Compensation Committee Wake-Up Call — The "Other Obstacle" to Leadership Transition

By Michael Conover

I had previously discussed the inevitable transition of numerous baby boomers holding leadership posts in nonprofit organizations. This topic has been well-covered for nearly a decade.

However, I believe the seismic shift that some had predicted has failed to materialize on the scale predicted due to a variety of factors, including: delayed retirements due to financial need or a resistance to change; the belief that age 75 is the "new 65"; or just procrastination.

The slowdown in the rate of change will not soften its impact, but intensify it. The delay on the part of these baby boomer executives — and the boards to whom they report — could increase the likelihood of an unexpected and disruptive leadership crisis. Problems can range from a noticeable decline in performance to an abrupt departure caused by sickness or death. Leadership changes under the best circumstances are not 100 percent successful; in crisis mode, the odds are much slimmer.

The other major obstacle is executive retirement arrangements (or lack thereof). As organizations finally confront the departure of a long-tenured executive, the details of the retirement arrangements come to the forefront. This is when many organizations and executives discover the price they'll pay for failing to address this issue in advance. Proper planning can not only minimize financial uncertainties for the executive and organization, but prevent other potential, very expensive obstacles.

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Many compensation committees fail to proactively raise the subject of retirement plans and the impact they will have on an orderly leadership transition. Reasons for this include financial costs; reluctance to broach the subject of leadership change; mistaken assumptions that arrangements made years ago will address current needs; embarrassment that arrangements are inadequate or have not been made; etc. Committee members must realize that time is not on their side for addressing retirement-related arrangements. Delaying can have a negative impact on both the executive and the organization.

Here are a few scenarios that illustrate the types of situations we usually discover in "11th hour" reviews of retirement arrangements:

- **Plan Document Failures:** Plan documents (e.g., employment contracts, deferred compensation arrangements, life insurance plans, etc.) that were developed many years ago and/or were drafted without consulting with experts to ensure compliance with current requirements pose potential problems to the unwary.

  The inclusion of what appear to be ordinary terms in the arrangements, or the failure to include critical details, can prove disastrous in terms of potential tax liability and penalties for the executive, as well as the employer. Language included to ensure that retirement resources are secure may produce inadvertent vesting of a benefit and tax liability long before it is actually available. Similarly, incorrectly structuring payments can result in unforeseen tax liability and punitive excise tax penalties.

- **Plan Administration Failures**: In some instances, well-drafted plan documents are not adhered to from an administrative standpoint. Contributions, excess contributions, payment amounts, and/or payment terms are made that fail to follow plan requirements. The failure to ensure compliance may result in adverse tax consequences to the executive and organization.

  Failure to properly recognize and report details of retirement arrangements is also common. The executive's W-2 form, personal tax return, and the organization's Form 990 may all need to include information related to the plan arrangements, as well as timely recognition of income when vesting occurs. Discovering these issues after the fact can necessitate amending prior year returns and also involve adverse tax consequences to the executive and organization.

- **Improbable Catch Up:** A compensation committee's failure to establish a specific position on retirement benefits for the executive, as well as a specific objective for the level of benefits to be provided well in advance of the probable retirement event, drastically diminishes the likelihood of providing any level of benefit beyond that provided to all employees. Waiting until a year or two prior to retirement will likely place an unreasonable financial burden on the organization to fund a benefit that might have been spread over many years of employment. Similarly, large contributions or payments toward the very end of employment may trigger an excess benefit situation, or the appearance of one, that may create adverse consequences for the executive and organization.

The Wake-Up Call

Most compensation committees spend most of their time on decisions about current cash compensation (i.e., salary, bonus, and incentive) matters for executives. Clearly, these are important matters that require the committee's attention in light of their disclosure to external stakeholders and the public. I am not suggesting committee members spend any less time on them.

I am, however, suggesting that compensation committees incorporate an immediate and recurring review of the organization's retirement program to ensure that all documentation, administration, and funding are in accordance with the organization's policy; on track to meet stated objectives; and fully compliant with pertinent regulatory and reporting requirements. Regular check-ups may also help the organization be more proactive on transition needs.

Executive management also has a role to play in this wake-up call. Steps should be taken to ensure that the compensation committee has access to all information and advice that will assist them in their efforts to confirm that all steps have been taken. This will help ensure that retirement arrangements pose no obstacles to the inevitable retirement and leadership succession that every organization faces.

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