



613 - Executive Compensation Issues for Nonprofits

Mary Kennard
Vice President & General Counsel
American University

Raymond Sczudlo
Vice President & Chief Legal Officer
Children's National Medical Center

Ellen Vargyas
General Counsel
American Legacy Foundation

Faculty Biographies

Mary Kennard

Mary E. Kennard, is the vice president and chief legal counsel for American University and manages both the in-house and outside legal representation and services for the university. Since joining American University, she has, in addition to her university legal practice, served as the co-chair of the university's diversity strategic plan, served as the acting vice president of development, co-anchored two award winning video training tapes with the College and University Personnel Association (CUPA-HR), and served as a lecturer at numerous national conferences on law and higher education. She is an adjunct faculty member of the Washington College of Law at American University.

Previously, she was at the University of Rhode Island (URI) as legal counsel for the university, Rhode Island Community College, and the Community College of Rhode Island. During her tenure at URI she also served as interim vice president for university relations, vice president for federal relations and public policy, and taught business management and higher education law courses as a member of the adjunct faculty. Before that she worked for the National Association of College and University Attorneys. She subsequently served as assistant university counsel at the University of Pittsburgh and as Howard University's university counsel and assistant to the vice president for legal affairs.

Ms. Kennard is the current president of ACC's Washington Metro Area Chapter (WMACCA), and is president elect of the National Association of College and University Attorneys (NACUA). Ms Kennard is a board member of the Washington Trust Company. She has served on the trust, stock option, and human resources and compensation committees of the bank board.

Raymond Sczudlo

Raymond Sczudlo is vice president and chief legal officer at Children's National Medical Center located in Washington, DC. Mr. Sczudlo is responsible for all aspects of the legal affairs, compliance, executive compensation and governance of the institution, and serves on its leadership council.

Prior to joining Children's National Medical Center, Mr. Sczudlo was senior vice president and general counsel of EYECAST Corporation. Prior to that, Mr. Sczudlo was a partner in the international law firm of Weil, Gotshal & Manges LLP, where he practiced in the areas of corporate, business, finance, technology, and international transactions. Mr. Sczudlo also served as an adjunct professor at the George Washington University Law Center, where he taught banking and finance.

As part of his outside activities while in private practice, Mr. Sczudlo served on the board of directors of the Children's National Medical Center (CNMC) in Washington, DC and its various affiliates, including service as chairman of the board of CNMC. He also served as chairman of the board of the Children's Hospital Foundation, and chairman of the board of Safe Kids Worldwide. He has served on, and chaired, a number of committees for CNMC

and its affiliates, including finance, professional affairs, audit, investment, legal affairs, and executive compensation. Mr. Sczudlo has authored numerous articles on banking, technology, investment, capital markets, regulatory and policy issues, and has been a frequent lecturer on such topics.

Mr. Sczudlo received a B.A. from the University of Detroit and a J.D. from Georgetown University Law Center.

Ellen Vargyas

Ellen Vargyas is the American Legacy Foundation's general counsel and corporate secretary. The American Legacy Foundation is located in Washington, DC. She provides advice and counsel on the legal matters facing the foundation including compliance, non-profit governance, contracts, intellectual property, and employment and manages Foundation litigation.

Before joining the Foundation, Ms. Vargyas served as legal counsel to the U.S. Equal Employment Opportunity Commission. At EEOC, she directed the commission's regulatory and policy programs and was the commission's in-house counsel. In addition, Ms. Vargyas was senior counsel for employment and education at the National Women's Law Center in Washington, DC, where she handled precedent-setting Title IX litigation that opened opportunities for women in athletics in educational institutions and developed the law prohibiting sexual harassment. She was actively involved in the passage of major legislation that expanded existing legal protections against discrimination in employment and published on legal issues of concern to women. Ms. Vargyas also directed the access to justice project at the National Legal Aid and Defender Association. She began her career as an attorney with Community Legal Services in Philadelphia, where she provided legal representation to low-income clients.

Ms. Vargyas is a graduate of Williams College and the University of Pennsylvania Law School.

