Severance Agreements for CEOs of Tax-Exempt Hospitals

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Tax-exempt hospitals often offer severance agreements to protect their Chief Executive Officers if they are ever terminated through no fault of their own. Although these agreements are common, they should be handled carefully to avoid creating excess benefit transactions under Internal Revenue Code section 4958.

Purpose

Hospitals offer severance plans for CEOs and other key executives in order to attract and retain the best possible talent, provide a secure work environment, remain competitive, avoid potential litigation and facilitate succession planning.

Hospital Boards hope these agreements will increase stability and reduce costly turnover by providing appropriate incentives to the executives. Simply put, these agreements are a form of golden handcuffs.

In return for a promise to pay severance, hospitals usually require the executives to sign general releases that reduce the likelihood of future lawsuits. Obtaining the release is important in an environment in which terminated employees often file lawsuits for various reasons. Without an offer of severance pay, there may be no incentive for an executive to sign a release.

Since severance payment amounts can be substantial, hospitals should carefully consider whether any such payment would be in line with the value received and whether it supports their charitable missions.

How They Work

A severance agreement usually obligates the hospital to continue an executive's salary and certain benefits for a number of months following termination of his or her employment. The severance benefits may operate on a single trigger, meaning that the severance pay and benefits would be provided if the executive's employment was terminated for any reason other than "for cause." Or they may use a double-trigger, which applies only if there is a change of control and the executive is subsequently terminated.

A severance plan may determine the amount of severance pay based on a combination of factors including the executive's years of service, position, total pay level and job performance. The amount of severance pay may also be significantly influenced by the contractual agreements offered in exchange. For example, in addition to the general release, a severance agreement may include a non-disparagement clause, a confidentiality clause and/or a limited non-compete clause. Each of these provisions can provide considerable value to the hospital, thus helping to ensure that the payment terms do not exceed fair market value.

In addition to cash payments, severance packages may include extended benefits, such as health insurance and other welfare benefits. Some include outplacement assistance to help executives transition to new positions, although the type and level of benefits vary widely. (At for-profit entities, severance plans often include accelerated vesting of stock options under certain circumstances. The IRS has said that practices at both for-profit and nonprofit entities could be used for benchmarking.)

Some hospitals include a mitigation clause, which reduces the severance amounts by all or a portion of the compensation the executive earns from his or her next employer. Therefore, the full severance amount is paid only if the terminated executive did not start another position during the severance payout period.

Getting it Right - Opinion Letters

To ensure that only fair market value is paid, and to avoid the appearance of self-dealing, a hospital may request an opinion letter from an independent professional prior to finalizing a severance agreement. The independent professional should be someone who holds himself or herself out to the public as a compensation consultant, performs compensation valuations regularly, and is qualified to perform compensation valuations.

Compensation consultants may consider the executive’s qualifications, tenure, loyalty, salary history, performance, value to the hospital, and the costs and disruption that could be incurred if he or she voluntarily left, especially if the departure was just prior to or during a major transition such as a change of control.

As part of this analysis, the consultant will research industry practices to determine how the terms compare to agreements of peer executives. This includes benchmarking the agreement terms against databases and other reference materials that help show market-based practices in the healthcare industry. The consultant will also consider relevant publications of the Internal Revenue Service concerning their positions on this type of compensation provided by tax-exempt organizations. The issuer may also determine whether the terms are reasonable based on his or her prior experience, training and professional judgement.

The purpose of an opinion letter is to provide an independent opinion on whether the severance agreement terms would be reasonable compensation for the services rendered by the executive. The terms of the agreements may be considered both separately and in conjunction with other compensation and benefits being provided to the executive. Therefore, the issuer of an opinion letter may analyze the payment terms to determine whether the resulting overall compensation package would be fair market value compensation for the services of the executive.

Common Terms of CEO Severance Plans

A survey of 196 hospitals and other health care providers conducted by Mercer, Witt/Kieffer and Hunton & Williams LLP in 2013 found that 83% of the respondents had written severance agreements with their CEOs. Those severance benefits were most commonly triggered by involuntary termination without cause (90%) or a change-in-control (65%). Some severance plans were triggered by non-renewal of contract (29%) or good reason (19%). A few even had written agreements that provided severance upon involuntary termination with cause (15%).

Among organizations that provided severance, the median fixed severance period for the CEO was 24 months. Most offered severance of one year (25%), 18 months (14%), or 24 months (49%). A few offered 36 months (6%).

About 73% of those respondents continued base salary only while the other 27% also continued some form of incentive compensation during the severance period. Most of these employers required a non-compete and/or non-solicitation agreement from their CEOs.

As these percentages suggest, severance agreements are believed to provide valuable incentives for executives to join hospitals and then remain in place, even through a major transition such as a change of control.

All of the facts including the nature of the hospital's activities, its size, the geographic area it serves, its challenges and its financial position may be considered in assessing whether the hospital's potential benefits would exceed the costs of the severance. A rural hospital's location may also be a factor which should be carefully considered, due to the challenges that could be faced if and when an executive has to be replaced.

The resulting package of cash compensation, deferred compensation and benefits, taken as a whole, must be fair market value and reasonable compensation for the executive's services. An opinion may also be based on the assumption that the executive will continue to perform his or her duties satisfactorily for the remainder of their employment.