Looking Ahead: Top 5 Compensation Committee Issues Facing Healthcare in 2014

By Steve Sullivan and Jim Hudner

The introduction of the Patient Protection and Affordable Care Act (PPACA) is the latest in a series of major developments in the healthcare industry, which also faces the continued emergence of for-profit entities and an increased pace of mergers/acquisition. The paradigm of healthcare delivery is fundamentally shifting away from the traditional fee-for-service model, as providers recognize that in the current environment, keeping people healthy costs less than treating them when they become ill.

Given the embedded approaches, complex integration issues and evolving governmental regulations, healthcare providers preparing for the future must be sufficiently flexible, innovative and adaptive to combine a new strategic vision with their core operational competencies.

We believe healthcare Compensation Committees face five key issues in 2014:

1) Aligning Business Strategy and Executive Compensation
2) Using Long-Term Incentives to Enhance Pay-for-Performance
3) Updating Compensation Governance for Non-Profit Healthcare Organizations
4) Improving Compensation Program Communication Strategy
5) Being Prepared with a CEO Succession Plan

In this White Paper, we discuss practical and effective approaches for these major challenges. The report is also available on our website at http://pearlmeyer.com/healthcare.

1) Aligning Business Strategy and Executive Compensation

Most hospitals and healthcare systems are in the process of changing direction and modifying their business strategies based on the criteria for care providers established within PPACA. Long driven by organizational objectives based on metrics such as admission count, case mix, procedure type and volume, providers are re-imagining a future under very different definitions of “success”. The new focus is on measures of clinical quality and safety, patient experience, community health and efficiency.

As healthcare executives and Boards are establishing new core business strategies, the roles and responsibilities of senior leaders are changing – and there is a need to reconsider how to adapt compensation programs to support that new direction. Hospital and healthcare system Compensation Committees are once again squarely in the mix. Their challenge: to help their organizations develop and implement new business strategies and reflect those strategies in executive incentive plan designs – all while balancing issues around internal and external pay equity, motivation, retention and regulatory compliance.

Perhaps ironically, one of the most daunting challenges is that these changes will not occur overnight. Because insurers are not immediately changing their reimbursement criteria, the industry faces an unprecedented transitional period. Providers will continue to be reimbursed for many traditional fee-for-service arrangements, even as the new criteria become an increasing part of the strategic equation. In response, many hospitals and healthcare systems are simultaneously managing to traditional financial, clinical and other performance criteria for the next couple of years, while working to identify their organizational objectives further down the road.

During this evolution, Boards must also address the need to integrate more physicians with clinical experience into the C-suite to reflect the shift in strategy. To overcome the traditional lack of cooperation and collaboration between physician executives and lay executives, organizations must begin actively developing physician executives now and establishing clear career paths for these new leaders. That requires fair, equitable and effective executive compensation arrangements for these physician-executive roles that support the overarching business strategy and also align with the objectives and compensation programs of other executives.

What's needed is a new approach to motivate and retain existing executive teams, while attracting and supporting physicians in critical new management roles. Such a new approach has several requirements, including:

- Driving care quality, community health and the reduction of fixed costs
- Adjusting to individual physician and lay executives' compensation requirements
- Supporting a team concept by providing the proper motivation for the complex work ahead under PPACA
- Strengthening the alignment of executive pay and performance

Committees can take some first steps toward aligning strategy and executive pay by prioritizing their organizations' objectives and executive accountabilities based on timing, criticality, measurability and line-of-sight. Organizational objectives that rate high on all these criteria and reflect the current reimbursement environment can potentially serve as short-term performance measures. A subset of these strategic objectives that also address clinical quality, patient outcomes, efficiency and community health may be useful in the development of a long-term performance incentive plan. Annual and multi-year incentive arrangements within the same overall executive compensation program can then be linked – providing a meaningful connection between short- and long-term performance.

