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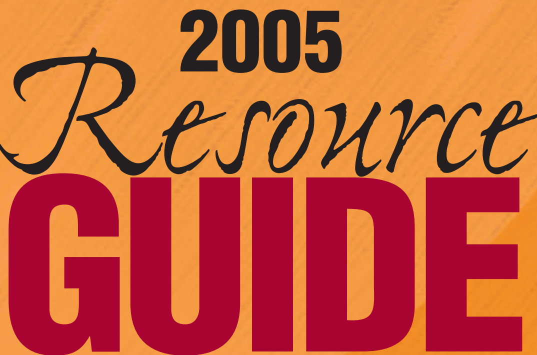

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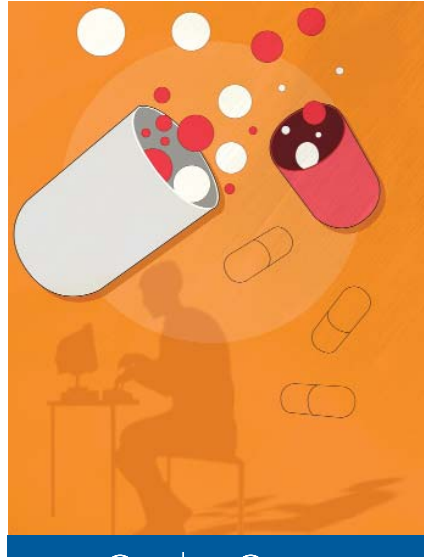

On the Cover

For more than a decade, the Food and Drug Administration has recognized the expanded use of computerized systems by the various industries that the agency regulates. The article, "FDA Considerations Related to Maintaining Clinical Trial Records in Electronic Form," written by Neil F. O'Flaherty and Pamela J. Furman, Olsson Frank and Weeda PC, Washington, DC, provides an in-depth discussion of the various considerations pertaining to the establishment and maintenance of electronic clinical trial records.

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Update on Executive "Comp": What the Regulators—And Boards—Are Focusing On

By Michael W. Peregrine and Ralph E. DeJong, McDermott Will & Emery LLP
and Timothy J. Cotter, Sullivan, Cotter & Associates
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The early returns are in, "exit polls" are being validated, and specific trends are becoming clear. After several months of uncertainty, clarity is emerging as to which non-profit executive compensation practices are attracting the greatest scrutiny, and from what direction the scrutiny is emanating. However, with greater clarity also has come a recognition that the external focus on compensation practices is a more sustained effort than may have been originally contemplated, and is no longer exclusively a tax law concern.

The midsummer pronouncements by the Internal Revenue Service (IRS or Service) concerning its expanded enforcement project attracted the attention of many compliance-sensitive non-profit organizations. Absent further clarification from the Service, however, these organizations lacked meaningful guidance on potentially problematic arrangements and processes. The IRS had been explicit with respect to the goals of its project (halting excessive compensation practices) and the processes it would apply to achieve the goal (e.g., information requests, "soft contacts" and, in some cases, examination). Absent any IRS indication of areas of particular concern, though, non-profits were left without direction on which portions of the compensation process to focus their compliance efforts.

Now, roughly six months later, the "votes" seem to be coming in and the information dam seems to have been broken. Clarity is beginning to emerge on the specific non-profit executive compensation practices attracting the greatest scrutiny, and the classes of regulators—and other interested parties—applying that scrutiny. Significantly, though, the comfort of such IRS guidance on "hot spots" has been tempered by the increased attention of state charity officials and "corporate constituents" (including dissident board members) to the issue. No longer is executive compensation oversight the sole province of the IRS.

On the bright side, the IRS has been forthcoming concerning compliance issues uncovered in the executive compensation audits conducted to date. Through a series of presentations throughout the fall, senior IRS officials have shared publicly their reaction to the "first wave" of responses to its initial compliance inquiries. More ominous, however, is the willingness of state charity officials to assert jurisdiction in executive compensation controversies, and the increase in litigation challenging board oversight of compensation matters. Furthermore, published executive compensation and loan studies, surveys and exposes by prominent non-profit industry media help to preserve "reasonable compensation" issues in the forefront of public discourse.

