Massachusetts Attorney General Report on Charity CEO Compensation Reviews Pay Practices and Introduces New Reporting Form

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Shortly before the new year, Non-Profit Organizations/Public Charities Division of the Office of the Attorney General (the AGO) released a detailed 92-page report on executive compensation at Massachusetts-based public charities.

The report analyzes the CEO compensation-setting practices at twenty-five large Massachusetts public charities, makes recommendations regarding additional criteria – apart from IRS guidelines – that charitable boards should consider in setting executive compensation, and introduces a new form (the "Schedule EC") that certain Massachusetts public charities will need to complete as part of their Form PC annual report.

AGO Survey of 25 Public Charities

The AGO is entrusted by statute to "see to the due application of funds given or appropriated to public charities" in Massachusetts and charged with preventing "breaches of trust in the administration" of public charities. M.G.L. c. 12, § 8. To that end, the AGO reviews financial matters at the public charities under its authority, including matters related to executive compensation.

The AGO conducted this focused review of CEO compensation by requesting twenty-five large Massachusetts public charities to complete a prototype "Schedule EC" covering the three-year period from 2009-2011. The participating charities also completed a detailed executive compensation information request.

The charities participating in the study were primarily health plans, hospital and provider systems, and universities. The report profiles the base compensation paid to the CEOs and discusses other elements of total compensation, including bonuses, deferred compensation, auto allowances, financial planning, life insurance, and severance payments. The study also highlights certain areas where the AGO considers benefits to be particularly generous.

AGO Favors Broader Criteria For Setting Reasonable Executive Compensation

The report observes that boards of the participating institutions exercised "care and attention" in meeting federal guidelines for setting "reasonable" executive compensation. When a public charity follows these guidelines, it establishes a presumption that the compensation is reasonable under federal tax law. Generally, these guidelines provide that if the independent members of the board approve the compensation, record their decision-making process in writing in a timely manner, and base their decision on a review of compensation paid by comparable institutions for comparable services, the presumption of reasonableness is established.

Under federal law, compensation that is not "reasonable" under the guidelines may result in steep penalties to the individual who received the compensation as well as to the officers and directors who approved it.

The AGO report opines that merely meeting such federal compensation-setting guidelines is insufficient to ensure proper administration of charitable funds. Rather, the report recommends that additional considerations should inform a charitable board's compensation-setting process, including:

- impact of the compensation on the charity's mission;
- impact of the compensation on the charity's reputation;
- level of financial risks imposed by certain types of compensation arrangements;

- whether the charity is paying more than is necessary to secure the needed executive talent;
- the relative magnitude of the CEO's total compensation package in relation to that of the charity's non-executive workforce; and
- the "tax subsidy" received by the charity due to its exemptions from income tax, property tax, or other forms of taxation.

The AGO report states that adding such additional data points and aspects of analysis to the executive compensation-setting process may lead to "more moderate rates of increase in CEO compensation". This will, according to the report, allow more charitable resources to be applied to the organization's charitable mission and may decrease the disparity between executive compensation and the compensation paid to the rest of the charity's workforce. Such broadened considerations may also "increase public confidence in the fairness or reasonableness of CEO compensation" at Massachusetts public charities.

New "Schedule EC"

The AGO report states that the purpose of the new Schedule EC is to provide more transparency regarding executive compensation by requiring more detailed and more timely disclosure of such information. The AGO report notes that the compensation information reported on Schedule J of IRS Form 990 may be more than a year out of date by the time it is made public.

Schedule EC will need to be completed by certain Massachusetts public charities as part of the Form PC annual report. More information about Schedule EC and related reporting requirements, including which types of charities will be required to file the new form, will be forthcoming in revised Form PC instructions which the AGO anticipates releasing early in 2014.

The prototype Schedule EC, and accompanying Schedule EC-1, were completed by the charities participating in the AGO study. Among other items, the prototype of the new form requires organizations to:

i. describe the nature of each compensation component reported on Schedule EC-1;

ii. provide an explanation regarding how and when any forms of contingent compensation (e.g., deferred compensation, incentive compensation, and retirement) accrue, vest, and are (or will be) paid;

iii. list loans and loan guarantees initiated or existing between the organization and the CEO;

iv. identify the compensation consultant used in establishing the compensation; and

v. describe how the CEO's compensation-setting process differs from the compensation-setting process for other members of the organization's senior management team.

The new Schedule EC proposed by the AGO should not be confused with the Department of Revenue's Schedule EC – Solar and Wind Energy Credit.

Conclusion

The AGO report includes a significant amount of information regarding compensation-setting practices at the twenty-five large public charities studied, providing other Massachusetts charities with valuable insight into how these practices operate.

In addition, the AGO report and the new Schedule EC both signal a strong renewed commitment by the AGO to publicly monitor and closely scrutinize (i) the level of compensation paid to top executives at public charities, (ii) the reasonableness of each compensation component as a means to accomplish the charity's mission, and (iii) the method by which compensation is set.

In light of this, Massachusetts public charities may want to review their executive compensation setting processes to make sure that they will withstand a possibly higher level of scrutiny.

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