HARLON GROUP

Healthcare – The Pending Crisis of CEO Compensation

Current Concerns of Not-for-Profit CEO Compensation ***May 2006***

The Harlon Group paper – *Healthcare – the New Frontier for Sarbanes-Oxley-Like Activity* – posted on the Harlon Group website – www.harlongroup.com – speaks of the 2005 activity of Charles Grassley, R-Iowa – pointing to greater scrutiny of not-for-profit executive compensation.

At the end of 2005, the IRS asked for and received final comments on further IRS clarification of how not-for-profit recognition by the IRS of organizations will be dealt with should an organization continue to pay what is considered excessively high executive compensation.

Both of these activities point to the increasing scrutiny on executive compensation in health care and other not-for-profit organizations.

Should Board Members of Not-for-Profit Organizations be Concerned?

No, if they pay attention to their fiduciary responsibilities for setting executive compensation levels.

Recent reports gained from data contained in IRS Form 990 filings from major health care organizations raise the specter that CEO compensation may be rather high.

Embedded in those reports are board member comments that they are helpless in setting executive compensation since executive compensation levels are set by the "market". Their contention may be that attracting and retaining good executive talent is driven by a cabal of health care executives and their advisors who make up the "market".

If that is the case, the board member of a not-for-profit health care organization takes on even more fiduciary liability. The antidote to that liability requires a clear understanding of what constitutes executive compensation and how levels of executive compensation should be compared to the "market".

A Primer of Executive Compensation Levels

The IRS asks that executive compensation include all remuneration for employment including cash value of all remuneration including benefits, use of automobiles, payments for supplemental executive retirement benefits, payments pursuant to severance agreements, deferred compensation agreements, and agreements for the purchase or sale of any goods.

Each of the above types of executive compensation is beyond arrangements to receive compensation found in employment agreements.

Reporting all compensation paid executives is becoming much more rigorous for publicly held for-profit companies and, in light of the same scrutiny, the same is happening for not-for-profit organizations.

Executive compensation is thought by the IRS to be excessive if the total amount of reportable executive income is greater than that paid by similarly sized organizations to executives with similar responsibilities and accountabilities.

Further, to not be considered excessive, the level of executive compensation should be commensurate with the benefit the executive brings to the not-for-profit organization, e.g., there should be fair value paid for the value the executive renders to the organization.

Paying excessive compensation to executives places the executive and the board member in jeopardy of having to pay excise taxes of up to 20% on the amount deemed by the IRS to be excessive.

Excessive Levels of Executive Compensation

Part of the board member's dilemma in setting executive compensation levels is the "catch 22" nature of the IRS regulations. According to the IRS, it matters not if the standard for executive compensation levels in the marketplace appears high to the prudent person. In fact, it is this "market pressure" that board members refer to when they claim their "hands are tied" by the market.

Another, and a much more compelling part of the board member's dilemma in setting executive compensation, is proving that the executive adds value to the organization and, thus, deserves the level of compensation paid.

Board Member's Responsibility

It is the second part described above that the board member exercises the most control. The board is asked by the IRS In setting levels of executive compensation to do the following:

- Fully and honestly describe the scope of the executive's responsibility and accountability to furthering not-for-profit goals of the organization

- Fully and honestly hold the executive's performance to task – clearly showing the levels of accountability the executive displays

- Implement documented procedures for annually (if not semi-annually) reviewing executive compensation including board procedures, list of peer group not-for-profit organizations used to compare compensation and remedies for fixing problems that cause non-compliance

By perception, executive compensation is tied by the media and consuming public to the level of increases in health care coverage. Whether board members want that perception or not, it is there.

Board members, and only board members, have the ability to correctly address the level of executive compensation that meets their fiduciary responsibilities and their responsibilities to the communities they serve.

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