

Exit Agreements for Nonprofit CEOs: A Guide for Boards and Executives

By  Tom Adams, Melanie Herman and Tim Wolfred | September 25, 2017



*"It's Time" by Kevin Sloan/www.kevinsloan.com
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When the founder or longtime executive of a nonprofit leaves an organization, the board often grapples with how to say goodbye and thank you. This question is loaded with complexities—feelings and relationships come into play, as do financial, legal, and reputational risks and rewards. There is a range of motivations for considering an exit agreement, some quite compelling. The executive, for instance, may seek a financial acknowledgment that he or she has skillfully led the organization over a long tenure—and maybe for a salary well below market rate. Still, actions that might have strong support within the board and meet the needs and expectations of the executive might not play well with the IRS, a state attorney general, or in the court of public opinion.

This article is intended to offer readers a context and a set of choices in considering whether an exit agreement is needed and, if so, what might be included. Because this is a relatively new area of exploration for the sector, each situation brings unique features, and broad generalizations aren't possible. What we offer here is a framework for:

- Distinguishing between different types of agreements, and when and how they are best used (e.g., an employment agreement, a separation agreement, or an exit agreement);
- Sharing case experience about the presenting situations where an exit agreement may be appropriate and the key considerations in exploring and shaping such an agreement;
- Understanding the legal and risk management questions that require attention in considering an exit agreement; and
- Providing an introduction to additional resources that may be helpful in considering this topic.

Whatever elements you end up putting in your exit agreement, we must stress the importance of seeking legal review of any draft exit agreement by an attorney who is licensed in the state where your nonprofit is located and also well versed in nonprofit law and IRS regulations. As you will see below, it is no simple task to construct an agreement that meets the noble goals of the agreement, protects both parties, and conforms to the myriad laws and regulations governing its terms. Professional advice is recommended.

Perspectives on Exit Agreements

Our writing team comes at this article from two perspectives. Two of us are leaders in developing an approach to successful executive transitions for the sector, and one of us is a thought leader in the field of nonprofit risk management, helping boards and executives better understand the consequences of risk taking and the legal and

other risks that arise from governance, strategy setting, and operations. An unshakeable tenet of successful executive transitions is the following simple fact: to have a good beginning with a new executive, it is important to have a good ending with the departing executive. Too many transitions become strained because of lack of attention to what comprises a good ending for an executive—particularly a founder or long-tenured leader.

Clients regularly ask us for help in drafting exit agreements with departing executives. (For purposes of this article, we will use “founder,” “CEO,” and “long-tenured executive” interchangeably, to mean an executive who has had a major role in shaping an organization, either in its founding and long tenure or through leadership during a long tenure.) An exit agreement, as discussed in this article, differs in several respects from a separation agreement and release. (For information on the latter type of contract, please see the sidebar, below.) How many departing executives receive an exit agreement and what the terms are generally are unknown. The terms of these agreements are considered confidential, and unless a party to the agreement intentionally or inadvertently violates the confidentiality provisions in a typical agreement, they are not available for inspection. In our experience, only a small percentage of CEO departures are governed by the terms of an exit agreement. The use of exit agreements occurs most often under circumstances that we will describe below. Most are drafted by an attorney working with an executive, a few board leaders, and perhaps an accountant who specializes in nonprofit compensation and law. In some cases, the CEO and the nonprofit retain separate legal counsel during the negotiation of an exit agreement.

Separation Agreements: Different Purpose and Rules

An *exit agreement*, as explored in this article, differs in several key respects from what is called a *separation agreement and release*. The latter refers to a contract whose principal purpose is to limit the legal exposure of the employer to claims alleging wrongful termination, breach of an implied or written employment contract, and other claims from employees departing under less than ideal circumstances. A separation agreement and release is a legally enforceable contract that commits the organization to compensate the departing employee in exchange for a promise by the employee not to bring legal action against the employer. Typical separation agreements contain additional provisions beyond the promise not to sue. For example, a separation agreement may contain a non-disparagement clause and a requirement that the departing employee keep certain information confidential or return the organization’s property.

Exit agreements (as discussed in this article) and separation agreements are consistently similar in several respects. First, if properly drafted, they are legally

enforceable contracts containing obligations applicable to both the departing executive and the nonprofit. Second, both types of contracts include consideration: a sum payable to the departing employee offered in exchange for the commitments made by the executive in the contract. Lastly, neither form of contract should be executed by the nonprofit without first obtaining legal review.

