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Executive Compensation Legal Issues for Colleges and Universities

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Introduction

- Executive compensation for colleges and universities creates numerous legal issues
  - Increasing government scrutiny and demands for public accountability have brought issues of executive compensation under the microscope.
  - Both the IRS and the Massachusetts Attorney General's Office are increasing their efforts to investigate and penalize colleges and universities that over-compensate senior personnel.

Introduction

- Regulation by State and Federal Law
  - Both the IRS and the Non-Profit Organizations/Public Charities Division of the Massachusetts Attorney General's Office scrutinize the reasonableness of a charity's executive compensation and the process used by the board to determine compensation.
    - Federal:
      - IRS 503(c)(1) tax exempt status
      - IRS Form 990
      - Reporting "comparison groups" to the US Dep't of Education
    - State:
      - Attorney General's Office ("AGO")
      - Reporting Requirements and Public Disclosure
      - Recent Legislation

- Colleges and Universities as Tax-Exempt Institutions
  - The vast majority of private colleges and universities are tax exempt entities as defined by Internal Revenue Code § 501(c)(3):
    - "Corporations, and any community chest, fund, or foundation, organized and operated exclusively for religious, charitable, scientific, testing for public safety, literary, or *education purposes* . . ." 26 U.S.C. § 501(c)(3) (emphasis added).

- All tax-exempt private colleges and universities are required to yearly file the IRS Form 990.
  - The IRS Form 990 requires disclosures of compensation of current officers, directors, trustees, key employees, and the five highest compensated employees.

Federal Law: Consequences of Non-Compliance

- IRS consequences for failing to appropriately compensate college/university executives:
  - Loss of 501(c)(3) tax-exempt status
  - Monetary penalties
  - Excise taxes
  - Damage to reputation

IRS Investigation Initiatives

- In September 2008, the IRS sent 400 questionnaires to public and private four-year colleges and universities asking about their unrelated business income, endowments and executive compensation practices.

- As a result of these questionnaires, the IRS is auditing over 30 college and universities, focusing on unrelated business income and compensation practices.

Consequences of Non-Compliance: Loss of Tax-Exempt Status

- Jeopardizing Tax-Exempt Status
  - Four factors the IRS considers in determining whether to revoke a non-profit's exempt status:
    - Whether the non-profit has been involved in repeated "excess benefit transactions;"
    - The size and scope of any excess benefit transactions;
    - If after excess benefit transaction, the non-profit implemented safeguards to prevent recurrences; and
    - If the non-profit complied with other applicable laws.

Consequences of Non-Compliance: Loss of Tax-Exempt Status

- With regard to executive compensation, colleges and universities can risk losing their 501(c)(3) status by:
  - Failing to “ensure that the school’s earnings do not inure to the benefit of any private shareholder or individual,” and/or
  - Failing to “operate for the benefit of private interests such as those of its founder, the founder’s family, its shareholders or persons controlled by such interests”

Intermediate IRS Sanctions

- The IRS can impose an excise tax "on individuals benefiting from excess benefit transactions."
  - Internal Revenue Code § 4958 imposes an excise tax on "excess benefit transactions" between a "disqualified person" or "organization manager" and the tax-exempt organization.
    - "Excess benefits transactions" are when a non-profit provides an economic-benefit to a disqualified person that exceeds the value of the services received by the organization in return.
    - "Disqualified person" is any person who was in a position to exercise substantial influence over the affairs of the tax-exempt organization (such as a President or CEO) at any time within the five-year period before the excess benefit transaction occurred.
    - "Organization manager" includes officers, directors, or trustees.

Intermediate IRS Sanctions

- Any qualifying individual who benefits from an excess benefit transaction is liable for:
  - 25 percent tax on the excess benefit.
  - 200 percent tax on the excess benefit if it is not corrected by the taxable period.

Insuring Reasonable Compensation per IRS Standards

- Colleges and universities should ensure that all executive compensation meets the IRS's 3 part "rebuttable presumption of reasonableness" standard ("RPR standard") .
- Executive compensation arrangements that satisfy the RPR Standard are considered presumptively reasonably by the IRS.

