

Transparency: What the EO Board Needs to Know About Executive Compensation

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Increased scrutiny of their executive compensation practices should prompt exempt organizations (EOs) to address sensitive issues regarding the transparency of related compensation decisions. While responsibility for executive compensation analysis may properly be delegated to an appropriately constituted board committee, organizational and legal tension often arises concerning the full board's "need to know." This tension reflects sincere concerns regarding executive privacy, the ability of the full board to readily comprehend the details of the particular compensation arrangements, and the potential for a time-consuming and distracting review and "soul-searching" regarding executive compensation programs and levels. However, failure to resolve this tension in favor of some basic organizational transparency will create legal risks for the EO and its board.

The Environment

This issue needs to be resolved in view of the current extraordinary public and regulatory scrutiny of how EOs compensate their senior executives. Most notably, the IRS has recently commenced a major initiative to "identify and halt abuses by tax-exempt organizations that pay excessive compensation and benefits to their officers and other insiders."¹ The IRS's specific concern is that some EOs may be abusing their tax-exempt status through "exorbitant" executive compensation arrangements.² As part of this initiative, the IRS will contact approximately 2,000 charitable organizations, seeking information on compensation practices and procedures. The IRS contacts will combine information-gathering with enforcement, and will focus on specific officers, types of transactions (including loans, leasing, and property exchanges) and on compensation-related Form 990 reporting.³

State charity officials have also been aggressive in their review of EO compensation practices, evaluating

the appropriateness of these arrangements under state nonprofit corporation and charitable trust laws. As with the IRS contacts, these reviews have focused not only on the *reasonableness* of a specific arrangement but also on the *process* by which the EO board/committee arrived at the particular compensation decisions. Significantly, several such recent reviews have been highly critical of the governing board's oversight of the compensation process generally, and of its awareness of the basic details of the compensation arrangements in particular. In each case, the review concluded that the level of board oversight and awareness was insufficient.

For example, in his high-profile and controversial "business compliance review" of the HealthPartners integrated delivery system in 2002-2003, Minnesota Attorney General Mike Hatch alleged that the HealthPartners board was deficient in its oversight of executive compensation arrangements.⁴ The Hatch report was particularly critical of what it claimed to be the board's failure to question specific compensation expenditures and a willingness to be controlled by its former CEO. The report also implied that the alleged failure of the full HealthPartners board to approve the executive compensation arrangements (as approved by its executive committee) was legally problematic. According to a member of the attorney general's staff, "The board did not appear active or even know what the top officers were getting."⁵ To underscore its point, the attorney general focused on corporate documents that it claimed "revealed no evidence that the board reviewed the determination of the cash compensation of the executive officers."

The most prominent recent example of state review of nonprofit executive compensation is the litigation filed in May 2004 by New York Attorney General Eliot Spitzer, seeking rescission of the compensation arrangements payable to Richard Grasso, then CEO of the New York Stock Exchange. The NYSE is a New York nonprofit, noncharitable corporation, and the bulk of the attorney general's arguments were based

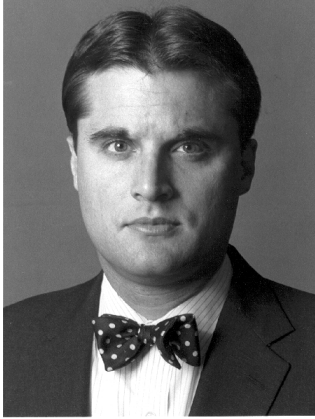
¹IR-2004-106, August 10, 2004.

²*Id.*

³*Id.*

⁴Minnesota Attorney General's Office Compliance Review Report of HealthPartners, January 15, 2003, <http://www.ag.state.mn.us>.

⁵Glenn Howatt, "Perks at HealthPartners; Attorney General Says He Found A 'Culture of Luxury' at the Nonprofit," *Minneapolis Star-Tribune*, January 16, 2003.



