Nonprofit CEO Employment Contracts: Key Tips, Strategies, Pitfalls and Best Practices

by Jeffrey S. Tenenbaum, Esq.
Chair of the Nonprofit Organizations Practice
Lewis Baach Kaufmann Middlemiss PLLC
Washington, DC

Hiring a new CEO is one of the most significant undertakings in the life cycle of a nonprofit, with far-reaching consequences for both the organization and the CEO. As such, the employment contract between them is a critical document for both sides. In principle, the contract should be clear, fair and balanced as between the parties. Of course, there are numerous strategies that can be employed by both the nonprofit and the executive to create advantages for each other, and being able to successfully implement such strategies will be informed by each side's respective leverage, among other factors.

This article is designed to point out the most critical provisions in nonprofit CEO employment contracts, but not from the particular perspective of either the employer or the executive. It addresses four key elements of nonprofit CEO employment contracts – term, termination, compensation and benefits, and authority and responsibility. While it does not endeavor to cover all of the material considerations or possible ways to address these aspects of nonprofit CEO employment contracts, it highlights the issues that tend to be the most important to consider.

Term

Initial Term. Often, the initial term is somewhere between two and five years. A key factor for nonprofits and chief staff executives to consider when assessing the length of the term is the variety of ways in which the term can end prior to expiration, which is discussed below. In short, the term and termination provisions are intimately intertwined and need to be coordinated.

Renewal Term. The agreement should specify clearly what happens at the end of the initial term. There are several typical options.

First, the agreement could simply *expire* upon the end of the term, with no obligation on either party to continue employment. The parties are always free to negotiate extensions if both of them desire to continue the relationship. Sometimes, it is advantageous for one party or the other to tee up such a renegotiation (e.g., a highly successful first-term CEO may be strongly positioned to negotiate much more favorable contract terms in a new agreement).

Another approach is an *automatic renewal* in the absence of some affirmative notice to the contrary (sometimes referred to as an "evergreen" contract); this is not uncommon. For example, if one party does *not* provide written notice at least 180 days prior to the expiration of the initial term, the agreement might renew automatically for one or more years under the

same terms and conditions.

It is important that both the executive and the nonprofit's board remain aware of any approaching deadlines for notices and adhere carefully to the specified procedures for providing notice, as set out in the agreement. This need is particularly acute when, as is typically the case with most nonprofits, there is significant turnover in volunteer leadership positions each year.

Termination

There are typically three core ways in which the agreement can be terminated by one side or the other *during* the term; there are other ways as well – such as reasons ascribed to the CEO's death or disability – but they are not discussed here.

Notice by the CEO – no cause or reason. Although by no means required, many agreements have provisions that allow the executive to terminate early – without the need for a reason or cause – by providing certain advance written notice to the employer. Typically, a CEO will want such a provision, particularly if the nonprofit will have a similar right. If the organization agrees to it, the notice period should take into consideration the hiring cycle and lead time required. That is, if the search process generally takes six months, the agreement might specify a notice period of six months.

Notice by the nonprofit – no cause or reason. It is the norm and a best practice to include a provision in the agreement that allows the nonprofit to end the agreement early without cause. Establishing cause sufficient for terminating an agreement can be difficult for an employer to do. That being said, it also is the norm and a best practice to provide the CEO with severance pay in the event of a no-cause termination; see the discussion below regarding severance pay. Severance pay should always be coupled with and conditioned upon the signing of a release of all potential claims against the nonprofit by the CEO. In addition, the notice period provided by the employer to the executive (often three months' prior written notice) effectively functions as additional severance pay.

Termination for cause. The agreement should contain a provision for termination for "cause." Cause should be defined very carefully and precisely, and needs to strike an appropriate balance between the parties. Typically, it includes such things as a material breach of the agreement, malfeasance, fraud, embezzlement, dishonesty, and gross negligence by the executive, among other things. For employers, be careful of cause definitions that require convictions of crimes; no nonprofit wants to await the outcome of a criminal proceeding. And for CEOs, beware of cause definitions that are too vague, subjective or otherwise ill-defined. A new best practice in cause definitions is to include material issues that "occur or come to light" during the executive's tenure that bring the executive "into public contempt or ridicule." Generally, with a termination for cause, no severance is paid to the executive, which is why the definition is so critical.

What happens when the agreement terminates? The agreement should specify what happens in *each* of the circumstances under which the agreement can end; in the examples outlined above, this includes four contingencies:

(1) Expiration of the term (and renewal terms, if any) – typically severance pay
(2) Executive gives notice – no severance pay
(3) Nonprofit gives notice (termination without cause) – severance pay
(4) Termination by nonprofit for cause – no severance pay

The interests of the parties here are clearly distinct; the executive is looking for as much security as he or she can get, and the employer wants to have as little expense as possible tied up in a person who is no longer performing services for the organization. Ideally, the agreement should find the appropriate balance between the needs of the parties.

Severance Pay. If the agreement is ended early by the *executive giving notice*, typically there is no compensation due beyond that due during the time the executive works for the organization. If the *nonprofit gives notice* prior to the end of the specified term (without cause), typically the employer will provide severance pay to the executive, and often will pay for the executive's employee benefits (e.g., health insurance premiums) as well during the severance period. Severance pay amounts vary, but often will start with a three- or six-month minimum, have a 12-month maximum (sometime longer for very long-serving executives), and otherwise will be tied to the length of service (e.g., one month of severance pay for each year of service, subject to the minimums and maximums above). Many factors need to be considered, including the length of service of the executive, the expected lead time for the executive to find new employment, and the impact on the employer to be paying both the departed executive and a new executive. As stated above, the notice period effectively functions as additional severance pay, so that should be factored into the contract negotiations. And the severance pay should be tied to a release of all claims signed by the executive.