Executive Compensation Issues for Nonprofits

#613

ACC 2007 Annual Meeting
Chicago, IL

Mary E. Kennard
Vice President and General Counsel
American University
President, WMACCA

Tax Related Issues: Lessons Learned From an Audit

1. Good counsel only goes so far
 - a. You can lead them to water ...
 - b. Make a noisy withdrawal
 - c. Write an opinion - if only to the file
2. Fully disclose "total compensation" to the full board
 - a. A term sheet may not be enough
 - b. A review by a small committee may not be enough
 - c. Concerned about confidentiality – sign nondisclosure agreements
3. Audit Committee review of the reasonableness of expenses
 - a. Contemporaneous documentation
 - b. Write on the receipt
 - c. Quarterly review
4. Redundant systems of oversight
 - a. Audit committee and compensation committee reviews are different
 - b. New eyes, new auditors
5. Act quickly to correct the record
 - a. Hire the PR firm and manage the media
 - b. Communicate to key constituents
 - c. Don't rely on the newspaper telling your story
 - d. Just don't email
6. Abstention is a yes vote for an organizational manager
 - a. The voting record matters
 - b. Voting the right way for the wrong reasons
7. Why is the spouse attending the event
 - a. Clarify that role and relationship
 - b. What about divorce or separation
 - c. Mixing business with pleasure
8. Competitive salaries mean good salary survey data
 - a. Who are your real competitors
 - b. Are they apples or oranges
 - c. What's being measured
 - d. Is it really total compensation or merely salary
 - e. Don't rely on the 990's of others – pay for good info
9. Save your files
 - a. Store them somewhere for 10 years not 6
 - b. Store them electronically with a searchable database
10. Cooperation will get you an advisory opinion
 - a. Fees, fines and penalties
 - b. Counsel for counsel

The Johnsonian Institution—Case Study

You have just been appointed General Counsel to the Johnsonian Institution, a not for profit, 501(c)(3) organization that has over one thousand employees. It is based in the District of Columbia, and has been in existence for over 100 years.

As you start your first day, the CEO of the Institution, Harry Large, storms into your office, complaining bitterly that the Board of Directors is presuming to question certain of his compensation arrangements and he demands that you pull together a solid defense of his compensation and other benefits for a board meeting next week.

He tells you the following:

1. When he was hired he brought with him a survey that he had done listing the positions and compensation of a number of his CEO buddies, and used that to negotiate with the executive committee of the board. In fact, his salary was 42% higher than his predecessor.
2. At the time of his hire, the executive committee did not think that the Institution could pay him the salary he demanded, so they structured an alternative means of getting him additional compensation, including a housing allowance purportedly to reimburse him for his out of pocket housing costs, although he already owned outright a substantial home in DC, and first class travel for him and his spouse.
3. These salary arrangements were not disclosed to, or voted upon, by the full board.
4. Although his contract is unclear, he has spent about 400 work days absent from the Institution over his seven year tenure. Part of this time was spent serving on other boards where he earned over \$5 million in cash and stock compensation.
5. After 5 years on the job, a small committee of the Institution agreed to a 45% increase in his salary, without any outside benchmarks.

What do you say? What are the issues?

* * * * *

After Mr. Large’s resignation, the board turns to you and requests your guidance on best practices and procedures on how to avoid the “recent unpleasantness”

Summary of Intermediate Sanction Regulations and Proposed Executive Compensation Administration Policy/Procedures

Regulation	Company Procedure(s)	Location in Policy Document
<p>IRS definition of Disqualified Person: A person who is in a position to exercise substantial influence over the affairs of the organization</p>	Defined in Company policy per IRS definition	“Scope” section
<p>Automatic Disqualified Persons: President, CEO, COO, CFO or Treasurer</p>	President & CEO and Leadership Council are “Executive” members	“Scope” section
<p>Other Disqualified Persons – facts tending to show substantial influence:</p> <ul style="list-style-type: none"> ▪ Compensation primarily based on revenues derived from activities of the organization that that person controls; ▪ Manages a discrete segment/activity of the organization that represents a substantial portion of the activities, assets, income, or expenses of the organization. 	<p>Company Categories:</p> <ul style="list-style-type: none"> ▪ Executive: President & CEO, Leadership Council, CEO of subsidiaries ▪ Senior VPs 	“Scope” section
<p>The following compensation transactions with Disqualified Persons are subject to the intermediate sanction rule:</p> <ul style="list-style-type: none"> ▪ Salaries, fees, bonuses, severance payments, deferred compensation that has been earned and vested or no longer subject to substantial risk of forfeiture, payments from revenue-sharing arrangements, payments to welfare benefit plans, expense allowance or reimbursement, foregone interest on loans. 	<p>Defined procedure for “New Hire”, “Employment Contract”, “Compensation/Benefits Changes” & “Incentive/Bonus Plans”</p>	“Procedures” section
<p>Exceptions that are not subject to the intermediate sanction rule:</p> <ul style="list-style-type: none"> ▪ Initial contract exception – an economic benefit provided to a Disqualified Person pursuant to a fixed payment provision in a written contract entered into before the person becomes a Disqualified Person; ▪ Material change to the initial contract, including by extension or renewal, is subject to the intermediate sanction rule. 		
<p>Review and approve transactions with Disqualified Persons (rebuttable presumption):</p> <ul style="list-style-type: none"> ▪ Independent approval by independent governing body/committee; ▪ Approval generally should occur as near in time to when (but before) the contract or other agreement to enter into a transaction with a Disqualified Person is executed, so that the approval is based on the facts as they exist at that time; ▪ For non-fixed payments, the rebuttable presumption can only arise after the exact amount is determined or a fixed formula for calculating the amount is specified. ▪ Provide sufficient information to determine that the economic benefit provided does not exceed fair market value for the services provided in return. Sources to prove fair market value could include a generally available compensation survey compiled by an independent organization, or a customized survey, etc. 	<ul style="list-style-type: none"> ▪ Requirement of advance approval from the Compensation Committee; ▪ Requirement of written opinion from an independent consultant to validate market data; ▪ Utilization of “Tally Sheet” type of Offer Information Sheet and Compensation Changes Information Sheet as reporting mechanism to the Compensation Committee. 	“Procedures” section

