

## GAO Issues Report on Compensation Policies and Practices at Nonprofit Hospital Systems

July 31, 2006

On Friday, July 28, 2006, the Government Accountability Office (“GAO”) released “Nonprofit Hospital Systems: Survey on Executive Compensation Policies and Practices,” reporting the results of its survey on the executive compensation practices of nonprofit hospital systems. The results of the survey, which was conducted at the request of William Thomas (R-CA), Chairman of the House of Representatives Ways and Means Committee, are likely to (i) provide additional support for tax-exempt reform legislation and/or (ii) strengthen ongoing enforcement efforts of the Internal Revenue Service (“IRS”) and other regulatory agencies with respect to the payment of executive compensation by tax-exempt entities.

**Scope of Survey:** As part of ongoing Congressional investigations by the House Ways and Means Committee and the Senate Finance Committee regarding potential abusive practices in the tax-exempt sector, in 2005, Chairman Thomas asked the GAO to investigate the policies and practices of tax-exempt hospital systems with respect to:

- Governance structures with respect to executive compensation matters;
- How nonprofit hospital systems determine executive compensation and benefits; and
- Internal controls used to monitor, approve and pay travel, entertainment and other benefits.

Although the GAO surveyed 100 of the largest nonprofit hospital systems (based on the number of staffed beds), only 65 hospital systems responded. The GAO did not attempt to verify any of the responses.

**No Conclusions or Recommendations:** The GAO emphasized that the report is not intended to provide any conclusions regarding (i) the level of compliance with applicable laws, rules or regulations or (ii) the adequacy of policies, practices or procedures of any of the responding hospitals. Notwithstanding the absence of any definitive conclusions or recommendations by the GAO, however, the information contained in the report appears to identify certain significant trends

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regarding the compensation policies, practices and procedures utilized by many hospital systems:

- **Apparent Positive Trends:** The GAO report reflects widespread efforts by hospital systems to adopt policies and practices designed to improve governance and reduce exposure to the imposition of intermediate sanctions excise taxes under Section 4958 of the Internal Revenue Code. For example, virtually all of the responding systems indicated that compensation arrangements for the Chief Executive Officer: (i) were approved prior to the effective date of the employment contract, (ii) were based on comparable market data, and (iii) were timely documented.

The report also indicates that all of the responding hospital systems had a conflict of interest policy that covers the members of the governing body responsible for the approval of compensation matters (“Executive Compensation Body”). In addition, over 95 percent of the responding hospitals hired outside consultants during the past two years to advise on compensation and benefits matters, and 61 percent required the compensation consultants to be free of any conflicts of interest.

- **Areas of Potential Concern:** Although the GAO report reflects significant efforts to establish compensation policies and procedures, the report also suggests that many hospital systems fail to properly implement and/or consistently apply the policies and procedures. The report further identifies certain common practices among tax-exempt hospital systems that may be viewed by Congress and/or the IRS as further evidence of abusive practices in the tax-exempt sector.

The comments issued by Senator Charles Grassley (R-IA), Chairman of the Senate Finance Committee, in connection with the release of the report suggest that the GAO report may increase support for tax-exempt reform legislation. Senator Grassley emphasized that the “GAO report confirms that there’s still much work to be done . . . to ensure that charitable assets benefit those who need them most rather than those who need them least.” The areas of concern identified by Senator Grassley include:

- *Deficiencies in Executive Compensation Governance and Approval Process:* Senator Grassley commented that certain survey results indicate significant deficiencies in governance: (i) almost one-third of the responding hospitals failed to establish written criteria for selecting members of the Executive Compensation Body, (ii) 17 percent of the responding hospitals indicated that their CEOs served as voting members of their Executive Compensation Bodies, and (iii) 90 percent of the responding hospitals did not pre-approve the CEO’s travel expenses.
- *Excessive Retirement Benefits:* The report reflects the widespread use of nonqualified deferred compensation and special retirement plans for nonprofit health system executives, including: (i) supplemental executive retirement plans (SERP), (ii) plans organized under Section 403(b) and 457(b) and (f) of the Internal Revenue Code, (iii) excess retirement benefit plans, and (iv) split-dollar life insurance plans. Senator Grassley expressed concern that the widespread provision of SERPs could result in “exorbitant deferred compensation amounts in addition to providing more traditional retirement plan benefits.”

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- *Other Benefits; Accountability:* Senator Grassley also noted that benefits provided to nonprofit health care executives need to be further evaluated “to ensure that nonprofit hospital executives are not being paid extravagant amounts and are being held accountable.”
- *Regulatory Deficiencies:* In a letter dated June 1, 2006, to the Commissioner of the IRS Tax-Exempt and Government Entities Division, Senator Grassley noted that the activities of tax-exempt hospitals are often difficult to distinguish from the activities of for-profit hospitals. Executive compensation, as well as reporting and transparency, were identified as specific areas of concern. In his comments on the GAO report, Senator Grassley further emphasized that many hospitals are using the approval process set forth under the intermediate sanctions framework to provide “benefits that usually are available only to the top rung of the employee ladder in corporate America.” Senator Grassley indicated that the payment of such significant compensation in accordance with the intermediate sanctions framework would suggest “major flaws” that warrant further reform efforts.
- *Lack of Transparency and Cooperation:* Senator Grassley noted that a significant portion (*i.e.*, 35 percent) of the hospitals failed to respond to the survey, and that many others turned in responses that were incomplete or inadequate. Senator Grassley stressed that the poor response rate is “unacceptable” and that “transparency and cooperation” is required from all nonprofit entities.

**Potential Implications for Tax-Exempt Hospitals:** The GAO report and Senator Grassley’s comments confirm that governance and executive compensation will continue to be scrutinized as areas of potential abuse by committees of Congress and the IRS. The report further suggests certain important lessons for tax-exempt hospital systems:

- A hospital system’s policies and procedures (and adherence to such policies and procedures) relating to executive compensation increasingly will be compared to emerging “best practices.” The GAO report likely will be used to identify further industry standards and best practices. Accordingly, health care systems should strongly consider reviewing current executive compensation policies, procedures and practices to ensure adherence to industry standards and best practices.
- The findings in the GAO report may strengthen ongoing efforts regarding enforcement and/or tax-exempt reform efforts. The enhanced potential for increased regulatory enforcement or legislative reform suggests that other activities of tax-exempt hospital systems also should be reviewed carefully by the board and management, including, without limitation, those relating to evaluation and documentation of community benefit, policies and procedures for charges to uninsured patients, charity care, debt collection, unrelated business taxable income, management service arrangements, governance, executive compensation and joint venture arrangements.

A copy of the GAO report can be found at <http://www.gao.gov/new.items/d06907r.pdf>

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