The areas where these agreements are often decidedly different include:

- **Motivation.** The principal motivation to negotiate a separation agreement and release is the desire to reduce the likelihood of a legal claim against the nonprofit, whereas the motivation to negotiate an exit agreement is to reward a founding or long-term executive and ensure a fair and appropriate ending to a long-term employment relationship. Legal counsel to nonprofits often recommend that a separation agreement and release be used any time the risk of a wrongful termination claim is more than minimal, assuming the nonprofit has the financial wherewithal to provide the consideration required for the contract to be enforceable.
- **Required contract terms.** An exit agreement is likely to be enforceable as long as it contains the necessary component parts of any legally enforceable contract: an offer, acceptance, and consideration. In contrast, a separation agreement and release must contain additional sections to render it enforceable in a court of law, and additional requirements apply when the departing executive is over the age of forty. These latter requirements arise from the **Age Discrimination in Employment Act of 1967 (ADEA)**, as amended by the **Older Workers Benefit Protection Act of 1990 (OWBPA)**. Those laws require that when the separation of an employee over the age of forty is governed by a release, certain procedures must be followed to ensure that the employee wasn't coerced into signing the release. The ADEA, as amended by OWBPA, sets out specific minimum standards that must be met for a waiver to be considered *knowing and voluntary*, and, therefore, valid. Among other requirements, a valid ADEA waiver: (1) must be in writing and be understandable; (2) must specifically refer to ADEA rights or claims; (3) may not waive rights or claims that may arise in the future; (4) must be in exchange for valuable consideration; (5) must advise the individual in writing to consult an attorney before signing the waiver; and (6) must provide the individual with at least twenty-one days to consider the agreement and at least seven days to revoke the agreement after signing it.

Presenting Circumstances

The following are the presenting situations where, in our experience, exit agreements are most common:

1. *A long-tenured executive or founder has accepted a below-market salary for many years. Or, he or she has received minimal or no retirement benefits from the organization and is playing catch-up to prepare for retirement.* Sometimes the conversations about these dilemmas start one or two years before the hoped-for retirement; more rarely, three or more years in advance. The point at which this situation is addressed dramatically impacts options, as we will discuss below. The more years there are before exit, the more options there are to address past inequities.
2. *The board wants to motivate a valued executive to stay for a defined period of time.* For instance, an organization may want its executive to remain in place to complete a capital campaign or to be part of winning a major multi-year government contract. The organization may use an exit agreement with certain defined benefits as an incentive for the executive to stay longer than planned or to clarify the commitments of the executive and board as to how long the executive will serve.
3. *The board makes an agreement with a departing executive that combines catch-up and fee-for-service after leaving his or her position.* In some instances, the succession plan and transition to a new executive involves an internal successor. An extended overlap period or consulting contract for defined services is deemed mutually desirable by the departing and arriving executives and the board. An exit agreement can address both historical catch-up and the terms of any service beyond the start date of the new executive.
4. *Sometimes an executive has been appropriately compensated, including salary and retirement. However, the board and/or the CEO want clarity and comfort with respect to the CEO's legacy, the CEO's continued involvement in any organizational activities, and/or the CEO's availability to help on an as-needed basis.* In this case, such a document might be a simple one- or two-page letter of agreement about things important to the CEO and the board.
5. *Even when none of the above circumstances applies, an honorific for a long and successful tenure seems in order in the view of the board and/or the executive.* The executive has received a decent salary, has adequate retirement savings in place, and will not be providing post-retirement services beyond orienting the new executive. But, as part of the process for bringing a healthy closure to the CEO's productive tenure, a monetary gift seems to be an appropriate and customary element.

There are many other ways to say thank you to an executive who has served an organization well. You may conclude that an exit agreement is not appropriate. (For other ideas on how to say goodbye and thank you, see sidebar at bottom.)

Exit Agreements: The Four Types

There are typically four reasons boards and executives explore the possibility of an exit agreement. These reasons correspond to the “type” or focus of an agreement. This section takes the four general types of presenting scenarios for exit agreements

and explores each in more depth through case examples. The cases are fictional and represent a random compilation of multiple situations.