References:

Intermediate Sanctions—The Rule

http://frwebgate.access.gpo.gov/cgi-bin/getpage.cgi?dbname=2002_register&position=all&page=3076

Intermediate Sanctions—the IRS view

<http://www.irs.gov/pub/irs-tege/eotopice03.pdf>

<http://www.irs.gov/pub/irs-tege/eotopice04.pdf>

Intermediate Sanctions—overviews

http://findarticles.com/p/articles/mi_m3257/is_n7_v51/ai_19780519/print
http://en.wikipedia.org/wiki/Intermediate_sanctions

Intermediate Sanctions—the IRS web site

<http://www.irs.gov/charities/charitable/article/0,,id=123298,00.html>

Intermediate Sanctions—compliance tools

<http://www.eri-nonprofit-salaries.com/index.cfm?FuseAction=Home.intermediatesanctions>

<http://www.intermediatesanctions.org/>

Intermediate Sanctions—Take a free course!

<http://www.eridlc.com/index.cfm?FuseAction=ShopCartTraining.ItemDetails&ItemID=129&CFID=3770534&CFTOKEN=8f335df36062e8a9-74EFF661-1143-5967-68129C5628EAD83C>

Intermediate Sanctions—What the Independent Sector Says

<http://www.independentsector.org/PDFs/sanctions.pdf>

Good Governance—The IRS view

http://www.irs.gov/pub/irs-tege/good_governance_practices.pdf

Governance and Executive Compensation—The Smithsonian Report

http://www.si.edu/about/regents/documents/IRC_report.pdf

EXECUTIVE COMPENSATION ISSUES FOR NON-PROFITS: BACKGROUND**Non-Profit Executive Compensation Basics**

- *Executive Compensation Must Be Reasonable.*
 - Tax-exempt organizations may pay reasonable compensation to their executives, defined as the amount that would ordinarily be paid for like services by like enterprises (both tax-exempt and taxable) under like circumstances. 26 CFR § 53.4958-4(b) (ii) (A).
 - All forms of compensation are included in the analysis. 26 CFR § 53.4958-4 (a) (4).
 - Unreasonably high compensation is considered an excess benefit transaction and is subject to substantial tax penalties. 26 CFR § 53.4958-4(a) (1) (“An excess benefit transaction means any transaction in which an economic benefit is provided by an applicable tax-exempt organization directly or indirectly to a disqualified person, and the value of the economic benefit provided exceeds the value of the consideration (including the performance of services) received for providing the benefit.”)
- *Disqualified Persons*
 - “Disqualified persons” are those persons in a position to exercise substantial influence over the affairs of the exempt organization at any time during the preceding five year period. 26 CFR § 53.4958-3(a).
 - CEO’s and CFO’s are disqualified persons. Whether or not other executives are is based on a facts and circumstances test. Criteria include whether the individual has or shares authority to control or determine a substantial portion of the organization’s budget, capital expenditures or compensation or s/he manages a discrete segment or activity of the organization that represents a substantial portion of the activities, assets, income, or expenses of the organization. 26 CFR § 53.4958-3 (e)(iv) and (v).
- *Rebuttable Presumption.*
 - The federal law does not mandate a process for exempt organizations to follow in setting executive compensation.
 - Exempt organizations may, however, choose to take advantage of a “rebuttable presumption” that executive compensation is reasonable and not an excess benefit transaction. 26 CFR § 53.4958-6. To take advantage of the presumption:
 - The compensation must be approved in advance by members of an “authorized body” of the organization (the governing body, compensation committee, or other authorized party), §53.4958-6 (a)(1);

