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EXECUTIVE COMPENSATION: REWARDING EXCELLENCE AND ENSURING GOVERNANCE

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Executive compensation governance is a major challenge for both profit and nonprofit organizations. Organizations are changing executive compensation advisors, and board members are either learning more about the executive compensation programs they are asked to approve or running the risk of incurring potential liability and embarrassment. Board directors fear the effects of egregious examples of arguably deficient governance as provided recently by the New York Stock Exchange as well as the Walt Disney Corporation.

The board is a critical group for making executive compensation a "win" for their customers, the community, investors, contributors, employees and executives. Organizations that honestly pay for performance outperform those that don't, and this serves to strengthen the business case for implementing a high-performance executive reward solution.

The business case for reasonable compensation and rewarding performance has been strengthened by corporate governance regulations in the for-profit sector (Sarbanes Oxley as well as SEC and NYSE rules) as well as by excise tax penalties that apply to tax-exempt organizations. The consequences in terms of liability and embarrassment are powerful arguments for good executive compensation practices. If good governance and resource management were not enough reason for boards and CEOs to accelerate the journey to becoming a high-performance organization, federal and state regulations are.

CONSEQUENCES OF POOR EXECUTIVE COMPENSATION GOVERNANCE

Clearly, each board member owes a fiduciary duty to ensure that officers and directors are not excessively compensated. Due to the increased scrutiny from federal and state regulators, it is critical that the "compensation paid" rewards executives based on established and clearly documented performance-based metrics.

Some of the realities that are impacting board members and make it difficult to obtain and retain quality board members include:

- Board members of many tax-exempt organizations face potentially significant personal liability if they fail to apply effective governance of executive compensation arrangements.

- Board members, especially those board members charged with determining compensation, must possess sufficient knowledge of executive compensation so that they can make educated decisions relative to compensation reasonableness. "I did not understand" is not an effective defense.

- Additionally, for-profit shareholder litigation appears to be succeeding in driving executives to personally pay money in order to settle shareholder litigation despite the likely presence of indemnification provisions and D&O insurance.

REASONS FOR PAYING FOR PERFORMANCE

Organizations that pay for performance consistently outperform those that pay only for service. So the business case for creating a high-performance culture is powerful. The reasons for paying for performance, in addition to complying with federal and state regulations, are to:

- **Reinforce the organization's mission, vision and concrete goals.** Organizations need a clearly defined mission and vision that translates into concrete goals for measuring executive performance. The test of the viability of the organization's strategy is the board's ability to translate it into performance metrics for executive compensation.

- **Align the executive's success with the organization's success.** High-performance organizations recognize and reward success. As the organization achieves goals, the executive team should be rewarded. Executives should be paid more in years when the organization meets or exceeds goals than in years when goals are missed.

- **Attract and retain executive talent that performs.** Executives who are willing to have their performance evaluated by the board will seek organizations that reward performance. Boards that are interested in executive compensation programs that reward performance will establish executive compensation strategies and then seek executives who fit the model of helping create and sustain a performance culture.

- **Provide a way to discuss the organization's goals and progress in achieving these goals.** Performance management is a key tool for communication when it is associated with a viable program of paying for performance. The board's role is to coach and facilitate executive performance through periodic and objective performance reviews.

PROTECTING BOARDS AND ORGANIZATIONS

Effective governance is clearly the answer to resolving the pay-for-performance challenge. Following a normal business-focused process—one in which compensation varies with the performance of the organization based on concrete and pre-established metrics—is the only way boards can add value to the organization and protect it and themselves from embarrassment. At a minimum, the process should include the following:

- Select the metrics of organizational performance that best reflect the responsibilities of the executive team for the success and future of the organization.

- Evaluate the performance of the executive based on these clearly established metrics of organizational performance.

- Develop executive rewards that compensate performance based on transparent and predetermined goals. In some cases, the board must stick to these preestablished goals in order to avoid excise tax penalties.

- Include regular reviews of the compensation arrangement in order to avoid excess-benefit transactions and unreasonable compensation.

- Carefully review the compensation arrangement with all board members outside of the committee charged with forming the compensation package. While a committee may be able to establish a safe harbor regarding compensation reasonableness, each board member must be brought up-to-speed as to why executives are being paid what they are being paid.

- Ensure compensation reasonableness by using data sources that the IRS likely will accept as appropriate and include unbiased measures of competitive compensation.

- Document the compensation decision-making process, including the compensation data sources used in arriving at the decision. Make sure that the board members making the decision, as well as any compensation consultants involved in the decision, are independent of the executive whose compensation is being decided.

The issue of defining the compensation opportunity is an objective one. It is the platform for paying for executive performance and provides the baseline from which executive compensation is established. Each board or designated committee should, at the very least, measure compensation reasonableness as follows:

- Define the competitive market and the market value of the job using a source of information that does not create a conflict of interest and is completely independent of bias or conflict toward the organization's management and auditors of the organization.

- Consistently apply the compensation data from the independent source to determine the competitive worth of the executive jobs in question. Make compensation decisions based on unbiased data that can be defended to state and federal regulators in the event that the compensation arrangement is questioned.

- Utilize an independent advisor to recommend compensation levels, and systematically follow such recommendations.

Here are some questions that IRS agents are trained to ask regarding examinations of 501(c)(3) compensation comparability data, but this can also be used as a checklist for board members:

- Were the executive compensation recommendations provided by a reputable firm with knowledge and expertise in the same industry as the applicable organization?

- Was this firm independent of both the organization and the executives whose compensation is in question?

- Does information used cover the period during which executive compensation was determined?

- Are the organizations surveyed comparable to the organization using the data?

- Are the jobs in the surveys comparable?

CONCLUSIONS AND SUGGESTIONS

Boards should establish executive compensation programs that provide reasonable and competitive rewards based upon executive performance. Where does your executive compensation program stand when placed under the spotlight of federal and state regulations?

Corporate governance is an important issue. Executives and boards should diagnose their organization's liability and vulnerability relative to pay-for-performance. The timing may be right to review all executive compensation practices as early as practicable this year.

LET'S NOT FORGET THE NEEDS OF NON-PROFITS

When we talk about governance, we cannot forget the responsibility of nonprofit board members

Each board member owes a fiduciary duty to establish compensation arrangements that do not excessively compensate officers and directors. In addition to federal oversight from IRS regulation on intermediate sanctions, state attorney generals directly regulate excessive compensation within charitable organizations, and these state regulators are becoming more active in their enforcement. It is critical that the compensation paid is reasonable in competitiveness, and rewards executives based on identifiable and clearly established performance-based metrics.

Here is what regulation means to nonprofit board members and executives:

- The board members of applicable 501 (c)(3) and 501 (c)(4) organizations face potentially significant personal monetary liability if they fail to effectively govern executive compensation arrangements.
- Key executives face personal liability in terms of the return of any excess benefit to their organization as well as potential excise tax penalties.
- Nonprofit boards must also be cognizant that inurement can threaten the organization's tax-exempt status. Incentive plans should be designed to be reasonable and must include a "cap" or maximum award.

They should be a goal-based plan that awards achievement based on clearly established goals (operational, customer, financial) as opposed to more questionable revenue-sharing plans.

Nonprofits may find ERI's software helpful when establishing compensation. ERI has developed an interactive software program that analyzes compensation paid to executives of tax-exempt organizations based on Form 990, Form 990EZ and Form 990PF data.

For more information on how nonprofits can access ERI Compensation Comparables Assessor™ & Tax-Exempt Survey, visit www.erieri.com.

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