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Mass. AG's Office Increases Oversight of Executive Compensation at the Commonwealth's Charities

The Massachusetts Attorney General's office recently announced that it is "increasing its oversight of executive and director/trustee compensation practices" at the Commonwealth's "larger and more significant public charities." While "[i]nitially, the focus will be on a representative number of our larger health care systems and health care insurers, [b]ased on that experience, the examination of executive compensation may be extended to other sectors."

The announcement came in a letter sent in early September to the Massachusetts Hospital Association and four of the largest health plans—Blue Cross/Blue Shield, Harvard Pilgrim, Tufts, and Fallon. The letter appears to be in wide circulation among Massachusetts non-profits.

While increased scrutiny of executive and director compensation is by now generally expected in the non-profit community, the letter from David Spackman, Chief of the Non-Profit Organizations/Public Charities Division of the AG's office, specifically announces a plan to examine compensation practices on a periodic basis at the most important public charities, beginning with the health care sector. The letter also contains several notable comments that suggest the direction those examinations may take.

Mr. Spackman's letter discusses at length and with a fair degree of skepticism public charities' use of market data in setting executives' salaries. As most public charities know, section 4958 of the Internal Revenue Code, added to the Code in 1996, prohibits charities from paying excessive compensation to their top executives. Many charities have adopted the "safe harbor" procedure set forth in the Treasury Regulations to create a rebuttable presumption that such compensation arrangements are reasonable. This procedure involves, among other things, reliance on comparability data. While the AG's office does not enforce compliance with section 4958, Mr. Spackman's letter points out that "there are clear analogies between section 4958 and the authority of the Division under state law."

Noting that executive salaries have continued to rise substantially notwithstanding the adoption of section 4958, Mr. Spackman opines that the section's "permissive inclusion of [market data from] the for-profit sector, with its now well recognized propensity for generous, if not excessive, executive compensation, almost certainly contributed to this increase." The letter quotes with apparent approval a conclusion by the Maryland Insurance Commissioner that "what was 'comparable' was not necessarily 'fair and reasonable.'" Finally, Mr. Spackman writes that "the widespread use of market data regarding average compensation levels may have encouraged *above average* compensation packages from boards under pressure to reward their top executives." (Emphasis in the original.) The summary of the section 4958 discussion observes ominously that "section 4958, intended only to establish a ceiling, may have created a floor. A procedure intended to serve as a tool may have become the product. Adherence to section 4958 has served senior management well; whether the public has benefited is less certain."

The Division's letter also discusses reporting requirements, noting disapprovingly "the complexity, including timing and reporting variability, of executive compensation that makes comparative analysis and disclosure difficult." Consistent with the new requirements of the revised federal Form 990, "the Division intends to move from the current system of annually collecting, well after the fact, limited amounts of information regarding a small number of highly compensated individuals, to a broader, more timely and proactive examination of executive compensation" that will seek to eliminate differences in reporting methodology, timing variations stemming from differences in fiscal year-ends and payment schedules, and double counting in multiple years of deferred compensation.

In addition to standardizing presentation, the Division's letter previews other "more expansive and robust reporting requirements." The Division intends to require "measurement of compensation increases against related industry performance standards." It will also require more disclosure of the process to review and set compensation, including the identity, qualifications and independence of consultants, the comparables used, and "the board and committee review and decision making structure on compensation matters."

The letter touches only briefly on the issue of director compensation, noting that while it is not, "standing alone, either illegal or a breach of fiduciary duty, [it] does however, potentially impair board independence, and is clearly contrary to [the] volunteer tradition that characterizes our charitable boards."

As noted, the Division's letter is addressed only to hospitals, health systems, and health insurers, but it strongly suggests that its observations are pertinent to the entire non-profit sector. While the Division disclaims any desire to substitute its judgment for that of independent boards on compensation matters, the letter pointedly declares that "unless this Division and our charitable boards address these issues head on,...the discretion now vested in our boards is more and more likely to be subjected to far more dramatic externally imposed limits and controls."

If you have questions about the Division's letter, please do not hesitate to contact your regular Ropes & Gray lawyer.