# Massachusetts Public Charities CEO Compensation Review

Executive Summary

December 2013

# Executive Summary

Executive compensation, particularly that of chief executive officers (CEOs), has increased rapidly in recent decades and has become a frequent subject of discussion nationally and regionally. While CEOs at for-profit companies have commanded the highest compensation packages, CEO compensation at public charities has also increased. In fact, high executive compensation at public charities frequently leads to greater levels of concern, because of the view that large compensation packages take money away from charitable missions. They can also negatively affect the perception of the charities with employees, donors and other constituencies, as well as with the general public. At the same time, the largest public charities are complex organizations in their own right, and demand a level of executive ability that is at least commensurate with that complexity.

The Non-Profit Organizations/Public Charities Division (the Division) of the Office of the Attorney General (AGO) undertook this focused review of CEO compensation as part of the AGO's efforts to increase transparency of executive compensation at public charities in the Commonwealth. This study explores a new approach to reporting executive compensation at public charities, describes components of executive compensation, and explains the process used by the organizations in the study to set and to evaluate CEO compensation.

We asked 25 of the largest public charities in Massachusetts to complete a prototype of a new reporting form for CEO compensation data for a three year period (2009-2011). We intend to incorporate a version of this new form, the "Schedule EC," into the Form PC annual report for certain Massachusetts public charities. We also requested the opportunity to review certain additional information about the 25 organizations' approach to executive compensation.

We found that CEO compensation at these organizations is complex and includes a variety of components, often including special retirement benefits not available to most segments of the workforce. Some CEO retirement programs are designed to replace a percentage of income in retirement, much like the defined benefit pension plans that have become rare for most segments of the workforce.

CEO compensation is generally high. Among the charitable organizations in the study it ranged from a low of $487,397 annually to a high of $8,827,494 (considering all elements of reported compensation).

Compensation for the CEO tended to increase annually, but total reported CEO compensation can fluctuate due to isolated payments or vesting events involving retirement and certain other forms of compensation. These types of payments and vesting events can make straightforward year-to-year comparison of compensation levels challenging.

Executive compensation comprises several broad categories of compensation and benefits. Public reporting of compensation is based on the following broad categories required by the Internal Revenue Service (IRS):

- Base Compensation
- Bonus and Incentive Compensation
- Other Reportable Compensation
- Retirement and Other Deferred Compensation
- Nontaxable Benefits

While we determined that it made most sense to build more detailed reporting using the IRS categories, the additional detail in the Schedules EC and in the materials we reviewed as part of the study led us to describe compensation components and other benefits that are part of CEO compensation under the following headings:

- Cash Compensation
- Retirement and Other Deferred Compensation
- Other Forms of Compensation and Benefits
- Contingent and Contractual Benefits

A set amount for base salary was the most prevalent element of compensation, used by all the organizations in our study. Nineteen organizations reported incentive compensation – either annual or long term – as an additional element of cash compensation. Nineteen organizations reported some form of supplemental executive retirement program or "SERP" to supplement retirement benefits available to non-executive employees.

We found that the organizations in our study approached setting the CEO's compensation with care and attention to the standards the IRS has set forth creating a presumption that the compensation is reasonable. Twenty-three used outside compensation consultants to assist them. The remaining two used IRS Form 990 data from comparable organizations to assess the reasonableness of their CEO's compensation. Despite the care these organizations took in setting CEO compensation, we found little evidence that the process restrained CEO compensation or its growth.

We believe that adding certain additional data points and aspects of analysis to the process of setting CEO compensation may to lead to more moderate rates of increase in CEO compensation, allowing more charitable resources to be devoted to the organization's charitable mission. That might also decrease the disparity between CEO pay and that of the rest of the workforce, a disparity that has generally increased in the United States in recent years and is a cause of concern to many.[1] Finally, broadening the analysis behind setting CEO compensation to include elements outside the narrow approach of peer comparison may increase public confidence in the fairness or reasonableness of CEO compensation. Examples of additional data points and aspects of analysis we recommend charities consider include:

- Charge the compensation committee with evaluating the reasonableness of compensation for other segments of the charity's workforce as well as executives.
- Include analysis of the relative magnitude of the CEO's total compensation package in relation to that of the non-executive workforce.
- Consider the level of public support the charity enjoys in the form of exemption from property tax and other forms of taxation.

This study and the Division's new Schedule EC are intended to increase transparency by explaining the types of compensation and benefit vehicles large public charities use to compensate senior executives and by requiring additional detail not generally reflected in the IRS filings (e.g., Schedule J), and by doing so on a more current basis.