2) Using Long-Term Incentives to Enhance Pay-for-Performance

Boards will be expecting healthcare leaders to begin coordinating patient care with a wide range of acute and long-term care organizations to improve the continuum of care and the health of the communities they serve. As executives' roles and responsibilities evolve, their compensation programs must also change. Healthcare reform will drive the adoption of new pay practices, including broader use of long-term incentive compensation plans (LTIPs). Because annual plan metrics are typically operational, they can't track and reward the types of sustained collaborative efforts needed to re-focus organizations on improvements in quality, safety and wellness results.

As for-profit companies increase their presence in the healthcare industry, the use of stock-based awards or phantom stock arrangements could help establish a level playing field on which physician and non-physician-executives are rewarded equally for driving new performance priorities under the PPACA. As in any industry, these large companies strive to increase stock value and total shareholder return for their investors. Those that use parent company equity-based awards for the executives imbedded in the individual provider organizations may consider a parallel long-term incentive plan driven by the performance outcomes of the particular hospital or healthcare system to ensure that individual plan participants perceive adequate line-of-sight and are able to impact the results driving compensation.

Healthcare organizations that cannot provide equity-based incentives (e.g., non-profits) can develop multi-year performance-based plans that use performance units or similar instruments whose value is based upon the executive team's multi-year performance against pre-established strategic measures. The award levels generated by these plans in non-profit provider organizations will also need to be calibrated with reasonable market practices in order to comply with intermediate sanctions regulations.

Boards may find it difficult to identify long-range metrics due to the unpredictability of the healthcare environment, or to set long-range performance goals for metrics such as care quality, community health, and others, since most organizations have never realized targeted levels before. Nevertheless, the success of such long-term plans will depend upon close alignment between plan measures and strategic long-term business performance. As a growing number of physician-executives are hired, both for-profit and non-profit Directors must also ensure that all compensation arrangements meet regulatory requirements that could affect participant eligibility and plan design, including patient referral, fraud and abuse. Employment and compensation arrangements must comply with Stark Laws, Anti-Kickback Laws, Corporate Practice of Medicine Regulations, Civil Money Penalties, PPACA, and the False Claims Act, as well as specific rules against private inurement. The balance between pay-for-performance and regulations is one that healthcare providers will need to carefully consider as they restructure their compensation programs to function properly in the PPACA era.

3) Updating Compensation Governance for Non-Profit Healthcare Organizations

The Intermediate Sanctions regulations under IRC Section 4958 provide non-profit Boards with three key criteria that can serve as a foundation for establishing effective and appropriate governance of their executive compensation programs:

- There is an independent Compensation Committee whose members are free from conflicts of interest that approves the total compensation package of all "disqualified persons."
- The Committee has valid market data for comparable positions, which can include information from both for-profit and not-for-profit organizations.
- The Committee reviews the market data, deliberates on compensation issues and documents its decisions regarding adjustments to pay and the decision process.

These three criteria provide a minimal outline for governance practices as they relate to executive compensation within any not-for-profit organization. However, organizations should consider expanding on the IRS's three-step process to ensure the best governance practices.

Independence
The IRS doesn't define what would constitute a conflict of interest for members of the Compensation Committee. Healthcare Boards of Directors therefore should be proactive about determining and documenting their own specific standards of Committee independence.

Many healthcare organizations have adopted the Director independence rules used by one of the stock exchanges. The standards below are based on the independence rules for companies listed on the New York Stock Exchange (NYSE), adapted to a non-profit organization:

- The Director has no material relationship with the organization other than as a Director.
- The Director has not been an employee (or had an immediate family member who was an employee) within the past three years.
- Neither the Director nor any immediate family member has received more than $25,000 per year in direct compensation, other than Director or committee fees, pension or other deferred compensation within the past three years (This amount should be set dependent upon what would be considered material to your Board members).
- Neither the Director nor any immediate family member has been employed by a present or former internal or external auditor of the organization within the past three years.
- Neither the Director nor any immediate family member has been employed as an executive officer of another company where any of the organization's present executives serve on the company's Compensation Committee.

These modified guidelines allow the testing of the independence of each of the Directors in a non-ambiguous and objective manner.

Charter
Creating a Compensation Committee Charter that documents and outlines its duties is another opportunity to strengthen compensation governance. The charter will clearly establish the roles and responsibilities of the Committee and its members providing the blueprint to a strongly governed Committee.