- 1. Catch-up.** A monetary package acknowledging the executive's salary has been significantly below market for a long period and/or the organization's retirement contributions have been low or nonexistent:

James was the founding executive of a human services organization, and built it from two staff and a \$50,000 budget to a 130-employee, \$5-million-net-worth leading service provider in his community. He served as executive for thirty-two years, and wanted to retire and move closer to his grandchildren when he reached age sixty-six. At age sixty, James recognized he had a problem. He had kept his salary below market for his position and region intentionally in order to hire more program staff. The organization had begun paying into his retirement account only five years earlier at a rate of 4 percent of salary per year. Even though his wife had a more generous retirement benefit, James faced the reality that he would need to work until age seventy-six to meet his personal retirement savings goals. Reluctantly, James raised this concern with the board chair, who agreed to convene the executive committee to consider what might be done.
- 2. Incentive to stay longer.** As an incentive to encourage the departing executive to remain as executive for a defined time for purposes important to the organization's welfare:

Irene was the founder of an environmental organization, and served as its CEO for twenty years. She informed the board of her intent to retire in six months' time. During this time, the organization was in the middle of negotiating a multi-year grant with a large institutional funder. When the board chair learned from the staff that the funder's confidence in Irene's leadership ability was fundamental to the successful completion of grant negotiations, he moved quickly to begin discussions with the executive committee about an arrangement whereby Irene would stay on past her intended departure date.
- 3. Post-retirement services.** Essentially, a contract for services to be provided after the leader moves out of the executive role:

Maybelle was the twenty-five-year founder of a child care center that served low-income families in an inner-city neighborhood. She had been tireless and highly successful in pursuing funding from foundations and from upscale donors who were attracted to her vision and tenacity for improving conditions for children and families in her center's environs. Donors spoke of her "special gift" for moving them to want to partner with her in her work. As she was preparing to retire, she told her board she wanted to stay involved with the child care center. It was agreed that she would move into a role as "ambassador" for the program with a core focus on major donor acquisition and retention. The board agreed to pay her a retainer of \$3,000 per month for her services.
- 4. Honorific.** A memorial, in writing, recognizing or honoring a departing founder:

Arturo was for thirty years executive director of a multi-service community center that had received numerous awards for its innovative programming for the neighborhood's immigrant populations. After he gave his board eighteen months'

notice of his impending retirement, he and the board engaged in extensive planning to prepare for the handoff to his successor. A goodbye dinner that had city leaders and appreciative neighborhood residents in attendance fulsomely celebrated Arturo's achievements. But a month after his departure, Arturo approached the center's board chair to say he was seriously disappointed that the board had not given him a monetary gift in acknowledgment of his tireless service to the neighborhood. He said such gifts were traditional, and had been given to departing executives he knew. The chair then sought advice from the search consultant they had used as to what was proper and customary.

Key Considerations in Drafting Exit Agreements

As intimated in the prior description of the four common reasons for negotiating an exit agreement, there is no doubt that many boards and executives find value in these agreements as elements important to successful CEO transitions. There are, however, some considerations worth addressing to increase the benefit and positive aspects of an exit agreement while diminishing the potential negatives. In this section, we will explore some of the important issues that should be considered prior to finalizing an exit agreement. After presenting each issue, we offer a series of key questions and tips for reflection.

- **Financial capacity.** The decision to provide exit compensation for a long-term executive typically arises from a board's desire to do something good and right. Many departing CEOs hope to be able to continue to serve the organizations they founded or nurtured even after their departures as full-time employees, so exit agreements are optimistic by nature. Among other things, they assume that the organization will continue along its current financial trajectory or even improve. In reality, the capacity of both parties to live up to the commitments in an exit agreement may change over time. The organization must have the reserves or ability to raise designated funds for this purpose so as not to impede future capacity to carry out its mission. For example, the commitment to make periodic lump sum payments to a departing executive may be in jeopardy if the nonprofit suffers a decline in unrestricted funding. Or, the assistance the executive was contracted to provide the organization under the new CEO turns out not to be needed. To appropriately consider issues related to financial capacity as it relates to the exit agreement, ask: *What is the likelihood that a change in capacity could impair the nonprofit's ability to provide the compensation, benefits, or other resources/support promised in the agreement? What steps can we take now in drafting the agreement to account for any changes in capacity (e.g., provide a single lump sum now rather than payments over an extended period, or include an "escape clause" that will enable the nonprofit to terminate the agreement in the event of a financial catastrophe)? Does the agreement provide for any opportunity to renegotiate its terms, should either side be unable to live up to the commitments contained therein?*