1 See, e.g., Facundo Alvaredo, Anthony B. Atkinson, Thomas Piketty and Emmanuel Saez, "The Top 1 Percent In International and Historical Perspective," Journal of Economic Perspectives, Volume 27, Number 3 (Summer 2013), pages 3-20.

The Office of the Attorney General wishes to express its appreciation to the 25 organizations that participated in this focused review. They are, in alphabetical order:

- Baystate Health
- Beth Israel Deaconess Medical Center
- Blue Cross and Blue Shield of Massachusetts
- Boston Medical Center
- Boston University
- Brandeis University
- Brigham and Women's/Faulkner Hospitals
- Children's Hospital
- Dana-Farber Cancer Institute
- Fallon Community Health Plan
- Harvard Management Company
- Harvard Pilgrim Health Care
- Harvard University
- ISO New England
- Lahey Health System
- Lawrence General Hospital
- Massachusetts General Hospital
- Massachusetts Institute of Technology
- Northeastern University
- Partners HealthCare System
- Sturdy Memorial Hospital
- Suffolk University
- Tufts Associated HMO
- Tufts University
- UMass Memorial Health Care

# Introduction

As part of their fiduciary responsibility, boards of directors of public charities are responsible for furthering the missions and safeguarding the assets of the charitable organizations they serve. An important element in that responsibility is to carefully scrutinize the executive compensation arrangements that they establish for their CEOs. Compensation that is excessive (or that is perceived to be excessive) can have significant negative impact on a public charity's operations and mission, and may result in tax penalties. Negative perceptions can also harm a charity's reputational assets, and large compensation packages often act as a lightning rod for criticism. Moreover, as our society becomes increasingly concerned about issues of income inequality, high executive compensation at charitable institutions—particularly at those institutions providing essential services like health care and education—is likely to receive more public attention. When members of the public pay high and rapidly escalating prices for these important services, high executive compensation packages spark even more pointed debate and suspicion. It is not always clear that large compensation and benefits packages are actually necessary to attract and retain executive talent. And apart from the simple cost of these high compensation packages, depending on the types of benefits that are included, some compensation arrangements can place the charity at considerable financial risk.

The CEO's compensation (along with that of other highly paid executives and employees) must be publicly reported, in some detail, on Schedule J to a public charity's IRS Form 990 (IRS Schedule J). The Form 990 is filed with the IRS; a copy is submitted to the Division for Massachusetts public charities. Because the IRS Schedule J reporting of compensation data is somewhat limited, and is generally delayed by more than a year, the Division has proposed the introduction of a new schedule—Schedule EC—to the AGO's reporting form, the Form PC.[2] The new Schedule EC would require additional, and earlier, reporting on executive compensation for Massachusetts public charities.

This report describes the compensation of CEOs at 25 large Massachusetts public charities and the processes those organizations used to determine, evaluate and approve the compensation packages. We hope the report assists readers in understanding the ways in which charitable organizations compensate executives, how various forms of compensation relate to the organization's charitable mission and direction, and how existing regulations may impact and influence compensation decisions.

The AGO conducted its focused review of CEO compensation by requesting the completion of a prototype Form PC schedule that covered a three-year period from 2009 to 2011. The goals of this review, and the development of the new Schedule EC, are to assist the public in obtaining more comprehensive information about executive compensation at Massachusetts public charities, and to do so in a way that is more timely than the reporting to the Internal Revenue Service.

2 All financial filings submitted to the Division are digitally scanned, and are available for public viewing at www.mass.gov/ago/doing-business-in-massachusetts/public-charities-or-not-for-profits/public-charities-annual-filings/public-charities-annual-filings.html.

- While the IRS has established a process for setting executive compensation which, if followed, allows a public charity to invoke a presumption that the compensation is reasonable under federal tax law, the AGO believes that this process alone may not assure reasonable compensation and that there are additional considerations that should be included.
- Responses to the prototype Schedule EC are included as appendices in a separate volume, published on the web and available at http://www.mass.gov/ago/ceocomp; the data obtained from those responses is presented in multiple charts within this report to allow for visual comparisons among organizations.
- The report takes a detailed look at the different types of compensation and benefits that were reported in the Schedule EC responses, and provides explanations to assist the reader in understanding the more comprehensive information included on the responses to the Schedule EC.
- The report next looks in detail at the different aspects of the compensation-setting process, including: the use of board compensation committees; the types of comparability data that are employed; the prevalent use of outside compensation consultants; and other institutional considerations that influence compensation levels.
- A number of observations follow, including discussions of: certain large lump-sum payments that appear on compensation reports; the fact that some CEO retirement plans are designed to operate much like the defined benefit plans that have declined in use for much of the general workforce; the exclusive and sustained focus on executive-suite compensation and benefits packages that may lead to a loss of perspective on what is "reasonable" and, over time, contribute to the escalation of CEO compensation packages at public charities.

