is not a fixed payment. If the organization changes the contract without the consent of the disqualified person, Intermediate Sanctions would apply to any new contract.

If organization managers rely on a reasoned written opinion from an appropriate professional (i.e., legal counsel, certified public

accounting firms with expertise in relevant tax matters, independent valuation experts who meet specified requirements), their participation in the excess benefit transaction will not be considered “knowing” and therefore, they are not subject to the excise tax.

COMPLIANCE CONSIDERATIONS

We recommend that tax-exempt organizations take the following six action steps:

- 1. Identify all disqualified persons and organization managers for the not-for-profit and set up a system for independent review of compensation and performance.

- 2. Form and educate an independent compensation committee of the board of directors.
- 3. Review or develop the organization’s Conflict of Interest policy.
- 4. Determine competitive remuneration levels for all disqualified persons through an independent compensation consulting firm.
- 5. Document process and rationale for determining competitive compensation and recommended compensation levels.
- 6. Review and update competitive compensation biannually or when appropriate (e.g., new employment contract).

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