- Private inurement risk.** Tax-exempt organizations must operate in a manner consistent with their charitable purpose. “Private inurement” refers to the impermissible transfer of assets from a charitable organization to insiders or disqualified persons who have significant influence over the organization. One example of impermissible private inurement is the payment of more than reasonable compensation to a CEO of a nonprofit. If payments to a CEO are beyond what the market calls for, CEO compensation may be deemed to be excessive compensation, thereby putting the nonprofit at risk of IRS-imposed fines and penalties on the organization and the individual board members who approved the payment of excessive compensation. The penalties tend to be levied first and foremost on the recipient of the excessive compensation (e.g., the CEO). In extreme cases, the IRS may revoke the tax-exempt status of the organization that has violated tax law by transferring the assets of an organization operating in the public interest to a private individual. The risk of IRS action over impermissible private inurement only applies to 501(c)(3) and 501(c)(4) organizations under the Internal Revenue Code. Consider the tips below to weigh the potential that payment(s) to a departing executive could trigger fines or penalties under IRS rules related to excessive compensation: Give careful consideration to the basis for determining the amount of the payment. Use the “measure twice, cut once” rule of thumb before approving the payment. *Ensure that the board is independent, or that an independent committee is authorized by the board; the group will deliberate and vote on the decision about whether and how much to pay an outgoing executive. To prevent bias and preserve independence, the individuals on the board or committee should not be related to the CEO, nor should they have significant personal relationships with the CEO. Carefully document the steps taken to determine the amount of exit compensation to be given, and evaluate its reasonableness, including the use of surveys, salary studies, or other compensation data that was obtained and relied on. If your nonprofit hasn’t recently purchased a salary study or undertaken a compensation review, consider doing so before finalizing an exit agreement. This action affirms the reasonableness of the exit compensation by supporting it with comparable market data. Make certain that the full board is aware of the details of the exit agreement, including the financial terms and research/basis for determining that the payout will not be considered excessive compensation by the IRS. Document the board’s action taken to approve the final exit agreement.*
- Stakeholder dismay.** News reports of “golden parachutes” paid to outgoing corporate CEOs are rarely if ever met with thunderous applause from anyone other than the executive’s immediate family. Although after careful deliberation a nonprofit board may decide that providing a one-time lump sum or series of payments to the outgoing CEO is the fair and appropriate thing to do, the stakeholders of the nonprofit may see it differently. To manage the potential that internal stakeholders (staff and volunteers) or external stakeholders (clients, funders, regulatory bodies, or the public) may be concerned when they learn of the payment to a departing CEO or the terms of an exit agreement: Negotiate the terms of the agreement with an expectation that the executive’s compensation will be known to stakeholder groups. The latest IRS Form 990 requires all types of nonprofit executive compensation to be reported. Form 990s are available for public

inspection. *Draft talking points about the board's process and rationale for offering the benefits in the agreement in order to have them on hand in the event they are needed.*

- **Contractual considerations.** The risk of a breach of contract claim arises any time an organization enters into a contract with another party. Breach of contract claims brought against a nonprofit are typically excluded under nonprofit liability insurance policies, which means that the nonprofit will not have insurance to cover the cost of defending such a claim. To minimize the risk that a former CEO will bring a claim for breach of an exit agreement: Use clear and unequivocal language in the exit agreement. The deliverables should be easy to understand by both parties as well as any dispassionate, third-party reviewer. *Make certain that the promises made in the agreement are ones that the nonprofit is confident it can fulfill. Don't include an alternative dispute resolution (ADR) option in the contract unless you have a clear understanding about what is involved, including the cost. Although ADR methods (e.g., arbitration and mediation) are generally seen as less expensive than litigation, the cost of using these methods can be substantial. Include an "escape clause" that specifies under what circumstances the agreement, or components of it (such as the obligation to pay a consulting fee), will be void. For example, the nonprofit may have grounds to stop paying a consulting fee to a former CEO if the departing CEO fails to take direction from the successor or is unwilling or unavailable to live up to the terms in the contract. Always obtain legal review of a draft exit agreement before executing the agreement or asking the departing CEO to sign. Both parties, not just the nonprofit, should have legal counsel review the agreement.*
- **Disclosure to incoming CEO.** The terms of an exit agreement with a departing CEO are likely to be negotiated *before* the new CEO begins his or her service at the nonprofit. Nonetheless, the new CEO will likely become aware of all contracts, including any contracts with the departing executive. Therefore, one of the risks is that the new CEO will expect a similar set of benefits and compensation when he or she departs the nonprofit. We encourage boards to disclose the terms of an exit agreement to an incoming CEO. To manage the potential of false expectations: *Disclose the terms of the agreement with the departing executive with the new CEO and explain the rationale behind the exit agreement, such as the role of the departing leader as the founder of the organization. Stress the unique nature of the agreement. Avoid a replay of the scenario that necessitated an exit agreement by addressing the compensation conditions in the organization that resulted in, for example, an executive paid below market value and underfunded for retirement.*
- **Internal equity.** Another important consideration is whether the proposed agreement with the departing executive is so different and out of character as to raise serious internal equity and morale issues. If the purpose is retirement catch-up, for example, what is the organization able to do to improve employer-paid retirement benefits for all managers and staff?

