Executive Compensation in a Transparent Environment

Scott Hamilton - National Managing Director
Joseph Wertï National Practice Leader

Gallagher Benefit Services, Inc.
Human Resources Consulting Practice

Presentation Outline

1. Regulatory Environment Update
2. IRS ìRebuttable Presumptionò Guidelines
3. Transparency Considerations
4. Governance Best Practices: Executive Compensation Decision-Making
5. Questions & Discussion

Starting Point:
Regulatory Environment

Regulatory Environment - IRS

- College & University Compliance Project
  - May 2013 Final Report
    - Almost all surveyed institutions had issues with UBI and Compensation reporting
    - Examinations started at 1/3 of schools
      - Significant issues uncovered at each
      - 20% did not meet IRS Rebuttable Presumption
        - Many comparability/data issues
      - Wage adjustments totaled $36m (Penalties: $7m)
      - Retirement Plan adjustments totaled $1m (Taxes: $200k)
  - Next Steps: IRS plans to use ñlearningsò and apply across entire tax-exempt sector

Regulatory Environment ï IRS (continued)

- Senate Finance Committee ï Exempt Organization ñTax Reform Options For Discussion
  - June 2013 Report
    - Provide additional fines/penalties for non-compliance
    - Reform reporting requirements
      - Direct filing of all Form 990 materials (incl. 990-T)
    - Executive Compensation Provisions
      - Clarify compensation reporting from ñrelated partyò or ñfor-profit joint ventureò relationships and determine ñprivate benefitò status
      - Modify ñrebuttable presumptionò with:
        - Governing body has ñReason To Knowò (higher standard for finding of negligence than ñreasonable personò)
        - Safety Zone replaced with ñminimum due diligenceò standard for decision-making process

Regulatory Environment ï State Initiatives

- New York
  - May, 2012: Executive Order 38 (Effective 7/1/13)
    - For nonprofits that receive more than $500,000 in state support each year and receive at least 30% of their annual funding from the state, no more than $199,000 in state funds can be used to compensate any executive
    - At least 75% of state-provided funds must go toward program services
      - By 2015, at least 85% of funds must be used for program services
    - Waiver process in place, but civil penalties apply to organization with:
      - Covered executive over $199k in salary, and
        - Payments above 75th percentile of comparable positions from ñapprovedò salary survey sources; or
        - Compensation arrangements not approved using ñdue diligenceò framework

Regulatory Environment – State Initiatives

- New York
  - July, 2013: Non-Profit Revitalization Act (Effective 1/1/14)
    - Modernizes/streamlines aspects of current laws
      - Meeting requirements updated for technology
    - Enhanced governance requirements/processes for executive compensation review
      - Employees may not serve as Board Chair (effective 2015)
      - Related-party transactions/Director independence defined
      - Conflict of Interest Policy required by law
      - Whistleblower Policy required by law
      - Equivalent "rebuttable presumption" process required by law, but no reasonableness safety-zone is created
    - NY Attorney General may bring action "to enjoin, void, or rescind compensation to any officer, director, or key employee that is not fair, reasonable, and not in the best interest of the corporation."

Arthur J. Gallagher & Co. Page | 7

Regulatory Environment – State Initiatives (continued)

- New Jersey
  - Beginning in 2010, the state began to limit executive compensation paid by state contracts for non-profit social service agencies that do business with NJ:
    - If revenue is $20 million or above: $141,000
    - If revenue is $10-$20 million: $126,000
    - If revenue is $5-$10 million: $119,850
    - If revenue is $5 million or below: $105,750
    - Excludes Physician and APRN employees
  - Using an "Amendment to 3rd Party Contracts", the legislation is effective with any organization with contracts entered into or renewed on or after July 1, 2010. Changes to state contracts in various other areas of nonprofit service are being discussed.

