

rethinking executive pay

IN COMMUNITY-BASED ORGANIZATIONS

The federal bailout of big financial institutions has brought unprecedented attention to executive pay. While much of the outrage has been focused on large banks, the biggest fallout from public anger and disappointment may be at the local level, and community-based nonprofit organizations, such as hospitals, social service providers, arts organizations and private schools, can be easy targets for critics because they're so visible. You know the questions: "How can they pay bonuses to executives when they're laying off employees?" "How dare they pay for the CEO's car? She's paid enough to buy it herself!" "They fired that guy a year ago, but he's still getting paid. What gives?"

QUICK LOOK

- ➔ Board debates about executive pay typically focus on six areas: how much to pay, salary increases and bonuses, incentive plan design, community values, contractual commitments, and executives' expectations.
- ➔ For nonprofits, the fact that the organizations belong to their communities, not to private investors, argues in favor of paying attention to the community's economic distress when making decisions about executive pay.
- ➔ While many boards view contractual commitments as unbreakable, they should be viewed as agreements and understandings that need to change as conditions change.

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To get and keep talented executives,

companies at least need to pay the going rate. They can't hire executives for less, and they can't keep executives if they don't pay as well as other firms competing for the same talent.

Given the current economic and political climate, every community-based organization's board should reconsider how it pays executives. If the board would be uncomfortable defending its compensation philosophy or executive pay program to the community or regulators, it should update it to reflect current realities.

This article addresses six executive pay issues boards of community-based organizations are examining, and discusses steps boards can take to ensure pay is defensible in the court of public opinion, fair to executives, and effective in attracting, retaining and rewarding talented leaders.

Background

The recession has put pressure on boards of community-based organizations to reign in executive pay, and some are responding by freezing salaries or reducing bonuses. Moreover, certain forms of pay that were common just a few years ago — and that tax-exempt, community-based employers began offering so they could compete for talent with general-industry employers — are being eliminated in today's environment:

- Country club memberships
- Cars and car allowances
- Tax gross-ups (bonuses that are used to cover taxes due on taxable perquisites)
- Severance payments for more than 12 months after involuntary termination without cause
- Retention incentives on top of fully competitive pay.

Programs like these attract as much criticism as high pay because they don't seem fair. Why should highly paid executives receive cars, car allowances or country club memberships when their business travel and entertainment expenses can be readily reimbursed? Why should terminated executives get two or three years' severance when most employees are entitled to only a few weeks' severance? Then there's the question about allocation of scarce resources. When employers complain about the cost of employee benefits yet continue

providing perquisites and generous severance packages, they should expect people to question their priorities.

Board debates about executive pay typically focus on six areas:

- 1. How much to pay.** How much do we need to pay to attract, retain and reward the right kind of leaders? Do we pay too much relative to our peers?
- 2. Salary increases and bonuses.** We're performing well, but how do we justify salary increases and bonus payments when other local employers are suffering? Doesn't that make it look as if we're out of step with the community we serve and the people who support us?
- 3. Incentive plan design.** Does our incentive plan reward the right things? Are we willing to defend the goals on which we base incentive awards?
- 4. Community values.** Does our executive pay program reflect our community's values? How will our stakeholders view the program, especially the perquisites and severance components?
- 5. Contractual commitments.** How can we deal with contractual commitments that no longer seem reasonable?
- 6. Executives' expectations.** How do we deal with executives who expect higher pay and richer benefits and don't seem to recognize that times have changed?

The way boards address these issues may depend on whether they view today's heightened scrutiny as a symptom of the recession or a turning point in the way executives are paid.

Issue No. 1: How Much to Pay

To get and keep talented executives, companies at least need to pay the going rate. They can't hire executives for less, unless they promote from within or recruit only from smaller organizations, and they can't keep executives if they don't pay as well as other firms competing for the same talent.

Paying the going rate means paying at median or average of the right peer group. If compensation is near median, organizations should be able to recruit and retain, and the board should be comfortable that pay is about where it needs to be.

However, some boards and most managers feel median pay isn't enough to attract the caliber of leaders they need, or to properly reward performance. Most boards want their institutions to perform above average, so they assume they need exceptionally good leaders and need to pay above median to get them. Most managers believe they are above average and expect to be paid that way. There is little evidence, however, of any meaningful relation between above-average pay and above-average performance, or that it takes above-average pay to get and keep above-average leaders.