Examples of Approaches to Exit Agreements

Because exit agreements are confidential, it is difficult to provide many details and examples. The following are examples of exit agreements as reported secondhand from knowledgeable consultants and attorneys. Not every example follows all the guidance above. There is no one, rigid guideline, so there exists a wide range of examples in most communities. The best way to learn more is to request an informational meeting with an attorney or tax accountant who specializes in deferred compensation and/or exit agreements for executives in the nonprofit sector.

Example 1: Catch-Up

A long-serving executive worked without pay for a number of years. Her financial situation changed as she approached retirement age. The board increased her salary within the limits of reasonable compensation, provided the maximum retirement benefit allowable under pension law, and agreed to retain her for five years after retirement as a consultant to advise on specific areas where she had expertise.

Example 2: Incentive to Stay Longer

At the request of the board, a long-serving executive agreed to continue to serve until age seventy-three, four years longer than his original retirement plan. The organization's primary funder had been awarding major contracts through a request-for-proposal (RFP) process every four years. The current RFP process had been delayed twice, thus delaying the executive's departure. In exchange for these additional years of service, the board agreed to continue to pay health insurance costs and make an annual payment for five years past retirement.

Example 3: Post-Retirement Services

After twenty-years, the founder of a regional clean water agency dedicated to removing all pollutants from the area's streams and lakes had grown weary of the fundraising and administrative duties that consumed most of her time. However, her passion for pursuing the agency's mission was undiminished. She asked to become a half-time lobbyist for her agency in the state legislature. The board agreed to move her into that position, with the stipulation that she would be supervised by her successor. They set her salary at \$40,000 per year.

Example 4: Honoring

Aware that their retiring executive and his wife were avid travelers, as a departing gift the board of directors gave him a \$5,000 “voucher” for use with the travel agency of his choice. The board paid for the voucher with funds donated by board members and a few longtime individual donors.

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An exit agreement with a departing nonprofit executive is a tool that can bring clarity to uncertainty about the departing leader’s post-CEO role with the nonprofit. In other cases, an exit agreement can be a tool for providing a catch-up financial contribution that recognizes, in part, the achievements and service of an undercompensated leader. Or, it can be a tool for saying thank you. But whatever the purpose or motivation behind the agreement, there are important considerations that must be examined in order to make certain that the final agreement is fair, appropriate, and legally defensible.

Ideas for Saying Thank You and Goodbye

Planning a farewell for a revered leader is personal. Each departing executive has preferred ways of giving and receiving recognition, praise, and goodbyes, as do the board members and staff who will organize the goodbye events. The planning requires sensitivity, skill, and, often, patience. And if the executive happens to be the founder—or founder-like in tenure and transformational impact—the stakes can be especially high.

Organizations that have successfully paid tribute to their departing executives tend to work from the following principles:

- Consult the executive in the planning and define a comfort zone that is win-win for the executive and the organization.
- Involve in the planning people from the board and staff who communicate well with the executive and understand the conditions for success from the executive’s perspective.
- Brainstorm creative ways to make the farewell memorable, fun, and meaningful for all parties—the executive, his or her family, the board, staff, and other celebrants.

A typical goodbye or thank you involves one or more events. Here are some examples:

- Organization A held three events for its outgoing executive: a small dinner with past board chairs with whom the executive had worked over two decades; a staff event organized by the management team; and a community-wide party where funders, government officials, clients, and their families could all come and say thank you.
- Organization B, a community development organization, had both a staff-only event for its longtime leader and a Saturday picnic to which the whole community was invited. The large public party had been specially requested by the community-focused leader.
- Organization C had a more traditional dinner and reception, with speakers who were meaningful to the executive and participants.

In selecting a gift for a departing executive, boards pay attention to what he or she enjoys and does for fun. Luggage for traveling, a cruise, and season tickets to a sports or arts series are examples of thoughtful gifts.

Departing an organization is a challenging and emotional event. Executives leave behind people they have enjoyed working with for many years. A well-planned farewell and thoughtful gift are often important contributions to a positive separation experience.

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