For CEOs, it is important to ensure that the severance obligation applies not only in the event of a mid-term termination by the employer, but also to an *expiration of the term and/or renewal term.* This is a trap that some CEOs fail to catch.

Finally, if the executive is *terminated by the employer for cause,* the agreement typically provides that the executive receives nothing beyond what was due prior to termination.

Compensation

Obviously, initial base salary should be clearly set out in an employment agreement. Generally, an initial salary is specified, with provisions made for future upward adjustments, sometimes with a minimum annual increase; CEOs also typically try to ensure that there can be no annual decrease in base salary. Some employers are cautious about specifying guaranteed increases for future years. The CEO's desire for future financial security must be balanced against the

uncertainty of future budgets, the economic environment generally, and the undetermined performance of the executive, among other factors.

Many agreements also provide a discretionary bonus opportunity, often tied to the attainment of to-be-specified goals, and often with either a target or maximum percentage (of base salary). It is important that the agreement lay out the process for how these goals will be set, that this is required to be done at the beginning of the fiscal year, and that it be made clear who will be involved in the process. Generally, it is not advisable for the full board of directors to be involved annual CEO performance evaluation and resulting base salary and bonus determinations; most often, it will be the executive committee (or a compensation committee, if there is one) that serves this function.

Some but not most nonprofit employers also offer a long-term incentive ("LTI") plan for their CEOs – designed to reward longer-term performance – in contrast to annual bonuses, which are usually based on achievements over the last 12 months. While LTI plans have understandable value, this is certainly not the norm in the nonprofit community.

Nonprofit executive employment contracts generally spell out the other employee benefits that the CEO will receive above and beyond the benefits provided to the rest of the organization's staff. While this has become less common in recent years – in part, due to the disclosure of some of these benefits and perks that must be disclosed on the annual IRS Form 990 return (e.g., first-class or charter travel, social or health club dues, companion travel, housing allowances, personal services, tax indemnification, and gross-up payments to cover the CEO's income taxes on certain benefits) – it is still not unusual to see certain such benefits provided to executives. Some common examples include additional paid time off and sometimes additional ability to roll over unused PTO and be paid out for accrued but unused leave upon departure, a geographic relocation allowance, and reimbursement of legal fees in connection with the employment contract negotiation (usually subject to a cap).

Nonprofits must be careful if providing medical, dental, retirement or certain other benefits to an executive that are more generous than the benefits provided to other employees of the organization. If such benefits run afoul of federal non-discrimination requirements, it can have potentially adverse tax consequences. Deferred compensation arrangements – more common in larger nonprofit executive employment agreements – also have to be carefully structured to not violate the IRS' strict rules in this area, governed principally by Internal Revenue Code ("IRC") Section 409A.

Bear in mind that total compensation paid to an executive of a tax-exempt organization – regardless of under which category the entity is exempt – must be "reasonable" (at or below fair market value) under the IRC proscription against private inurement. Serious violations in this area can put the tax-exempt status of the organization at risk. Executives of Section 501(c)(3) and (c)(4) organizations also are personally subject to potentially severe "intermediate sanctions" penalties should they receive either compensation that exceeds fair market value or non-business-related benefits, perks and the like that are not treated as

taxable income. In addition, members of boards or committees that approve such arrangements can be personally subject to intermediate sanctions penalties. There are certain steps that a nonprofit employer can take to minimize the risk that a compensation package will be deemed unreasonable – i.e., approval of the compensation by a group of disinterested decision makers, reliance on appropriate benchmarking or comparability data, and contemporaneous documentation of the same.

Finally, be aware that compensation paid to nonprofit executives from most affiliated organizations needs to be reported on the IRS Form 990 return as well.

Authority and Responsibility

Last but not least, it is typical and a best practice for the employment agreement – and often the organization's Bylaws – to provide that the CEO shall have sole and exclusive authority for the hiring, firing, supervision, promotion and compensation of all other staff of the organization, subject to budgetary parameters set by the board of directors. Failure to include such a provision can sometimes lead to micromanagement of staffing decisions by the board of directors – a situation that is not healthy for either the organization or the executive.

Other Provisions

There are typically numerous other provisions in nonprofit executive employment contracts that are beyond the scope of this article. Some of these may include provisions regarding indemnification and limitation of liability, conflicts of interest and ethics, confidentiality, non-competition, and non-solicitation of employees. Some employment contracts also contain alternative dispute resolution procedures, such as arbitration, mandatory non-binding arbitration for certain types of claims, and the loser being obligated to pay the other party's legal fees in the event of a dispute between them.

Conclusion

For all of the issues addressed in this article, it is to the benefit of both the executive and the nonprofit to have a clear understanding of the rights and obligations of each party prior to the executive candidate accepting employment, and prior to the public announcement of the new executive's hiring. Careful, detailed, thoughtful, good-faith negotiation between the parties and a comprehensive, balanced, well-drafted contract that accurately reflects the agreement between them will go a long way toward helping to pave the way for a long-term, successful nonprofit-CEO partnership.

For more information, contact the author at jeff.tenenbaum@lbkmlaw.com.