In some cases, paying above median makes sense. But many organizations pay above median without a real rationale. Some boards are retreating from their previous intent to pay above average and are saying, in effect, "We will pay at the 75th percentile if and only if we perform at the 75th percentile."

Note that some boards base executive pay on practices at organizations that are questionable comparators, such as much larger organizations, much more complex organizations, organizations in different industries or with different business models, or a peer group made up largely of for-profit companies. Other boards look only at organizations in their own communities. The best approach is to choose a comparator group that represents the talent pool from which the organization recruits. Any other approach can raise red flags about whether comparisons are truly valid, or look like an attempt to justify unreasonably high pay.

Issue No. 2: Salary Increases and Bonuses

For nonprofits, the fact that the organizations belong to their communities, not to private investors, argues in favor of paying attention to the community's economic distress when making decisions about executive pay.

Most board members understand that increasing executive salaries by 4 percent or 5 percent won't have a large impact on the bottom line or on the lifestyles of executives, but might send a negative message to employees, customers, financial supporters and other important constituent groups, especially if the organization is trimming costs in other areas. Foregoing salary increases for a year seems a small price to pay to show stakeholders that the board shares their concerns, and that executives are willing to put the good of the organization above their own interests.

Another way to demonstrate that the board is attuned to the economic distress in the community is by reducing or delaying incentive awards. If the board has the latitude to exercise discretion in determining award size, it would be appropriate to consider economic conditions in the community, making sure that awards and total compensation are no higher than in years past, when economic conditions were better.

Trimming other discretionary components of executive pay, like perquisites (auto allowances, club memberships, discretionary contributions to retirement benefits), could also be appropriate.

Issue No. 3: Incentive Plan Design

Incentive awards in nonprofit organizations should be based primarily on achieving mission-related goals. Tax-exempt organizations that base awards substantially on profitability may be sending the wrong signal to stakeholders, indicating that they care more about financial performance than community service. Boards should make sure that any bonuses or incentive awards are justifiable in relation to the organization's tax-exempt mission and, insofar as possible, for achieving goals that its stakeholders support. Boards of nonprofit hospitals, for example, in the face of legislative reform efforts focused on reducing cost of care and improving access, might be wise to shift emphasis from financial performance to clinical quality and redefine the measure of financial success as cost-effectiveness, rather than profitability.

The bottom line: Boards need to make sure they are rewarding results that their stakeholders support. It is easier to justify incentive awards the closer the goals are to the heart of the organization's tax-exempt mission—meeting the needs of the community served, doing it well and doing it efficiently.

Issue No. 4: Community Values

Recently, tougher proxy disclosure rules and the requirement for nonprofits to disclose executive compensation in IRS form 990s have brought executive pay, benefits and perquisites out in the open and exposed them to public scrutiny and criticism they didn't face when the programs were designed. Because they often come into conflict with community values, perquisites and severance are two key issues worth examining.

Perquisites. A lot of boards are deciding it's not worth the effort to defend controversial executive perquisites. No board member wants to have to explain why a tax-exempt organization pays for a car or a country club membership for its CEO, or why it covers 100 percent of executives' health insurance premiums even as it shifts more costs to other employees. Perquisites like these are being eliminated because it is hard to justify them, even in the for-profit sector, and they attract more negative attention than they are worth. Many organizations now limit perquisites for executives to nothing more than cell phones, PDAs and laptop computers—items that are business necessities, not perquisites.

For executives who do not recognize that **times have changed,** boards have to decide what course of action will best serve the organization.

Severance. Executive severance payments are often very large, making severance a hot-button issue. Most people would agree that terminated employees, even executives, need severance benefits while they look for a new job, but it's hard to justify three years' severance for a CEO when severance for most employees is just a few weeks or a few months. Furthermore, the public is quick to label executive severance as a reward for failure. Many organizations are responding to public opinion by reducing severance benefits for executives and refusing to offer generous severance to new hires. One year of severance for a CEO or senior executive typically will not inflame controversy, but three-year severance periods, once common, are becoming relics of a different era.