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on New York Nonprofit Corporation Law. What the board knew — or did not know — about the CEO's compensation arrangements has been the subject of intense debate both in the legal filings and in the media.⁶ The attorney general has argued that the full NYSE board was not told about certain forms of compensation provided to the CEO over a four-year period, nor about the true nature of certain pension supplements transferred to the CEO's control. (Part of the factual basis for this allegation came from consultants' notes that were not protected from discovery by the attorney-client privilege.) Rescission is sought because the board's approval was allegedly based on "materially incomplete, inaccurate and misleading information." This allegation has been challenged by the former chairman of the NYSE compensation committee (himself a defendant), who has taken the position that the NYSE board (through its compensation committee) was aware of the compensation and benefits provided to the CEO and provided the necessary approvals based on full knowledge and understanding of the details of those arrangements.⁷ In a very recent development, an independent committee reviewing compensation practices of the Statue of Liberty Foundation concluded that while its senior executives were probably worth what they were being paid, the comparability and other data were not supportive of their compensation levels. The committee further concluded that the board was unaware of certain important aspects of the CEO's compensation arrangements.

A third noteworthy factor has been the emergence of specific "best practices" compilations addressing corporate executive compensation practices. Although

most of these "best practices" compilations have focused on public companies, their application to EOs has been widely recognized.⁸ Principal among these have been publications by the National Association of Corporate Directors (NACD)⁹ and The Business Roundtable (TBR).¹⁰

The NACD and TBR recommendations are based on the common premise that, while there is no "one size fits all" approach, certain fundamental best practices indeed apply across the board to compensation committees. Furthermore, this is not a situation where the unique for-profit mechanisms of stock options and other equity-based compensation render such "best practices" inapplicable to EOs. To the contrary, EO tax law and nonprofit corporate law concepts of excessive private benefit, private inurement, reasonableness, and waste of assets make these recommendations highly relevant to EOs.

In our most recent *EOTR* discussion of this topic, we addressed the structure and operation of an EO's executive compensation committee.¹¹ We now address the extent to which the knowledge, process, and decisions of the compensation committee should be conveyed to the full board.

⁶See, e.g., Strassel, Kimberly A., "Mr. Grasso's Money," *The Wall Street Journal*, August 13, 2004.

⁷Thomas, London Jr., "The Man Behind Grasso's Payday," *The New York Times*, March 14, 2004. See, also, Report of the Independent Committee to the Board of Directors of the Statue of Liberty — Ellis Island Foundation, Inc., July 2004.

⁸James H. Cheek, III et al., *Report of the American Bar Association, Task Force on Corporate Responsibility* (2003) (at fn. 62), available at http://w3.abanet.org/buslaw/corporatere-sponsibility/final_report.pdf.

⁹Report of the NACD Blue Ribbon Commission on Executive Compensation and the Role of the Compensation Committee, ©2003, *The National Association of Corporate Directors*.

¹⁰"Executive Compensation: Principles and Commentary," November 2003 ©Business Roundtable.

¹¹Peregrine, DeJong, and Cotter, "New EO Focus — The Board Compensation Committee," *The Exempt Organization Tax Review*, March 2004, p. 265.

The Controversy

The compensation transparency issue arises in part as a “spillover” from general Sarbanes-Oxley policy considerations that promote integrity of financial reporting and enhanced governance oversight of executive compensation decisions. In this environment, there is an increased emphasis on providing the full board with information that the board reasonably would or might consider necessary to exercise its oversight obligations and to evaluate the legal compliance risks facing the corporation. The emergence of the transparency issue can also be traced to legitimate concerns by board leaders and executives alike regarding the following issues that militate against transparency:

- **Confidentiality** — the desire to limit to the smallest group possible specific details about a senior executive’s personal compensation and benefit arrangements, particularly in view of media and community interest in such details.
- **Efficiency** — if an executive compensation or similarly *properly constituted* board committee has effectively addressed the propriety of a compensation arrangement, why must the process be replicated by the full board?
- **Competence** — executive compensation issues are inherently complex and are properly the province of a specifically constituted committee, the members of which are selected in part for their particular skills and experience in addressing compensation and benefits issues, which results in the ability to address such matters effectively and efficiently.
- **Disruption** — concerns that board disclosure may result in a time-consuming and potentially disruptive and divergent review of this issue.