Insuring Reasonable Compensation per IRS Standards

- The RPR Standard:

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

Insuring Reasonable Compensation per IRS Standards

- To meet this test, it is advisable for colleges and universities to:
  - Establish an independent compensation committee;
  - Establish procedures or guidelines governing the use of appropriate comparability data;
  - Ensure that no one involved in setting salaries has a conflict of interest;
  - Document all compensation decisions; and
  - Accurately report compensation on IRS and other forms

State Law: Consequences of Non-Compliance

- When operating or doing business in Massachusetts, public charities are required to:

  (1) register with the Attorney General's Non-Profit Organizations/Public Charities Division, and

  (2) to file annual reports with the Division

  These filings are all publicly available to increase awareness, accountability and transparency of public charities.

  – Failure to file results in AG publically publishing a list of non-compliant charities, and potential enforcement actions.

The Attorney General's Enforcement Powers

- G.L. 12, § 8: "Attorney General to Enforce Due Application of Charity Funds"
  - "The attorney general shall enforce the due application of funds given or appropriated to public charities within the commonwealth and prevent breaches of trust in the administration thereof."

- Recent Legislation
  - In 2012, the Massachusetts State Senate introduced legislation regulating compensation to independent officers, directors and trustees.

Consequences of Excessive Compensation

- In March 2011, the Massachusetts Attorney General commenced an investigation into the $4.2 million severance package awarded to the departing CEO of Blue Cross/Blue Shield.
  - In the review, the Attorney General's Office focused on
    - The terms of the contract that gave rise to the severance award;
    - The board of director's involvement in approving the compensation and severance package;
    - The process used by the board to evaluate the president's performance; and
    - The circumstances of the president's termination.

The Attorney General's Office Findings

- The amount of Killingworth's severance package was larger than all of the severance packages in BC/BS peer group.
- "Absent a foundation significantly better than 'everybody else gets it,' these arrangements are simply another form of executive compensation, particularly when they survive for more than an initial period and become a virtual retirement benefit."
- BC/BS procedures for reviewing Killingworth's performance, compensation, and Board oversight were flawed.

Negative Impact on BC/BS

- Attorney General audit of all compensation procedures.
- The Attorney General's Office's written findings were made public.
- Public perception of excess in the industry, eroding confidence in non-profit leadership, concerns over effective board oversight of executives and compensation.
- The BC/BS Board decided to return, in the form of a rebate or credit, the amount of the severance package to premium payers.

The Responsibility of the Board of Directors in Determining Compensation

- Two legal duties: Duty of Care, and Duty of Loyalty.
  - It is the job of the board to be a “check” on the President/CEO and to make sure that the “organization is faithfully carrying out its purpose without extravagance or waste.”
  - This was the problem identified at BC/BS: the Board of Directors lacked independence and failed to oversee Killingworth.

The Responsibility of the Board of Directors in Determining Compensation

- The board is responsible for setting the compensation of the President and other key personnel.
- The AGO encourages Boards to use outside sources, such as compensation consultants, to make informed decisions regarding executive compensation.

BUT!

- Boards, not compensation committees, are ultimately responsible for compensation decisions and cannot rely solely on consultants.

Determining Compensation by Using Peer Groups

- How do colleges and universities choose their peer groups?
  - Each year colleges and universities submit “comparison groups” to the U.S. Department of Education, which is then tabulated in the Integrated Postsecondary Educational Data System (IPEDS) to get comparative data in several areas, including executive compensation.
  - The Chronicle of Higher Education analyzed the comparison groups of approximately 1,600 four-year colleges.

Determining Compensation by Using Peer Groups

- On average, colleges selected 16 peer institutions for their comparison group who had a higher average SAT score, graduation rate, endowment, budget and enrollment.

- Colleges should carefully choose their peer institutions, as they are required to report comparison groups and this data in IPEDS is publically used and becomes the face of the institution.

Determining Compensation by Using Peer Groups

- For academic purposes, comparing “upward” is beneficial.

- However, for purposes of executive compensation, a small college using a peer group of large research universities and Ivy League colleges will increase the average executive compensation for their “comparison group”

Bottom Line:

- Colleges and Universities can ensure that their executive compensation arrangements are lawful by:
  - Thoughtfully designing and implementing procedures for setting executive compensation
  - Ensuring that decision-makers are independent;
  - Making a good faith effort to determine appropriate compensation based on a school's:
    - Size
    - Revenue
    - Organizational Structure
    - Mission
    - Standing among peers

Conclusions

- Given today's economy and the Federal/State government's requirements for transparency in executive compensation for non-profits, it is especially important to ensure that colleges and universities set reasonable executive compensation plans.

- Failing to do so has dire consequences. Beyond the Federal and State legal implications, it can also damage an institution's reputation and cause public outcry.