Arthur J. Gallagher & Co. Page | 8

Regulatory Environment – State Initiatives (continued)

- Other State Initiatives (FL/NH/MA/IL)
  - Various bills introduced in state legislatures attempting to limit non-profit executive compensation, none have passed yet
  - MA Bill 13-33 would regulate operating margins, CEO compensation, and financial asset disclosures for not-for-profit hospitals and healthcare organizations
    - 8% maximum margin, CEO compensation limited to 100x minimum wage employee
    - Civil penalties for violation, paid into State Medicaid fund
  - California voters (Mountain View, CA) passed referendum trying to limit local hospital CEO salary at 2x Governor's compensation

Arthur J. Gallagher & Co. Page | 9

Process Overview:
IRS Rebuttable Presumption

The IRS ï Section 4958

- Adopted in 1995 as part of the Taxpayer Bill of Rights
  - IRS obtained a new authority to impose an excise tax penalty as an intermediate sanction in cases where exempt organizations engage in an ñExcess Benefit Transactionò
    - Impose excise tax on individual who received the excess benefit and on those individuals who approved the transaction
  - Most of this new authority has been directed to matters of executive compensation
- IRS Viewpoint: *"It is the board's ultimate responsibility to set executive compensation, and that function should not be delegated to a consultant, specialist, or one individual. A committee of the board can be delegated to do that work, but the full board should be asking many questions when that information is presented"*

Excess Benefit Transaction

- Essentially anything that has to do with enriching an individual at the expense of the tax exempt organization
  - Common focus is on compensation, defined as all cash, benefits, and perquisites
    - Fringe benefits, housing, retirement plans
    - Work arrangement, employment agreements and severance packages
  - Includes the concept of the value of the work received by the organization in exchange for the value paid by the organization
  - Failure to report any material consideration for executive can result in ñAutomatic Excess Benefit Transactionò
    - Spouse travel, payment of expenses as compensation, etcé
    - Immediate loss of ñrebuttable presumptionò no matter the omission

The IRS: Rebuttable Presumption

- *Rebuttable Presumption* is an assumption that is taken to be true unless someone comes forward to contest it and prove otherwise.
  - Also known as "Safe Harbor"
- A tax exempt organization must meet three requirements to have payments under a compensation arrangements presumed to be reasonable

IRS has published a guide, *Rebuttable Presumption Procedure is Key to Easy Intermediate Sanctions Compliance*, discussing views on executive compensation and suggested steps in preparing documentation to comply with IRS regulations. It's at irs.gov/pub/irs-utl/m4958a2.pdf.

Arthur J. Gallagher & Co.

Page | 13

The IRS: Rebuttable Presumption

1. The compensation arrangement must be approved in advance by an authorized body of the applicable tax-exempt organization
   - Composed of individuals who do not have a conflict of interest concerning the transaction
2. Prior to making its determination, the authorized body obtained and relied upon appropriate data as to comparability
3. The authorized body adequately and timely documented the basis for its determination concurrently with making that determination

Arthur J. Gallagher & Co.

Page | 14

The IRS: Rebuttable Presumption

- Documentation requirement is key
- IRS suggests that it should include:
  - The terms of the transaction approved and the date approved
  - The members of the authorized body present during debate and those who voted
  - The comparability data relied on and how it was obtained
  - Any actions taken by a member of the authorized body who had a conflict of interest for the transaction

Arthur J. Gallagher & Co.

Page | 15

The IRS: Rebuttable Presumption

- IRS suggests that it should also include:
  - If the authorized body determines that the reasonable compensation for a specific arrangement varies from the range of comparable data obtained
    - The authorized body must record the basis for its determination
  - For a decision by an authorized body to be documented concurrently
    - Records must be prepared by the later of the next meeting, or 60 days after final action by the authorized body

Arthur J. Gallagher & Co.

Page | 16

Pay Level Reality Check

- Even with the "rebuttable presumption" IRS guidance suggests that:
  - Base salary should not exceed the 65th – 75th percentile of comparable published market data
  - Total cash should not exceed the 75th percentile
- Federal defense contracts specify that total compensation over the 65th percentile will be excluded from reimbursable costs
  - States using framework to set salary limits for use of taxpayer funds
- Having a credible and documented approach to pay-level setting is a basic requirement for governing bodies

Arthur J. Gallagher & Co.

Page | 17

Transparency Considerations

Arthur J. Gallagher & Co.

Page | 18

Transparency 101

- IRS Form 990 should be a Boardõs best friend
  - It can quickly become your ñpublic enemyò
  - Board members should question any line item that can be material from an external perspective:
    - Significant expenditures that require ñexplanationò
    - Program service revenue classifications
      - Other Revenue (UBI?)
    - Compensation of ñOfficers, Directors, Trustees, and Key Employeesò
    - Other Fees (Part IX - Line 10g)
    - Other Expenses (Part IX - Line 24)