It should cover such issues as:

- Who will make up the Committee and how many members will it have?
- Is the Committee required to have physicians among its members?
- How often and when will Committee meetings be held?
- Over which job positions will the Committee have oversight?
- What policies and procedures require Committee approval (e.g. merit increases, annual and long-term incentive plans and payments, etc.)?
- Will the Committee have the authority to independently contract with outside advisors?
- What will be the role of management in support of the Committee?

Executive Compensation Philosophy
An executive compensation philosophy articulates the goals of the compensation program and serves as a blueprint for the Compensation Committee's decision-making. One of the key elements of the compensation philosophy is the basis for identifying the peer organizations to be used by the Committee for comparing compensation levels. In addition to defining this peer group, a sound compensation philosophy provides guidance to the organization on:

- Competitive Positioning

    - The market level is determined by a peer group analysis and compensation surveys. The philosophy should also establish a weighting scheme for the data collected, which will define "market."
    - The philosophy should specify the market data percentile to which the Committee will position executive total compensation, individual compensation components (e.g. base salary, total cash compensation), or the aggregated level of compensation for the executive team.

- Compensation Profile

    - The Committee can determine the mix of compensation: base salary, short-term incentives, long-term incentives and benefits. Members may choose a compensation profile that follows the market data or is positioned differently, based on its particular organizational issues.
    - In general, placing more weight on salary and benefits is appropriate for a relatively mature, stable or conservative organization; putting more emphasis on incentives is typically a better fit for a younger, more entrepreneurial, or rapidly changing organization in need of flexible arrangements.

Minutes
Finally, careful documentation of Compensation Committee meeting discussions and associated decision-making actions will not only satisfy the final leg of the IRC's three step process, but also help members understand the history of the compensation adjustments and the rationale behind changes to the program. The minutes should indicate how the comparable data was considered and whether pay was based on individual or organizational performance. It is also important for the minutes to indicate when the Committee adjourned to executive session (without any members of management present) and the general nature of the items discussed, to help bolster the case for the independent, arms-length decision-making process.

Strong governance practices aren't difficult to establish, but do require careful thought to ensure they meet the needs of the organization and provide the organization's constituents with a level of comfort that its mission and assets are being protected.

4) Improving Compensation Program Communication Strategy

Like for-profit Boards of Directors, today's non-profit healthcare Directors must be responsive to multiple constituencies. Patients, physicians, donors, regulatory agencies, the media, and the communities that are being served all are keenly interested in ensuring that the non-profit fulfill its charitable role. While communication strategies generally should be planned at the Board level, this is particularly true for the Compensation Committee, which often draws unwanted and unwarranted attention due to the public perception that many executives in today's market are overpaid.

Too often, not-for-profit healthcare Compensation Committees do not adequately think through how to best communicate the overall compensation program until the media has branded its executive compensation program as inappropriate or excessive. By proactively and carefully communicating the merits of the overall program and how it will promote the community's health needs, the Committee can anticipate and be positioned to quickly respond to criticism. Providing clear answers to the questions likely to come from the organizations' constituents can help frame the compensation discussion in a positive light.

Likely questions from major donors or the media might include:

- Why is the pay program structured that way?
- Who conducts the executive compensation review?
- What organizations are used for comparing peer pay?
- Where within the competitive range are the CEO and other executives positioned?
- How do the yearly pay increases for the executives compare to the increases for other employees?

Providing candid responses to these questions and relating them back to the established compensation philosophy can help the Board to frame the compensation discussion properly, before the media or other outside organizations criticize the program without context. The IRS provides all non-profits with a venue to provide information about their compensation program. Schedule O of Form 990 may be used to describe the compensation philosophy of the organization, including the target comparator group and the organization's market positioning strategy. Within this disclosure, the Board can explain how performance measures are used in the incentive compensation program and the importance of these measures in the operation of the business or the fulfillment of the organization's mission.

Preparing to communicate the philosophy externally offers the Compensation Committee an additional opportunity to verify that the resulting program design is aligned with the business strategy of the organization. This alignment takes on greater importance as organizations continue to restructure and realign compensation in response to PPACA.