Collectively, these recent developments provide enhanced justification for more focused compliance efforts by non-profit corporations as they review and upgrade their executive compensation processes and arrangements.

SPECIFIC AREAS OF IRS INTEREST

In its well-publicized August 10 announcement, the IRS described the basic parameters of its executive compensation enforcement initiative, and the general areas on which it would focus attention.[1] These included officer compensation, "insider" transactions, and Form 990 reporting strategy. What attracted the most attention was the expansion of the initiative, from 200 to 2,000 targeted charitable organizations, thus increasing the likelihood that a (financially or organizationally) sophisticated non-profit will be contacted.

Recently, the IRS has publicly addressed the importance it places on the executive compensation initiative, and shared its reaction to the responses it has received from the initial wave of contacts and inquiries. (It is important to note that not all 2,000 letters have gone out to targeted non-profits; senior IRS officials have indicated that a fairly modest fraction of the letters have gone out, and that the remaining letters should be sent to non-profits by the end of 2004.) Significantly, the IRS has identified excess executive compensation as one of the four key initiatives currently underway by its Exempt Organization (EO) Division (the other three being credit counseling, antiterrorism, and abusive schemes). With respect to all of these initiatives, the EO Division will focus on being "data driven," rather than reacting to controversies appearing in the public milieu.[2]

The specific executive compensation compliance issues publicly identified to date by the IRS involve both the compensation approval process, and issues with respect to fringe benefits and deferred compensation.

PROCESS-RELATED CONCERNS

IRS Comments. From a *process perspective,* the IRS has been very forthcoming in identifying factors and concerns that might affect the ability of a non-profit organization to justify executive compensation as reasonable. These include the following:

- *Changed Circumstances:* Compensation decisions based on specific performance goals and objectives may need to be revisited when these goals and objectives are changed during (or even at the conclusion of) the performance period.

- *Payments Despite Failure to Achieve Goals:* Similarly, compensation issues are likely to arise when the executive receives contemplated goal/incentive based compensation in those situations where the goals or incentive criteria arguably have not been achieved.

- *Compensation Committee Structure:* The failure to structure the compensation committee with independent members as suggested by emerging "best practices" and as required to qualify for the "rebuttable presumption of reasonableness" under the intermediate sanctions regulations.

- *Process Conflicts of Interest:* Executives whose compensation is being reviewed (and their direct subordinates) should not be allowed to supervise or otherwise retain direct involvement in the production of the compensation study. In those situations where the compensation consultant seeks factual information from a subject executive, the inquiry should be through, or under the supervision of, a board or compensation committee member.

- *Independence of Consultant:* Echoing emerging best practices in the area, the compensation consultant engaged by the non-profit should be "independent," *i.e.,* have no prior business or social relationships with the executive the consultant is evaluating. Assuring that the responsibility for preserving the independent nature of the consultant falls on the board or compensation committee, strict confidentiality is to be preserved with respect to all compensation-related correspondence and documents to and from the consultant.

- *Use of Comparables:* While the use of similarly situated for-profit corporations is an acceptable practice, it will be important that the compensation report take into consideration comparable compensation arrangements of other non-profit organizations. Senior IRS officials have stated that some non-profit comparables must be included in the mix; it would not be appropriate to rely solely on data from for-profit corporations. Of course, the continued ability to use data from comparable for-profit corporations is a subject of debate as part of the Senate Finance Committee's consideration of federal non-profit oversight legislation.

- *"Spreading" Certain Longer-Term Payments:* Certain types of payments, such as retirement supplements, deferred compensation, and long term incentives, often are earned and paid over multiple years of employment. In the case of retirement supplements and deferred compensation, the IRS considers it appropriate to express these amounts as a percentage of total compensation for the year under examination (although a non-profit should note that it may be advantageous to prorate these benefits over the entire period of employment for comparability analysis purposes, regardless of when actual payment occurs). By contrast, the IRS prefers to have

long term incentive amounts spread evenly over the period during which the long term incentive performance was measured, even if the cash payments are made in one or more later years.