Transparency 101 - continued

- Without oversight, IRS Form 990 can be basis for misleading article or study that could impugn reputation of organization
  - IRS Special Reports (Hospitals, Universities, etcé)
  - NH Hospital Executive Compensation Study
  - Crainõs Chicago (or other city) Business annual ñTop 10 Non-Profit Salaryò article
  - Fiscal Timesõ ñ10 Insanely Overpaid Nonprofit Execsò
  - Responsive Philanthropy
  - And on and oné

If you can see it, so cané

- Form 990 Peer Comparisons
  - Boards and outside organizations are calculating operating metrics from Form 990
    - Can be part of Executive Compensation Review
    - May also be part of outside comparison for donors, press, etcé
  - Sample metrics can include:
    - Direct Labor Cost Information
      - Total compensation costs (Officers/Directors salaries, Other Employees, Benefits, Payroll Taxes, Pension, etcé) as % of Revenue
        - As % of Dues/Assessments, Donations, or other key revenue metric?
      - Aggregate administrative or overhead costs as % of revenue/donations

Governance Best Practices: Executive Compensation Decision-making

Arthur J. Gallagher & Co.

Todayõs ñBest Boardò Profile

Å ñBest Practiceò Boards of today are typically:

ï Highly engaged

ï Cautious about future and rigorous about strategic planning

ï Demanding transparency

ï Pushing independence

ï Not promoting ñbusiness as usualò for compensation levels, benefits/perquisites, or other executive compensation arrangements

Å Who are we really competing with for talent?

Å What is our defined ñpeer groupò now that we can see into cost of most external executive arrangements?

Å Do we really need to pay above 50% Percentile for executive retention? Are we effectively using variable pay?

Å What are the 1-year, 3-year, and 5-year performance metrics we are leading towards and do we have the correct people in place?

Arthur J. Gallagher & Co.

More Board Insights

Å Boards are carefully monitoring role and outcomes:

ï Oversight/Insight/Foresight

ï Carefully monitoring ñbright lineò between governance and micro-management

Å Example: Member wanting information regarding compensation for senior managers other than IRS required ôdisqualified individualsö and suggesting need for adjustment approval

ï Pushing for stronger board selection framework in order to access strategic/independent talent

ï Regulatory environment stressing fiduciary liability, boards are requesting more outside assistance (consultants, auditors, etcé) to ensure validity of basic systems/reporting

Arthur J. Gallagher & Co.

Top 5 Best Board Practices

1. A clearly defined Mission Statement that has relevance to staff, board members, and constituents
2. Whistleblower Protections that defines the individuals covered, the provisions to prevent discrimination or retaliation, the process for protecting confidentiality, and the ladder for reporting claims
3. A Duty Of Loyalty statement, where board members are required to put the interests of the organization first at all times, exercising a duty of loyalty when making decisions
4. Clear Conflict of Interest statements that define what activity or relationship could be in conflict
5. A Charter that describes the duties of the committee charged to oversee executive compensation, links to mission/purpose/values of the organization, and how it reports its decision and rationale to the full board

Arthur J. Gallagher & Co. Page | 25

Top Executive Compensation Committee Practices

1. Executive Compensation Policy, documenting process for adjustments, governance and regulatory requirements, values, and outcomes
2. Executive Compensation Philosophy that describes the committee's ability to weigh the link between compensation and performance, ensure the retention of high-performing executives, and critically review and apply the performance and market practice data made available to them from an unbiased third party
3. Executive Compensation Communication Plan with clearly identified press contact and prepared "talking points" to address compensation philosophy, salary determination process, and market relevance of salary level

Arthur J. Gallagher & Co. Page | 26

Top EC Committee Practices - continued

5. Committee member Handbook including Form 990, market documentation, incentive plan information, total compensation summaries, minutes of prior meetings, adjustment histories and other appropriate documentation
6. Committee should ensure alignment between Executive Director/CEO incentive compensation program and bonuses paid to key executives. Formal executive incentive plans covering key leaders are increasingly prevalent
7. Committee should review the use of "Executive Agreements" or employment contracts across the organization. Key executive agreements are becoming more prevalent as severance, disability, deferred compensation, and other long-term considerations are moving from variable to strategic

Arthur J. Gallagher & Co. Page | 27

Questions & Discussion

Business Without Barriers™

Contact Information

Scott E. Hamilton - National Managing Director
Â scott_hamilton@ajg.com
Â 800.715.2667

Joseph A. Wert ï National Practice Leader
Â joseph_wert@ajg.com
Â 973.650.0309

Thank You!
Gallagher Benefit Services, Inc.

Business Without Barriers™