**The Public's Interest in Executive Compensation Information**

In 2009, the AGO observed that in the health care arena, the rapid escalation of executive compensation in the context of rapidly increasing health care costs merited additional and more timely reporting on executive compensation. The same can be said for higher education. The extent to which the size of executive compensation packages directly contributes to the cost of these important charitable services is less important than the attitude toward costs that is created or supported by the existence of rich compensation packages.

See footnote 11 p. 14.

# The Regulatory Context For A Discussion Of Charitable Executive Compensation

## A. The AGO's Oversight Role

The AGO, through the Division, is responsible for "see[ing] to the due application of funds given or appropriated to public charities" in the Commonwealth and charged with "prevent[ing] breaches of trust in the administration" of public charities.[3] Within this broad mandate, the AGO reviews decisions made by boards of directors and senior executives at public charities to ensure that they are consistent with the fiduciary duties of care and loyalty that such decision-makers owe to the charities they serve. Their decisions must be made based on the best interests of the charity and may not result in the diversion of funds away from their charitable purpose to the unwarranted private benefit of other persons or entities.

Payments that exceed fair market value, including excessive compensation, could constitute a misapplication of charitable funds as well as a breach of trust in the administration of those funds. Determining what constitutes fair market value for executive services, however, can be difficult. Even deciding on the factors relevant to the determination is not straightforward. For example, is the relevant "market" for this "fair market value" determination limited to other similar non-profit organizations whose CEOs have similar responsibilities? Or does the "market" include all companies that might seek the services of the individual whose compensation is under review, irrespective of for-profit or non-profit status and irrespective of similarity of organization? Alternatively, should for-profit companies be excluded from the "market" on the ground that for-profits likely pay more, and salaries should be lower at charitable companies simply as a matter of principle?

In assessing a board's performance of its fiduciary duties in making these and other decisions, the Division examines the way in which the board approached determinations like these. There are no regulations dictating precisely how a board should make these determinations consistent with its fiduciary duties. Of course, reasonableness is always required. Regulations and standards from other relevant oversight bodies can provide useful guidance. The most prominent example of such guidance is the Treasury regulations issued under section 4958 of the Internal Revenue Code.

## B. Internal Revenue Service (IRS) Standards: Section 4958

The IRS oversees tax-exempt organizations, including most public charities, in part for purposes of ensuring that the organizations' exemption from taxation is warranted. One aspect of IRS oversight is ensuring that the resources of an exempt organization are devoted to the organization's mission and not paid or used for the private gain, or inurement, of particular individuals. Compensation, like other payments charities make, must be no more than fair market value for the services being provided. In 1996, Congress enacted new provisions of the Internal Revenue Code that authorize the IRS to impose significant taxes on charity insiders who receive excessive compensation and on directors and officers who knowingly approve such compensation arrangements. Prior to this change, the IRS's sole remedy in cases of excessive compensation was revocation of the organization's exempt status. Because the new section 4958 and its associated regulations a provide an alternative to the rarely-invoked "ultimate penalty" of revocation, they are often called the "intermediate sanctions" framework.

3 M.G.L. ch. 12, § 8.

Section 4958 of the Internal Revenue Code provides for significant taxes to be assessed against people involved in an "excess benefit transaction" (including a transaction in which a charity pays compensation in excess of fair market value to a "disqualified person" – someone in a position to exercise significant influence over the affairs of the organization).[4] Regulations provide a "safe harbor" or a set of conditions which, if met, create a rebuttable presumption that a compensation arrangement is not an "excess benefit transaction" (and that it is reasonable). A compensation arrangement is entitled to the rebuttable presumption of reasonableness if:

- The compensation arrangement is approved in advance by an authorized body of the organization (e.g., the board of directors or a committee of the board) composed entirely of individuals who do not have a conflict of interest (e.g., a body composed entirely of independent directors);[5]
- The authorized body obtained and relied upon appropriate data as to comparability prior to making its determination; and
- The authorized body adequately documented the basis for its determination concurrently with making that determination.[6]

The IRS may rebut the presumption of reasonableness only if it "develops sufficient contrary evidence to rebut the probative value of the comparability data relied upon by the authorized body."[7] If the transaction involves a fixed payment, such as under an employment contract, the IRS's evidence is "limited to evidence relating to facts and circumstances existing on the date the parties enter the contract pursuant to which the payment is made."[8] Relevant data for assessing reasonableness of compensation 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 of the disqualified person."[9]