- *Compensation Report Features:* Reflecting the IRS' obvious interest in the strength of the comparability data, a compensation report should include the following information with respect to each "compared" organization:
  - The complete name of each organization being cited for comparability purposes (which the IRS refers to as a "compared organization");
  - The tax status (for-profit or non-profit) of each compared organization;
  - The annual revenues of each compared organization;
  - The number of employees of each compared organization;
  - The standard industry code (SIC) of each for-profit compared organization;
  - National Taxonomy of Exempt Entities code of each compared organization that is tax-exempt; and
  - A detailed description of compensation arrangements for each compared executive (*e.g.,* current salary, annual incentive compensation, bonuses, deferred compensation, long term incentive compensation, fringe benefits value, pension benefits, supplemental retirement benefits, severance compensation, and consulting fees received).

Furthermore, the report should incorporate the consultant's work papers, indicating the manner by which the various comparability analyses were made. While the IRS acknowledges that such expectations regarding the sufficiency of a compensation report may seem daunting to some non-profits, some recent responses have included little or no supporting data for the comparability report.[3]

Practical Observations. IRS perspective notwithstanding, it would appear that the above list represents more of a "wish list" from the IRS of aspirational goals rather than an absolute list of requirements for the proper compensation reporting process. To be certain, the greater the number of the above factors that are present in a given circumstance, the greater the weight that the IRS is likely to give to the report. However, the authors' collective experience is that relatively few non-profit, tax-exempt organizations currently meet the standards referenced above. The IRS perspective implies that non-profits should rely on custom surveys and or custom cuts of established survey data bases, either of which can have a significant cost and perhaps very limited samples.

Many non-profits rely on the results of multiple surveys published by independent firms (consulting firms and survey groups). In most cases such organizations would rely on categorical or regression data for organizations in their industry (*e.g.,* other not-for-profit hospitals) of comparable size (*e.g.,* revenues between $150MM and $400MM). If several surveys with large samples report relatively consistent results for comparable organizations in the same industry and of roughly the same size and complexity, the approval body can be confident that the results represent prevailing market practice. Under such an approach, it is unlikely that the organization will know the names of all the organizations represented in the data and their exact revenue and employee levels[4] unless the survey provider is contacted and asked to provide a special report in this regard. A custom survey certainly permits the highest quality information and is the best way to ensure exact comparability, but if every non-profit follows this course of action surveying will be a never ending process. This argues for more accurate and structured compensation disclosure on the Form 990 to provide a level of the executive compensation information within the non-profit community that currently is available for the executives of publicly held companies.

The authors believe that the increased emphasis on the level of detail in the consultant's report is consistent with best practice and truly supportive of governance control of the executive compensation process. Best practice requires that the report contain the aggregated survey data from each survey source for each job. Assumptions about size categories used, any updating of the survey data and job matching decisions should be fully explained and easily identified. The cash compensation (both currently and projected) for each covered executive should then be directly compared to the survey data and a resulting market position clearly identified for each individual and outliers clearly highlighted. The same holds true for benefits, but because most benefits apply to all the covered individuals, the focus of the analysis can be the group, except for unique benefits.

We suggest that a non-profit rely on for-profit data only when a compelling business reason exists. If executives are actually recruited from for-profit organizations and former executives have been recruited by such organizations, such a practice is likely justified. However, even in such situations the comparators must be comparable (*e.g.,* be of roughly comparable size and complexity) and reflect a realistic labor market (*e.g.,* the CEO of a non-profit hospital with revenues

of $100 million is not likely to be recruited to run a large publicly held pharmaceutical firm, even though such a firm is "technically" part of the healthcare industry).