There is a tempting logic to each of these concerns. Nevertheless, in the current corporate responsibility environment, some level of compensation transparency with the full board is the “smart play.” A transparency mechanism that balances privacy, efficiency, competence, and institutional concerns with the EO board’s fundamental need to know will best serve the EO in the event of regulatory challenge. In addition, smart and intentional transparency will also support the EO well in the event of scrutiny by, and disclosure to, the media or the general public.

Board’s Delegation Powers

The argument in favor of a transparency mechanism, resulting in meaningful disclosure to the full board, is not intended to undermine the basic ability of a governing board to delegate certain critical issues to standing or special board committees for resolution. It is a fundamental concept of corporate law that a board can (and normally will) delegate to committees the performance of parts of the oversight function, and

use committees to implement and support that function.¹² Indeed, in our first discussion of this topic (*The Exempt Organization Tax Review*, March 2004, p. 265) we consider in detail the emerging best practices directly addressing the role of an independent compensation committee in developing compensation arrangements for senior corporate leadership.

Nevertheless, it is similarly a fundamental concept that with the power of delegation comes ongoing responsibility to monitor the performance of the delegated function. When the board delegates an important function to a board-level committee, the duty of governance oversight requires the full board to maintain an ongoing presence in, and bear ultimate responsibility for, the overall performance of that delegated function.¹³ Admittedly, this involves tension between two legal principles: while the board’s right to delegate the review and approval of executive compensation decisions to a properly formed committee is in most cases clearly established as a matter of law (subject to certain discrete limitations), that delegation cannot completely absolve the governing board of the need for at least a minimum level of continuing oversight of executive compensation.

This perspective is shared by the most prominent best practices compilations:

“Compensation of the CEO and other top executives should be determined by a compensation committee composed entirely of independent directors. . . . [T]he compensation committee should assist the board of directors in carrying out its responsibilities with respect to the corporation’s compensation programs.”

Source: The Business Roundtable; *Executive Compensation: Principles and Commentary* (November 2003) p. 4, 5.

“The board of directors bears the ultimate responsibility for all decisions pertaining to executive compensation. However, the board may delegate some of its duties to the compensation committee.”

“The compensation committee should strive to give accurate and thorough reports to the full board. No director should be embarrassed because he or she did not know what the compensation committee has done, particularly with regard to employment contracts.” [Emphasis added.]

Source: *Report of the NACD Blue Ribbon Commission on Executive Compensation and the Role of the Compensation Committee*, p. 16, 28.

¹²American Law Institute, *Principles of Corporate Governance: Analysis and Recommendations* (St. Paul, Minnesota 1994), p. 93, Section 3.02; Revised Model Nonprofit Corporation Act, Section 8.25 (Committee of the Board), © 1988, American Bar Association.

¹³*Id.*

Effecting Transparency

In the authors' view, the necessary extent of board oversight over compensation decisions can be effected through a transparency mechanism that balances the board's need to know with concerns of privacy, efficiency, competence, and disruption. The goal of such a mechanism would be to provide the full board with a prompt and comprehensive statement, authored by the appropriate committee, of the compensation philosophy of the corporation, the process by which executive compensation decisions were made, and the elements of individual compensation arrangements.

There is, however, no particular model applicable to all types of EOs. The selection of the appropriate transparency mechanism requires thoughtful consideration of the particular EO's governance structure and philosophy, and should be made in consultation with professional advisors. Possible alternatives can range from "notice based" (i.e., a progressive approach relying more on the powers of delegation) to "ratification based" (i.e., a conservative approach relying more on the principles of full disclosure).

Notice-Based Form of Transparency Mechanism. A by-law or compensation committee charter provision that effects this form of transparency mechanism could read as follows:

The compensation committee shall, within a reasonable time after its annual meeting to review and approve executive compensation and benefits, provide to the board a summary of the committee's work, including the compensation philosophy of the corporation, the process by which the committee has reviewed and approved executive compensation and benefits, and the procedures used by the committee to assure to the greatest extent possible under the circumstances that the corporation qualifies for the rebuttable presumption of reasonableness under the intermediate sanctions regulations of the Internal Revenue Service. The annual report of the compensation committee to the board shall include either a summary or detailed information regarding the forms and amounts of compensation and benefits provided to individual executives, the form and extent of which shall be determined by the board chair in his or her sole discretion.