Issue No. 5: Contractual Commitments

Employment contracts have become commonplace in many industries, particularly for CEOs and senior executives. But boards often find themselves stuck with contractual obligations they never intended to have or never understood. Contracts are often executed by trustees who leave the board long before the commitments need to be honored by their replacements; retirement benefits are approved based on a simple formula, such as 50 percent of final average pay, with no recognition of what the cost is likely to be; and evergreen employment contracts sometimes entail an obligation to pay severance even at retirement.

While many boards view contractual commitments as unbreakable, they should be viewed as agreements and understandings that need to change as conditions change. Surely unusual circumstances such as a recession so bad that employers need to cut benefits for other employees, the loss of a significant portion of an endowment fund, or the reform of health care at the federal level are game-changers that warrant reopening contract negotiations with executives.

The easiest time to modify contractual terms is when an executive is being replaced. No board should offer the next executive hired the same terms as the last one, unless it is totally comfortable with those terms. For the continuing executive, it is harder to change terms, but most employment contracts have a clause that allows for cancellation or renegotiation with appropriate notice. A board that believes it is important to change terms should be able to do it, if executives care as much about their organizations as about their own pay. It may cost something to make the change, but an appropriate salary increase should be a fair trade-off for most perquisites. Non-renewal of an employment agreement on the same terms often constitutes constructive termination triggering payment of severance, so the negotiation needs to be handled sensitively and openly. Since the reason for making the change is to protect the institution, an executive should be willing to make the change, so long as the board explains its intent well and avoids letting the negotiation become confrontational.

Issue No. 6: Executives' Expectations

Some executives see compensation as the measure of their success and demand more, placing their own financial well-being ahead of what is best for the organization. The current economic climate and the heightened scrutiny sure to accompany the new form 990 reporting requirements are excellent reasons for boards to refuse to give in. This applies not only to existing employees but also to new hires. Boards do not have to make unusually rich offers to fill open positions, as there are generally plenty of good candidates for most job openings.

For executives who do not recognize that times have changed, boards have to decide what course of action will best serve the organization. Contractual terms must be honored if they cannot be renegotiated, and few boards are willing to lose a key executive who is performing well over pay issues.

Make sure compensation committee members are truly **independent** and not overly influenced by management.

But an executive who wants to make a move simply to earn more money is going to find fewer opportunities in today's open market. Boards that are simply unable to increase pay should not apologize for taking a firm stand when unreasonable demands are made. Difficult discussions about pay issues need to be grounded in doing what is best for the organization as a whole, not what is best for an individual executive.


Next Steps for Boards

There are steps boards can take to prepare themselves for an environment of increased media and regulatory scrutiny:

- Review best practices for governing executive pay within your industry, and make sure you are adopting them in your own organization. If you are not sure you are conforming to best practices, your attorney or consultant should be able to help.
- Make sure compensation committee members are truly independent and not overly influenced by management. The compensation committee's role is to exercise fiduciary responsibility, even when executives are disadvantaged by its decisions.
- Review how you position executive pay in comparison to peers. If you are targeting pay above median, think about the rationale for doing so and whether it makes sense in today's climate. If you aren't ready to defend the rationale to the public, then it may not be right for the times.
- Set goals that truly stretch the executive team, especially if pay is above median. Avoid tying awards too much to profits, and focus instead on goals that match the public's needs and expectations for your organization.
- Review all forms of executive compensation and eliminate those likely to provoke public scorn. Consider eliminating perquisites unless they serve a business purpose.
- Carefully review severance provisions for each executive. Adopt a conservative severance policy and reasonable payment timeframes, with offsets for income from new employment.
- Review executive employment contracts to make sure they still serve the organization's needs. If an employment agreement becomes outdated, the board has every right to reopen negotiations, just as it periodically renegotiates labor agreements.

Conclusion

Executive compensation cannot be inflexible. It needs to be dynamic, changing as organization and community needs change. Boards cannot be afraid to modify their approach to executive pay when the situation warrants it. Some changes may be temporary, such as waiving salary increases or bonus payments during the recession. Other changes may be permanent, such as eliminating perquisites.

Rethinking executive pay may be difficult, and implementing changes may be even harder, but the end result will be good for the organization and good for executives because a total compensation philosophy centered on doing what's right for the institution and the community it serves will be more defensible to stakeholders. 

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