With respect to Committee activities, it is our general recommendation that (a) the Compensation Committee interview and engage the compensation consultant (and, where necessary, outside counsel); (b) the Committee have primary responsibility (if not complete discretion) regarding the retention and termination of the independent compensation consultant; (c) the Committee (in consultation with legal counsel) establish the work plan for the consultant; (d) the Committee (again with advice of legal counsel) establish the parameters within which the consultant will interact with organizational staff and executive leadership; and (e) with input from legal counsel, the consultant report its findings directly to the Committee.

FRINGE BENEFITS/DEFERRED COMPENSATION CONCERNS

There are several reasonably common forms of fringe benefit arrangements drawing IRS attention as part of its executive compensation audits and reviews. One such form is spousal travel, long known to be an area of potential tax and corporate "waste of assets" exposure for the institution and affected corporate officers, directors, and their spouses. Other targeted forms of expenses include personal use of corporate-owned assets, corporate reimbursement of what essentially are personal expenses, no-interest or low-interest loans, and various personal professional services. The IRS is focusing on several issues in connection with these types of expenses:

- Did the non-profit employer intend to treat each taxable item as compensation (by reporting it as taxable compensation, or by including it as a compensatory item in the executive's employment agreement)? If not, the item could be treated as an automatic excess benefit transaction.

- Did the non-profit employer report the item correctly for tax purposes (in terms of the taxable value, on the appropriate form, and for the appropriate tax year)?

- Is this an item that can approximately be paid for out of the non-profit employer's assets?

That the IRS is beginning to consider these issues should prompt non-profits to revisit existing policies and procedures governing spousal travel, director compensation, reimbursement for business expenses, executive fringe benefits, receipt of substantial gifts, and income tax reporting. Not only should the policies accurately reflect tax law principles, but the employer should establish procedures and internal controls that are designed to comply with the tax law principles. Other fringe benefit issues identified by the IRS that may have mainstream application include tax preparation services, the provision of computers and loans to buy personal residences, and similar personal items (but which are not being treated as compensation).

The IRS reviews are also identifying certain issues associated with the nonqualified deferred compensation arrangements of executives of non-profit organizations. The IRS is focusing on the coordination of the limit on deferrals into § 457(b) arrangements (when more than one arrangement is available in a particular year), hardship withdrawals under § 457(b) arrangements (to assure that hardships are bona fide and substantial), and on the "substantial risk of forfeiture" in a § 457(f) arrangement (to confirm that the risk is truly substantial). On the latter issue, "rolling vesting" arrangements and covenants not to compete are drawing significant IRS attention, as the IRS tries to determine whether employees have too much control in setting the terms of these vesting arrangements. Every non-profit with a § 457(b) or 457(f) arrangement should be reviewing these basic terms to determine whether they are "audit ready" on these major design issues.[5]

STATE CHARITY OFFICIALS' REVIEW

Non-profit executive compensation has always been a topic within the general oversight jurisdiction of state charity officials, either through "charitable trust," "waste of assets," or other similar grounds. Indeed, there have been numerous, prominent examples over the years in which a state attorney general has aggressively pursued allegations of excessive non-profit executive compensation (see, *e.g.*, Adelphi University, Allina, Health Midwest, HealthPartners).

Certainly, the New York Attorney General's ongoing litigation against the former CEO of the New York Stock Exchange (NYSE) and the former Chair of its Compensation Committee, seeking rescission of an executive compensation arrangement, is a prominent current example of this level of interest. While not a charitable corporation, the NYSE is nevertheless incorporated under the state non-profit corporation code, and many of the Attorney General's arguments regarding process, duty, and procedure could readily be applied to the mainstream non-profit charitable corporation.

Perhaps a more noteworthy (if less publicized) development was the King Foundation decision of mid-summer, reportedly the first instance in which a charity was sued under state law for payment of excessive compensation.[6] In a jury trial,

two former corporate executives of the King Foundation were determined to have defrauded the charity by paying themselves excessive compensation and perquisites. The Texas Attorney General and a new foundation board had sued the former executives, on the grounds that their compensation arrangements violated the Texas Non-Profit Corporation Act. In addition to the assessment of actual damages (*e.g.*, restitution), the jury also awarded the foundation $14 million in punitive damages.