## C. Massachusetts Charities Law Considerations

The Division has looked to an organization's compliance with section 4958 as an important factor in analyzing the appropriateness of executive compensation and its consistency with Massachusetts charities law.[10] However, the AGO does not enforce tax laws or regulations, including section 4958, and is not bound by the standards these tax regulations set forth. The Division noted in its 2009 Memorandum on executive and director compensation[11] that since the enactment of section 4958 and the issuance of the "rebuttable presumption" regulations, executive compensation at public charities increased rapidly, continuing a trend that predated section 4958. The Division raised the concern that instead of setting a "ceiling" on compensation rates, section 4958

4 For example, the "disqualified person" receiving the excess benefit may be subject to a tax of 25% of the amount of the excess benefit and, if the excess benefit is not returned to the charity, a tax of 200% of such excess benefit. Also, any organization manager who knowingly participated in (for example, by approving) the excess benefit may be subject to a tax of 10% of the excess benefit. See 26 U.S.C. § 4958.

5 Independent directors do not have a financial interest in the transaction.

6 26 C.F.R. § 53.4958-6(a).

7 26 C.F.R. § 53.4958-6(b).

8 26 C.F.R. § 53.4958-6(b).

9 26 C.F.R. § 53.4958-6(c)(2).

10 See, e.g., letter to John William Poduska, Sr., Chairman of the Board of Directors, Citi Performing Arts Center, dated December 5, 2007, available at www.mass.gov/ago/docs/nonprofit/findings-and-recommendations/citi-center-findings-letter-120507.pdf.

11 See memorandum to Massachusetts Hospital Association, Blue Cross and Blue Shield of Massachusetts, Harvard Pilgrim Health Care, Tufts Health Plan, and Fallon Health Plan, dated September 2, 2009, available at www.mass.gov/ago/docs/nonprofit/findings-and-recommendations/bcbs-memo-090209.pdf (2009 Memorandum).

may have instead created a floor, and raised the question whether section 4958 has served well the public's interest in ensuring that charitable assets are devoted to charitable missions.[12] As noted above, the AGO assesses executive compensation at public charities in terms of whether the compensation is consistent with fiduciary duties the executive and the board owe to the charity. Those duties may require the consideration of factors beyond the steps needed to comply with section 4958.

In addition to assessing compensation itself, the AGO supports increasing the transparency of executive compensation. The Division's 2009 Memorandum also explained some of the challenges to creating and supporting transparency in the reporting of executive compensation. For example, "compensation" for purposes of section 4958 and reporting on IRS Form 990 (the annual information return the IRS requires of most tax-exempt organizations) and the Massachusetts Form PC (the annual report the Division requires of Massachusetts public charities) includes various forms of retirement benefit plan and deferred compensation amounts, including amounts that have not yet been paid and, in some cases, amounts to which the executive does not yet have a vested right. Those same amounts will be reported later when the executive's unqualified right to receive them "vests" (that is, when he or she is entitled to receive them at the appointed time, such as retirement, and they are no longer subject to risk of forfeiture). This results in double-reporting of certain amounts, many of which do not initially appear on the individual's W-2 form because they have not been paid, but only set aside for the CEO's future benefit.[13]

Reported figures in the "retirement" or "other reported compensation" categories may give the impression that executive compensation varies considerably from year to year. Sometimes significant reported figures are due to adjustments in or funding of retirement or other benefit or deferred compensation plans. Such amounts are frequently not related to the executive's performance in that particular year, but instead reflect a negotiated benefit package designed to pay the executive a certain amount at a point of time in the future. If the organization hasn't adequately funded the plan, it may make a significant "catch-up" transfer in one year. Or, a large number may be reported in a given year because the executive vested in a portion of the benefit (meaning that his or her right to receive that amount is no longer subject to risk of forfeiture). Many organizations maintain these kinds of plans for executives, but they differ in how they report payments to these plans. Some may report them as "retirement" while others may report them as "other reportable compensation." As described more fully below, the lack of consistency in reporting reflects a flexibility in the design of such supplemental executive plans, but contributes to misunderstandings about the nature of executive compensation as reported on the Form 990.

