WHITE PAPER • OCTOBER 2013

Negotiating the Nonprofit CEO Contract

BY JAMES ABRUZZO, EXECUTIVE VICE PRESIDENT
& MANAGING DIRECTOR, NONPROFIT PRACTICE

Executive Summary

The nonprofit board's most important decision is hiring or extending the contract of the CEO. And for the prospective or sitting CEO, there is no more important decision than either accepting the position or extending its term.

Over the last 30 years I have been involved in literally hundreds of these situations, as an executive recruiter acting on behalf of the board, as a board member offering pro bono advice to my organization or as a paid compensation consultant acting on behalf of the board or the individual or, sometimes as a "friend of the family."

To help with many of the questions often raised during negotiations, following is a series of Frequently Asked Questions and answers to best navigate this important time.

Frequently Asked Questions

FAQ - Our past CEOs have never had contracts; we trust each other, why should we offer a contract now?

James Abruzzo (JA) - In addition to the many other elements contained in a contract (see below), if there is anything in writing about the amount of compensation, or the start date, or references to the employee manual to describe benefits, there is a contract - or at least, a letter of agreement.

FAQ - What are the simple elements that should be covered by a contract?

JA - The length of the contract and, as important, the date by which both sides (the organization and the individual) agree to begin to talk about a renewal or non-renewal of an agreement.

The starting salary and some indication of how that salary can change over time. For example, an increase tied to the CPI; 3% per year; or, "between 1% and 5% depending on performance;" Special benefits beyond the standard offered to the CEO such as additional vacation time, extra life insurance, etc.

FAQ - What is the best approach to increasing CEO salary?

JA - Salary and total compensation should be tied to performance, which should be linked to the mission and strategy of your organization. This requires the board to review and evaluate the CEO's performance to make a judgment about the merits of an increase. Usually for the CEO there is a minimum increase in salary and the opportunity for extra pay for exemplary performance through a bonus.

FAQ - Can and should nonprofit organizations offer bonuses?

JA- Bonuses are now common for nonprofit CEOs. And they offer great advantages to both the CEO and the organization: for the CEO, in addition to the potential of extra earnings, there is the important plus that the board must evaluate the CEO; bonus can provide the CEO with significantly higher compensation in a good year, without raising the salary for the next year; and, without a bonus, the annual CEO evaluation is often not performed, or is cursory.

Best practices involve creating a set of performance criteria (tied to the mission or the strategy), that are mutually agreed upon in advance and that are quantifiable. Elements should be measurable and include fundraising goals, financial stewardship, completing the strategic plan, etc., along with some discretionary criteria decided upon by the compensation committee. Also, dates for when the criteria are agreed upon and when the evaluation is performed should be in the contract.

FAQ - What about special perquisites like a car, country club membership, etc.?

My recommendation is to exclude those from the contract. Keep it simple. Sometimes the optics of the CEO's compensation, not the amount of salary, create a negative public profile. If the CEO was given a car in his or her present position, then eliminate the car and gross up that value and include it in the compensation. The same holds for other perquisites like country club memberships, etc. And, unless the CEO uses the car or the club exclusively for business, there are personal tax implications and so the fewer the perquisites, the simpler the accounting.

FAQ - How does the board determine what package to offer a new CEO?

There is no simple rule of thumb. There are however, a number of factors: first, understand that the incoming CEO will know what your former CEO is earning, everything is public; and you should know how much that CEO is presently earning and what are his or her expectations. Even before the final interviews the prospective candidate and a search committee member should have a conversation about expectations on both sides. Also, it is common practice to increase an incoming CEO's compensation by at least 15% and sometimes up to 50% above present compensation. And while cost of living between one city and another could be a factor, remember it costs the same to send a child to a private college no matter what location.

Other important considerations are reimbursement for relocation and reimbursement for house hunting trips for the CEO and spouse.

FAQ - Are there legal restrictions regarding the amount of compensation a board can offer a CEO?

JA - There are IRS regulations, sometimes referred to as Intermediate Sanctions, which allow the government to question the amount a senior nonprofit executive may be paid. However, by following some simple procedures and by commissioning a compensation study, the board can create a "safe harbor" from the IRS.

FAQ - Severance is a one-way street; it benefits the CEO if we want to get rid of him, but he can resign anytime he likes.

JA - This is true. However, severance agreed to in advance can mitigate (but not necessarily eliminate) the risk of a costly buy out, legal fees and extended negotiations. If both sides agree to an amount of severance in advance, in writing, there is some protection for the board. Boards should always have the right to fire someone, for any reason, and severance "pays" for that right.

For the incoming CEO, severance is expected and common. He or she will never really know the organizations until already on the job - the chairmanship may change, a merger could occur, etc. And as the CEO ages, particularly during negotiations for renewals, the CEO becomes less desirable in the marketplace and therefore requires protection.

Length of severance is anywhere from six months to two years. The length of severance determines the contractual amount of salary the organization must pay the CEO who is fired "without cause." The severance is, in effect, the length of the contract.

Severance clauses can be long, torturous and take dozens of hours of legal negotiations. They needn't be. Severance should cover situations when the individual is fired without cause or if the individual resigns "for good reason" and should also describe the situations when the board may fire the CEO "for cause" and not be liable to pay severance. And there are ways to lessen the chance of the CEO leaving your organization for another job.

FAQ - We can't force someone to work for us if they don't want to, what are you referring to?

JA - The rules around nonprofit executive compensation are more limiting than for profit executive compensation but there is a form of "golden handcuffs" that is frequently employed. Technically called a 457(f), it is a promise to pay the executive a lump sump of income if he or she remains with your organization until a certain date - say for four years. If the executive resigns willingly or is fired for cause before that time, they lose the payment completely.

The 457(f) is also beneficial to the employee because that lump sum can grow tax deferred until it is received and becomes a powerful tax deferred vehicle for the individual. This is just an outline, the rules are more complicated, but more nonprofit organizations are offering 457 (f) plans to their executives.

FAQ - Okay, knowing all of this, how do we begin negotiating either a new contract or a renewal?

First, assign the task of negotiations to one person from the executive, compensation or search committee - it is not a group exercise. Then, for a new hire, use your search consultant as a go between - the negotiation period is perilous, emotions can run high and relations can easily erode. If there is no search firm, encourage the individual to retain a compensation consultant or lawyer to negotiate on his or her behalf. When negotiating a new contract, sometimes a consultant is hired as a "friend of the family" who can be the go-between, insulating both sides, bringing creative knowledgeable solutions while allowing the chair and the CEO to continue to work together as a team.

Established in 1989, DHR International is one of the largest retained executive search firms in the world, with more than 50 offices around the globe. We conduct search assignments at the board of director, C-level and functional vice president levels. DHR's renowned consultants specialize in all industries and functions in order to provide unparalleled senior-level executive search, management assessment and succession planning services tailored to the unique qualities and specifications of our select client base.

DHR International
Worldwide Headquarters
10 South Riverside • Suite 2220
Chicago, IL 60606
P 312.782.1581 • F 312.782.2096