The jury concluded that the former executives had failed to seek and obtain board approval for (or otherwise notify the board of) their compensation arrangements, which were determined to have been excessive. Furthermore, the jury determined that the related actions of one of the former executives in this regard (the former Secretary) arose from malice, a concept not normally applied in excessive compensation analyses.[7]

Similar scrutiny of executive compensation arrangements also arose this summer with respect to the Statue of Liberty Foundation. This prominent charity had been the subject of scrutiny from both the media and from the Department of Interior because it had been overcompensating its top executives, among other concerns. A review conducted by an "independent committee," with the assistance of outside counsel, concluded that the Foundation's executive compensation arrangements lacked supporting documentation. Specifically, the committee concluded that while the top executives were worth their salaries, neither the information available on comparable salaries nor the Foundation's internal documentation supported those salaries.[8]

Another recent example of state charity official review of executive compensation arrangements is the New York Attorney General's recent review of the financial practices of the James Beard Foundation, a well-known culinary charity. The focus of the Attorney General's review was on the charity's financial expenditures (including management expenditures), financial accounting and reporting, filing of state and federal tax returns, and adherence to the charitable mission. These matters had also been the subject of an internal investigation by outside counsel.

This level of scrutiny is consistent with an earlier review by the California Attorney General of the compensation payable to the chief executive officer of The Irvine Foundation. The compensation arrangement called for an annual salary and benefits of $900,000 in 2002 reportedly 17% of the organization's entire payroll for thirty-three employees. While the Attorney General found the CEO salary to be appropriate, it was critical of a series of retirement-related financial gifts and payments. In particular, it ordered the repayment of a cash parting gift.[9]

SCRUTINY OF GOVERNING BOARDS

The role (and related liability profile) of non-profit governing boards in reviewing and approving executive compensation arrangements is highlighted by two recent, highly prominent Delaware cases. Both cases were based on allegations of breach of fiduciary duty for failure to adequately oversee certain executive compensation decisions.

Delaware cases are worthy of note to non-profit corporations because of the number of businesses incorporated in Delaware, the volume of business controversies litigated in Delaware, the strength of its judiciary, and the fact that it has a unified corporation code for both business and non-profit corporations. Both of the new Delaware cases allege violations of fiduciary duty similar to those owed by directors of non-profit corporations. Accordingly, the rulings of Delaware courts on director conduct can be particularly informative to non-profit organizations.

For example, the essence of the allegations in the highly prominent *Disney* shareholder derivative action is that (current and former) *Disney* directors acted with recklessness and bad faith in their review and approval of certain executive compensation and termination decisions with respect to the chief operating officer. Specific allegations included breach of duty and waste of asset allegations with respect to (1) negotiating, approving and/or ratifying the initial employment agreement (in particular, alleging the agreement paid excessive compensation to an executive inexperienced in working as an officer of a public company); (2) failing to adequately monitor, oversee, and supervise the work of the chief operating officer to ensure that *Disney* received benefits commensurate with the compensation payable to the officer; and (3) failing to undertake all reasonable steps necessary to minimize or rescind any obligation of the company to pay the amounts owed the chief operating officer upon termination (after less than two years in the position). The complaint also alleged the presence of "disabling" conflicts of interest amongst the board members serving at the time of the officer's termination based on the directors' individual relationships to the chief executive officer allegedly responsible for the employment and termination decisions.

Similar bad faith/duty of loyalty claims were made in the action brought by an unsecured creditors committee against Integrated Health Services, Inc., once one of the largest national long term care providers. In a late August 2004 decision, the Delaware Chancery Court refused to dismiss the creditors' claims that the board of directors breached their duties of loyalty and good faith by approving or ratifying certain executive compensation arrangements without adequate information, consideration, or deliberation.