Moreover, the information reported on the Form 990 and Form PC is often quite stale by the time it is reported. In some cases, it may be nearly two years old. The Form 990 requests compensation data from the calendar year that ended during the fiscal year that is the focus of the Form 990. While the Form 990 is due four and a half months after completion of the fiscal year, organizations are generally entitled to two extensions of three months each. For organizations whose fiscal year ends on September 30, for example, the Form 990 might not be submitted until mid-August of the following year; the compensation data reported on IRS Schedule J will reflect the calendar year ending during that fiscal year end, i.e., the year ending almost 20 months prior to the report's submission. The delay is an obstacle to transparency.

12 2009 Memorandum at 4.

13 The final column on IRS Schedule J attempts to account for such double reporting by requiring charities to indicate whether any of the compensation on the current report had been reported as some form of deferred compensation on a prior year's IRS Schedule J. But because of its lack of specificity, the Division has found this column to be of only limited utility. Some of the organizations we spoke to have expressed similar reservations about its usefulness.

# Study Methodology

We selected 25 Massachusetts public charities from among those with the highest reported gross support and revenue and the highest reported compensation.[14] While we did not set out to confine the study to particular industries, the group of 25 includes a health care sub-group (including four health plans and twelve hospitals or provider systems) and a higher education sub-group (including seven universities). This allowed us to compare and contrast approaches and practices within and between these two major groups. The other organizations in our study, Harvard Management Company and ISO New England, also share certain characteristics in that other entities in their primary areas of activity are generally commercial rather than charitable.[15]

We asked each organization to complete and submit a prototype "Schedule EC" for its CEO for calendar years 2009, 2010, and 2011.[16] We focused on CEO compensation rather than asking for information about a broader set of executives because we deemed the CEO position to be most analogous across organizations (whereas other positions can encompass different duties depending on varying organizational structure and staffing). We requested three years of data in hopes of observing trends and a variety of examples of reports to determine how effectively the prototype form would capture and explain those variations.

We developed the prototype Schedule EC based on the IRS Schedule J, which already calls for fairly detailed information about executive compensation. The Schedule EC requests information in the same general categories as the IRS Schedule J, but the EC asks for information about each individual component within the categories. It also asks for narrative explanations about each figure or program that is not self-explanatory. We believe that the break-down of information and the accompanying explanations will significantly increase the transparency of compensation reporting and will reduce confusion that may arise from various aspects of current reporting mechanisms, such as the double-reporting of certain elements and aggregation of others (such as "other reportable compensation," one of the categories in the IRS Schedule J).

In addition to the Schedule EC, we asked the organizations to assemble additional information for our review that we thought would enable us to understand the process the organizations used to assess the "reasonableness" of the compensation packages reported.[17] This deeper examination helped us develop an understanding of organizations' practices in invoking the section 4958 rebuttable presumption and helped us develop impressions about which questions and information requests might be most productive to implement on a broader basis.

**The Impact of Transparency: Blue Cross Blue Shield Example**

In 2011, the AGO conducted an investigation of Blue Cross and Blue Shield of Massachusetts' payment of more than $4.2 million in severance to its former CEO, whose employment the board had terminated. The AGO's investigation and report shed light on the practice of including severance provisions in CEO contracts that entitle the CEO to substantial payments upon termination of employment for nearly any reason short of intentional misconduct. Blue Cross and Blue Shield refunded $4.2 million to its members.

See footnote 32 p. 68.

14 Selections were based on data reported for calendar year 2009, the latest year for which we had complete reported information for all public charities.

15 Harvard Management Company is, essentially, an investment management firm that manages the Harvard University endowment in the same way that commercial investment managers would. Harvard's decision to "in-source" this service allows it to avoid paying large advisory and incentive fees to outside commercial investment managers. ISO New England manages the power grid and market for the New England states, dealing with the largely for-profit power companies in the region.

16 See Appendix A for a copy of our prototype Schedule EC, and Appendices C through AA for the submitted Schedules EC.

17 A copy of the Information Request is at Appendix B.

Some of the organizations did not make available all the information we had requested.[18]

Other organizations, including all of the hospitals, offered or even requested the opportunity to discuss with us our impressions and questions about the materials we had reviewed. We found these discussions helpful and express our thanks to those organizations.

Because the additional information we reviewed is sensitive, because we have not reviewed the same level of information at organizations other than the 25 in our study, and because the review is intended to contribute to better understanding of procedures and practices generally, we do not report organization-specific information that is not reported in the attached Schedules EC.

18 Several of the universities declined to allow us to review some of the materials that would have been responsive to our Information Request and provided access instead to a subset of materials and/or a narrative constructed to explain the organization's approach to executive compensation.

Office of Attorney General Martha Coakley

One Ashburton Place

Boston, MA 02108

(617) 727-2200

www.mass.gov/ago/charities