5) Being Prepared with a CEO Succession Plan

Among the most important responsibilities of the Board of Directors is ensuring that the institution is led by talented executives who can provide visionary, strategic and operational leadership. Maintaining a continuity of effective executive leadership is largely dependent on having a carefully developed and monitored succession plan. While this planning is critical in any environment, it is especially important given that the significant changes taking place in the healthcare sector may require a different mix of leadership skills. A well-conceived succession plan will document the approach for transitioning new leadership in the event of a planned or unplanned termination scenario. (e.g., retirement, disability, termination or other unexpected event). Importantly, Committees should develop a succession plan ***before*** the need arises.

Key steps in developing a succession plan include:

Defining Required Leadership Skills
The skills that characterize tomorrow's healthcare executives (in particular the CEO) will not be the same as those deemed most important pre-PPACA. While the traditional CEO has always needed multi-faceted skills, a premium was placed on having strong operational skills with an emphasis on cost management.

The evolving healthcare environment will require broader and deeper skills, with greater emphasis on strategic thinking, as well as an ability to lead an organization through a period of transition, ultimately resulting in a greater focus on patient outcomes, quality standards and integrated delivery models. This changing landscape has led to an increase in "physician-led" organizations – a trend that will need to be watched closely as Boards assess the future plans of their organization and determine required leadership skills.

Skill Assessment
The first order of business can sometimes be the most sensitive: to assess the extent to which the current CEO possesses the required skills defined by the Board, assuming that retirement is not imminent. This could lead to one of three results:

- There is a good match between the CEO's current skills and the required skills
- There are some gaps, but there is an opportunity and desire by the CEO to fill these gaps, either through coaching, leadership development or complimentary executive talent.
- There are significant gaps between current and desired skills that are unlikely to be met, resulting in the Board preparing for a CEO transition.

Beyond the assessment of the current CEO's skills, it is also important to assess the skills of other senior executives to evaluate the bench strength within the organization. The internal talent of the CEO's executive team may not necessarily square with the skills that will be required of healthcare executives going forward. In these cases, it may be prudent to dig deeper into the organization (e.g., two or three reporting levels below the CEO) to determine if there is potential talent that can be developed internally.

Action Plan
With clarity on the required skills, the gaps that exist and assessment of the current CEO and other internal talent, the Board should develop a specific action plan based on its findings.

Elements of the plan may include some or all of the following:

- Determining appropriate steps to broaden or deepen the leadership skills of the current CEO based upon the skill assessment or, if the gap is too substantial, moving quickly to develop plans to identify a successor.
- Identifying potential internal candidates to succeed the CEO, whether for the purpose of a near-term transition or a longer-term succession plan.
- Defining and overseeing the development of identified internal candidates, including executive coaching, progress assessments and any needed course adjustments.
- Defining the selection process (including use of recruiters, timing of activities and internal/external communication) and identifying internal and/or external candidates.

- Developing specific contingency plans in the event of an unplanned CEO departure (e.g., early retirement, disability, death).

Finally, as with any plan, there needs to be clarity regarding who is accountable for each action step to ensure the succession plan is properly executed.

Possibly the single most important role of the Board is to select the “right” leader. The ability to provide support and feedback that allows the CEO and his/her leadership team to succeed will only become more critical in the changing healthcare world.

To learn more about the critical compensation issues facing the healthcare industry, please visit http://pearlmeyer.com/healthcare.

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For 25 years, Pearl Meyer & Partners (www.pearlmeyer.com) has served as a trusted independent advisor to Boards and their senior management in the areas of compensation governance, strategy and program design. The firm provides comprehensive solutions to complex compensation challenges for multinational companies ranging from the Fortune 500 to not-for-profits as well as emerging high-growth companies. These organizations rely on Pearl Meyer & Partners to develop global programs that align rewards with long-term business goals to create value for all stakeholders: shareholders, executives, and employees. Pearl Meyer & Partners maintains U.S. offices in New York, Atlanta, Boston, Charlotte, Chicago, Houston, Los Angeles, San Francisco and San Jose, as well as an office in London.

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