Similar to the allegations in *Disney*, the creditors' committee claimed that the directors subordinated the best interests of the company to their allegiance to the chief executive officer by approving certain compensation arrangements.

Both *Disney* and *Integrated Health Services* offer specific examples of aggrieved corporate constituents alleging that the governing board breached its fiduciary duty in connection with executive compensation plan oversight. The "bad faith" and "duty of loyalty" allegations seemed to be designed to (a) leverage the defendant directors on the basis that most "D&O" insurance policies do not cover "bad faith" claims; and (b) take the alleged conduct out of the realm of the "business judgment rule" (thus making the relevant issue a matter of fact and not of law). As noted above, that these cases applied to for-profit companies should not diminish their potential importance to non-profits, given the general significance attributable to corporate law decisions of Delaware courts.

CONCLUSION

Given this substantial level of new (and in some cases clarifying) developments and guidance, a few observations can be drawn:

1. The issue of regulatory and board oversight of, and media interest with, non-profit executive compensation is not going to go away, and indeed is likely to become more prominent in the future.

2. The governing board must take control of this process, hire the consultant, and directly supervise his/her work. Management's primary role in this process is to provide background information at the compensation committee's direction.

3. The consultant must be independent. He/she cannot be accepting fees/commissions related to his/her recommendations, have a personal relationship with the executives, or work for a firm having other significant business relationships with the organization.

4. The compensation committee must be independent and conduct its activities in a manner consistent with "Rebuttable Presumption" regulations.

5. Compensation-related market assessments must continue to improve:

   - More detail regarding the compared organizations and their relevance to the subject organization's situation

   - More detail regarding the market data relied on

   - More detailed analyses in market assessment reports regarding the organization's market position

   - More detailed information regarding the cost of all elements of the compensation program, especially retirement benefits

6. Incentive awards can only be paid when the predetermined performance objectives are achieved.

7. Certain benefit arrangements should be carefully reviewed (*e.g.*, loans for personal residences, spouse travel).

8. Nonqualified deferred compensation issues will increase in regulatory/governance prominence.

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9. With increasing oversight from state charity officials, board/management should carefully scrutinize compensation practices that could be considered as "waste of assets" under state non-profit corporate law (e.g., excessive executive/governance retreats at "luxury" resorts, spousal travel, "luxury" boxes at sporting events, personal use of organizational property).

10. Recognize that from a purely practical perspective, the reasonableness of compensation arrangements will be judged by "the court of public opinion" in addition to applicable law.

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END NOTES

1 IR-2004-106, August 10, 2004.

2 Comments of Martha Sullivan, Director, Exempt Organizations Division, Internal Revenue Service, October 1, 2004, as reported in *The Exempt Organization Tax Review,* November, 2004, p. 141 (henceforth, Sullivan Comments).

3 *See, e.g.,* Sullivan Comments, *supra;* comments of Leonard Henzke, Tax Law Specialist, Internal Revenue Service; and Catherine Livingston Fernandez, Chief, Executive Compensation Branch, Tax Exempt/Government Entities Division, Internal Revenue Service to the American Bar Association, October 1, 2004, as reported in *The Exempt Organization Tax Review,* November, 2004, p. 143-144; 146.

4 Typically published surveys list all participants in alphabetical order.

5 *See, e.g.,* comments of Catherine Livingston Fernandez and Leonard Henzke, *supra,* note 4.

6 *See* comments of John Vinson, Assistant (Texas) Attorney General, as reported in THE DALLAS MORNING NEWS, June 15, 2004.

7 *Id.; see also The Austin American Statesman,* June 12, 2004.

8 *See, e.g.,* Report of the Independent Committee of the Board of Directors of the Statue of Liberty—Ellis Island Foundation, Inc., July, 2004.

9 SAN JOSE MERCURY-NEWS, December 10, 2003; THE SAN FRANCISCO CHRONICLE

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