The oral presentation would be supplemented by a short written summary of the elements of the specific compensation decisions (which could be presented in the form of slides, so as to prevent the distribution of handouts that might be disseminated too broadly), and directors would be invited to review the full written report of the compensation committee (and reports submitted by its directors). Note that this suggested approach is designed to accommodate the board's right to know without undermining the efficiencies gained by the basic delegation. The board normally should have the right to rescind any action of the committee or otherwise revoke the delegation should

the board believe it necessary to do so based on the committee's report.

Ratification-Based Form of Transparency Mechanism. This more conservative approach, less accommodating to the concerns of confidentiality, efficiency, competence, and disruption, involves distribution of the full committee report and of all reports furnished to the committee by its advisors. It would also require approval/ratification by the board of all executive compensation decisions. To adopt such an approach, the bylaw or committee charter provisions above should be revised to read as follows:

The compensation committee shall, within a reasonable time after its annual meeting to review and approve executive compensation and benefits, provide to the board a detailed report on the committee's work, including the compensation philosophy of the corporation, the process by which the committee has reviewed and approved executive compensation and benefits, the procedures used by the committee to assure to the greatest extent possible under the circumstances that the corporation qualifies for the rebuttable presumption of reasonableness under the intermediate sanctions regulations of the Internal Revenue Service, and copies of all materials presented to the committee by corporation staff and external professional advisors. The annual report of the compensation committee to the board shall include detailed information regarding the forms and amounts of compensation and benefits provided to all individual executives. The board shall then make an independent decision as to whether to ratify the committee's approval of the compensation and benefits arrangements.

This approach is best suited where ratification is mandated by state law, by the corporate bylaws, or by the unique governance philosophy of the corporation.

The most important factor in designing a transparency mechanism is, of course, what works best for the institution (after deferring to appropriate legal requirements). Taking an "a la carte" approach, the universe of documents that might be considered as part of a customized transparency design include the following:

- the organization's compensation philosophy, including the overall intent of the executive compensation program, the markets used for comparison purposes, the elements of the program, and the desired positioning of compensation elements in the marketplace,
- a summary of the process used by the compensation committee to make executive compensation decisions,
- factors considered by the compensation committee in making executive compensation decisions,
- a description or summary of the CEO's (and other key executives') compensation (base salary and

incentive awards) and benefits program, including key employment contract provisions, and how the program compares to comparable marketplace practices,

- the relationship between executive compensation and organizational performance, and the performance metrics considered in making compensation decisions,
- any issues regarding organizational and/or individual executive performance that may affect board and/or public perception, and
- the overall costs and organizational impact of material changes to executive compensation levels and benefits programs.

No matter the precise form of transparency mechanism, the board should always have the right to access all written reports of the committee and of its professional advisors. After all, if everyone in the outside world is readily able to review the EO's Form 990 return, including the compensation and benefits provided to senior management, it is imperative that all board members know enough about executive compensation and benefits to explain and defend the entries on the Form 990. This information is best shared with the board at the time (or close to the time)

when executive compensation decisions are made. Such a session will also help prepare the board for situations in which the executive compensation program could be publicly and negatively depicted (i.e., when the Form 990 is accessed and reported by the media). As part of this process, board members should be encouraged to meet privately with compensation committee members if they have more detailed questions or concerns. In addition, some board members may be uncomfortable voicing questions and concerns in an open forum.

Regardless of the specific method by which an EO may delegate executive compensation decisions, corporate responsibility principles mandate some degree of transparency of those decisions to the full board. Any practice that could be reasonably interpreted as restricting or discouraging the board's ability to understand the nature and total costs of all forms of executive compensation could place the organization's tax-exempt status in jeopardy and the board at risk of breaching its fiduciary duty of care. This is particularly the case given the heightened level of regulatory scrutiny of EO executive compensation practices, and the ability of the public to access much of the relevant information through Internet resources.

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