- The authorized body is composed entirely of individuals with no conflict of interest with regard to the compensation arrangement, §53.4958-6 (a)(1);
 - The authorized body obtains and relies upon appropriate comparability data, §53.4958-6 (a)(2); and
 - The authorized body adequately and contemporaneously documents the basis for its determination, §53.4958-6 (a)(3).
- If the exempt organization does not take advantage of the presumption, the indicia of reasonableness will still be the appropriate use of comparability data, the contemporaneous documentation of the reasons underlying the compensation decision and whether the decision maker(s) had conflicts of interest.
- *Appropriate Comparability Data* §53.4958-6 (c) (2).
 - Relevant information includes but is not limited to compensation levels paid by similarly situated organizations, both taxable and tax-exempt, for functionally comparable positions; the availability of similar services in the geographic area of the applicable tax-exempt organization; current compensation surveys compiled by independent firms; and actual written offers from similar institutions competing for the services if the individual.
 - Comparability analyses should be done by the board or compensation committee. They are often conducted by outside consultants (should be engaged by and report directly to the board).

Recent IRS Statements Regarding Non-Profit Executive Compensation

- Report on Exempt Organizations Executive Compensation Compliance Project http://www.irs.gov/pub/irs-tege/exec_comp_final.pdf
- Statement of Steven Miller, Commissioner, Tax Exempt and Government Entities Division, Internal Revenue Service, before the Oversight Subcommittee of the House Ways and Means Committee, July 24, 2007 (<http://waysandmeans.house.gov/media/pdf/110/07%2024%2007/Miller%20testimony.pdf>)
 - “The media has reported high salaries and generous allowances at some charities and foundations. High compensation based on the fair value of services an executive performs for the exempt organization is consistent with current law. The key question is whether the compensation is comparable to what similar organizations pay for similar work. The organizations used for comparison may include for-profit as well as nonprofit organizations. The law permits reasonable compensation, even if

high. It does not, however, permit excessive compensation.”

- Letter from Kevin Brown, Acting Commissioner, Internal Revenue Service, to Senator Charles Grassley, Ranking Member, Committee on Finance, June 28, 2007 (<http://finance.senate.gov/press/Gpress/2007/prg072307a.pdf>)
 - In reviewing executive compensation in exempt organizations in previous two years, IRS found:
 - Widespread reporting errors;
 - Instances of excessive executive compensation in 25 charities involving 40 individuals resulting in the assessment of \$21 million in excise taxes.
 - Notes IRS’s concern about loans to executives and the compensation practices of tax-exempt hospitals.
 - Concludes: “We expect to scrutinize executive compensation in virtually every new exempt organization’s compliance initiative. As we continue to gain experience, we will review the use of comparability data to support the compensation amounts and assess the methods used to establish and approve the compensation. We will also be alert to increasing sophistication in the types of compensation exempt organizations use to pay their executives and other key personnel.”

Selected Resources on Non-Profit Executive Compensation

- Hopkins, Bruce R. *The Law of Intermediate Sanctions: A Guide for Nonprofits*. John Wiley & Sons, 2003.
- **Independent Sector**, (<http://www.nonprofitpanel.org/final/>) *Panel on the Nonprofit Sector: Strengthening Transparency, Governance, Accountability of Charitable Organizations, a final report to Congress and the Nonprofit Sector* June 2005. See Chapter 11, Executive Compensation.
- **Board Source** (<http://www.boardsource.org/>)
 - **Dollars and Sense: The Nonprofit Board’s Guide to Determining Chief Executive Compensation**, which guides nonprofit boards through the process of setting an effective chief executive compensation plan.
 - **E-Policy Sampler: Executive Compensation**, which includes an introduction to the topic, key elements, practical tips, suggested resources, and sample policies.
- **Salary Surveys**
 - **Charity Navigator**
<http://www.charitynavigator.org/index.cfm/bay/content.view/cpid/630.htm>
 - **Chronicle of Philanthropy**
<http://www.philanthropy.com/free/articles/v18/i24/24003901.htm>

- **Grantmakers Salary and Benefits Report**, Council on Foundations.
(<http://www.cof.org/>)
- **GuideStar Non-Profit Compensation Report** <http://www.guidestar.org>
- **The NonProfit Times**
<http://www.nptimes.com/07feb/special%20report.pdf>
- **Professionals for Non-Profits**
http://nonprofitstaffing.com/images/upload/DC_Sal_Survey_2007.pdf
http://nonprofitstaffing.com/images/upload/NY_Sal_Survey_2006.pdf