

Director Compensation Plans: Time to “Kick the Tires”

BY MICHAEL W. PEREGRINE & RALPH E. DEJONG, MCDERMOTT WILL & EMERY, LLC, & TIMOTHY J. COTTER, SULLIVAN, COTTER AND ASSOCIATES, INC.



Despite what you may have heard recently, director compensation plans remain a valuable non-profit governance tool in most states. Nevertheless, recent related controversies offer non-profit boards a useful opportunity to “kick the tires” of existing and proposed director compensation plans to ensure their legal and “optical” feasibility. This is especially the case in today’s challenging economic environment where regulators are increasingly sensitive to constituent concerns with respect to perceived excessive compensation and self-dealing.

IN THIS REGARD, IT SHOULD BE noted that the laws of roughly one-third of the states specifically authorize the payment of reasonable compensation to directors of non-profit corporations, and roughly one-third of the states are silent on the issue, with the remaining one-third prohibiting the practice in one form or another. In addition, the prestigious Panel on the Nonprofit Sector, in its highly regarded 2007 *Principles of Good Governance and Ethical Practice*, specifically acknowledge that non-profit corporations may wish to compensate directors, and provide a series of recommended guidelines by which the practice can be properly structured and monitored. So, while it is fair to say that non-profit director compensation is not a universally accepted governance practice, it cannot be said that the practice is *per se* inconsistent with non-profit law or best practice.

The current “hubhub” emanates from Massachusetts, where Attorney General Martha Coakley has challenged the director compensation programs of the four major non-profit, charitable health insurance companies operating in the state. Following an extensive investigation, the attorney general issued a report in mid-April concluding that the practice of compensating independent directors “departs from the charitable industry and judicially recognized norm and creates unavoidable conflicts of interest.” Notably, the attorney general’s opposition was not based on concerns with excessive compensation—the reasonableness of the compensation plans was not questioned. Rather, the opposition was based on the lack of a *compelling rationale* for the compensation. According to the report, non-profit charities should only undertake a director compensation practice if it’s supported by “sound and convincing rationale.” Indeed, the report

concluded that the rationales provided by the health insurers for their director compensation plans were “unsupportable.” One of the arguments made by Coakley is that most of the other non-profit charities in the region do not compensate their directors, even though they face the similar challenges as described in the health insurance companies’ rationale. According to Governance Institute research, director compensation rates have hovered around 10 percent of non-profit hospitals nationwide since 2005.¹

What is particularly significant is that the rationales submitted by the health insurers and found wanting of the attorney general included most of the rationales typically adopted by non-profit hospitals and health systems to support their own director compensation plans. Those rationales include the following: a complex and highly regulated industry; extraordinary time demands on board members; directors provide services for which the organization otherwise would have to pay; and compensation is required to attract high-quality directors in a “seller’s market” for director services.

Coakley seeks to subject the practice of director compensation to regulatory oversight by requiring attorney general approval. Indeed, as of this writing, she is pursuing legislation that would prohibit all public charities from paying director compensation without her approval. However, the report does not suggest what type of rationale would be needed before the attorney general would approve a director compensation plan. In response, two of the Massachusetts plans so far have agreed to suspend their director compensation plans consistent with the attorney general’s position. Yet, to date there has been no apparent spillover of Coakley’s position in other states. That should

be small comfort for non-profit providers or health plans in other states that are or may be considering a director compensation plan.

Indeed, the “smart play” for those organizations is to review their own director compensation plans in light of the Coakley report. Given the core of Attorney General Coakley’s challenge, the central focus of such a review should be to examine and rearticulate the rationales for the board’s compensation plan. Every effort must be made to ensure that the compensation plan rationales are clear and compelling, and that they can be distinguished from those found wanting in Massachusetts. It would be unwise to assume that a compensation plan rationale considered insufficient in Massachusetts will be found to be persuasive by charity officials and attorneys general in other states. Beyond the rationales for the board compensation plan, other review topics would logically include, but would not be limited to:

- The current position of state non-profit law and the state’s attorney general
- How conflicts of interest are avoided in the board’s approval of the compensation program, and how the review and approval process can be structured so as to qualify for the “rebuttable presumption of reasonableness” under the federal tax law intermediate sanctions rules
- Empirical evidence as to how the program has contributed to more effective governance (e.g., though improved director recruitment and retention)
- The specific services that are being compensated
- Methodology for determining the appropriate level of compensation
- Independent oversight of the compensation program
- Public/constituent perceptions of the program

In this regard, it is important to acknowledge the types of benefits that many non-profit

1 Biennial Surveys of Hospitals and Healthcare Systems, The Governance Institute (2005, 2007, 2009).

hospitals and health systems perceive as arising from director compensation plans:

- Directly impacts the organization's ability to recruit the type of board members it requires as necessary or as the most desirable candidates:
 - » The best candidates typically are very busy in their "regular jobs," while the required time commitment for effective board and committee service, in most organizations, has increased significantly.
 - » Candidates for board service also have to wrestle with potential reputation-related and financial risk issues associated with not-for-profit healthcare board service.
- Provides tangible recognition and rewards for the valuable contributions made by

competent board members, for which the organization would otherwise have to pay.

- Encourages better attendance and higher levels of participation at board and committee meetings.
- Supports high-performance expectations.
- Reinforces accountability.
- Focuses the attention of busy individuals on their governance obligations and responsibilities.
- Focuses boards more heavily on new member recruitment and selection.

In many states, director compensation is a recognized non-profit sector practice that provides tangible recognition and rewards for the valuable contributions made by highly competent board members. Yet, this position

is not universally held among important constituencies (e.g., the media, certain public policy groups, and, potentially, state charity regulators). The recent Massachusetts controversy does not jeopardize the legality of all such non-profit plans, but it does send a signal as to the legal and policy concerns that should be addressed by non-profit boards that maintain or are considering establishing such programs. ●

The Governance Institute thanks Michael W. Peregrine, partner, and Ralph E. DeJong, partner, of McDermott Will & Emery, LLC and Timothy J. Cotter, managing director, of Sullivan, Cotter and Associates, Inc. for contributing this article. They can be reached at mperegrine@mwe.com, rdejong@mwe.com, and timcotter@sullivancotter.com.