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Agenda for the Executive Compensation Committee: A Guide for Minimizing Regulatory and Reputational Risk

by Timothy J. Cotter

Editor's Note: This article outlines agenda items for the board's Executive Compensation Committee. It is the first of several that will further explore many of the agenda items discussed below. Watch for additional articles on the Great Boards website and in other publications from AHA's Center for Healthcare Governance.

The rapidly changing health care market has created significant demand for executives with proven leadership capabilities, often accompanied by highly competitive compensation arrangements. At the same time, health care executive compensation continues to be a focus for regulators, politicians, unions, the media and organizational stakeholders. Thus, the job of the executive compensation committee is more challenging than ever.

Committees serving not-for-profit health systems and hospitals must successfully attract and retain high-performing executives while minimizing regulatory and reputational risk. Part of the committee's role is to establish practices that maximize informed decision-making and mitigate risk. In this environment, where intense scrutiny is the new normal, compensation committees should conduct a comprehensive risk assessment and adopt agenda items that will help identify exposure associated with failures to:

- Ensure that compensation is aligned with changing business conditions and strategies.
- Adopt best practices in governance.
- Preserve and enhance the image of the organization. (See Figure 1 on page 2)

By identifying these issues up front, and addressing the 10 agenda items outlined below, the committee can make informed decisions and take steps to manage these risks proactively, rather than waiting until they are identified.

Suggested Agenda Items for the Compensation Committee

1. **Re-evaluate the executive compensation philosophy.** Executive compensation is evolving and the committee should examine the premises on which the program is based:

- Where should the organization target executive pay? Under what situations should it fall above the middle of market practice?
- Do base salaries of executives need to be adjusted every year?
- To what extent should executive compensation be linked to organizational performance?
- What is the business case for having significant special benefits for executives?

2. **Respond to the changing health care environment.** The committee should assess environmental impacts on the executive compensation program and take action as required. For example:

- How are the incentive measures aligned with the emerging requirements for scale, value and cost?
- As the organization considers mergers or affiliations, are there appropriate and affordable change-in-control provisions in place?
- As the health system becomes more fully integrated after a merger or acquisition, what is the appropriate leadership structure, how many executives are required and how should existing compensation be modified?
- Are the executives' skill sets relevant for the new environment?
- Does the program include practices (e.g., tax gross-ups, which involve paying an executive's tax liability for a component

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of the compensation program) that are no longer contemporary?

3. **Conduct an assessment of the peer group and the market data relied on by the committee.** The soundness of an organization's executive compensation practices is heavily dependent on the comparability data used. Would your organization's data hold up to scrutiny by a regulator? Although the IRS's recently released Final Report of the Colleges and Universities Compliance Project pertains to a different kind of nonprofit organization, its findings have implications for not-for-profit hospitals and health systems as a key area of focus is the nature of the organizations represented in the comparability data. Criteria to consider include:

- Size – Peer organizations should typically range from 50% to 200% of the organization's revenue.
- Location – Should a rural Midwestern health system be compared to systems in high-cost urban areas?
- Complexity – Should a system composed of small community hospitals be compared to large academic medical centers?
- Performance – How should external benchmarks (bond ratings, performance outcomes and industry rankings) impact peer group composition?
- Relevance – Do you recruit from or lose people to these organizations?

4. **Carefully evaluate actions likely to draw media and/or regulatory scrutiny.** Examples include:

- Making a significant severance payment when the termination has been described publicly as voluntary.
- Form 990 disclosures of large executive increases and/or significant payments when the health system/hospital is giving no/modest increases to staff, or implementing staff reductions.
- Using a process that does not attain the rebuttable presumption of reasonableness. (See box on page 3)

Given the transparency fostered by Form 990 and current media interest, these kinds of actions are likely to draw unwanted attention. When such actions are taken, the committee should develop a well-defined public relations and media strategy.

5. **Quantify the anticipated cost and disclosure implications of major executive compensation obligations.** These include common market practices, such as severance, supplemental executive retirement plans (SERPs), deferred compensation, long-term incentives, retention incentives and accumulated paid-time-off banks. As health systems and hospitals face financial challenges as well as scrutiny, committees need to anticipate the cost of such commitments, which can create unexpected financial strains when paid — and a firestorm of stakeholder and media indignation when disclosed on the Form 990. The committee may be well served to review pro forma Form 990s for future filings before finalizing compensation decisions.

6. **Conduct selected audits.** Publicized cases of executive malfeasance in not-for-profit organizations suggest consideration be given to periodic audits of executive compensation-related expenditures. For example, internal/external auditors could:

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Figure 1: Three categories of risk management

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Establishing the Rebuttable Presumption of Reasonableness

Good governance processes will go far to demonstrate the due diligence of the compensation committee in making appropriate and reasonable compensation decisions. If the following steps are not taken, an organization bears the burden of proving reasonableness. 1) Use an independent body to review and establish the amount of compensation in advance of actual payment. 2) Use permissible comparability data to inform compensation decisions. 3) Document the process used to establish the compensation amount contemporaneously.

- Compare what the health system/hospital actually pays its executives to what was approved by the committee.
- Review executive expense reimbursements for compliance with policy, tax regulations and system image standards.
- Validate scores for performance measures on which incentive awards are based.

Left unaddressed, these kinds of issues may result in significant reputational damage.

7. **Pay attention to internal equity.** Increasingly, there is an internal and external expectation that the average rate of compensation increase for executives should not significantly exceed the average rate of increase for other employees. While this is a complex issue with many facets, committees should have substantial business justification for treating executives better than staff employees. Considerable differences may leave the organization vulnerable to employee unrest and unfavorable media attention.

8. **Assess advisor independence.** A new SEC rule covering compensation advisor independence, while not specifically applicable to the not-for-profit health care sector, provides an opportunity to strengthen the defensibility of your compensation program. Factors to consider in assessing advisor independence include:

- Is the advisory firm providing other services to the organization and what are the associated fees for these services?
- Is the advisory firm's revenue from the health system or hospital a significant portion of its revenues?
- Does the firm have appropriate conflict of interest policies?
- Does the firm or its advisor(s) have business or personal relationships with committee members and/or the CEO or senior executives?

Conflicts of interest in the executive compensation process will compromise program defensibility. The committee is in the best position to determine whether any conflicts exist and to take appropriate action.

9. **Move toward greater transparency.** There is consensus that greater transparency surrounding executive compensation strongly contributes to appropriate and defensible compensation programs. The committee would be well served to:

- Review outside earned income to identify potential conflicts and ensure executives are properly focused on the organization's interests.
- Provide a report on executive compensation programs and levels to the full governing board on a regular basis.
- Consider the development of a Compensation Discussion and Analysis (CD&A) comparable to that of a public company, to support internal and external transparency.
- Ensure that executive compensation is properly reported on the Form 990 and required governmental filings. Best practice suggests that the board review the Form 990, including required compensation disclosures, prior to its filing.
- Use tally sheets to assist committee and board members in understanding the total current and expected cost of all economic benefits provided to each executive.

10. **Ensure a strong committee oversight process.** Good governance processes support appropriate and defensible committee decisions. For example the committee should:

- Establish an annual calendar of committee activities.
- Receive meeting materials and staff support adequate for the committee to make informed decisions.
- Consider adding an outside expert to the committee, if permitted under state statute, when there is a lack of internal expertise.

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- Ensure sufficient meeting time to adequately review and deliberate proposals.
- Establish a process that obtains the rebuttable presumption of reasonableness for off-cycle decisions, such as new hires and retention arrangements.
- Make use of an executive session when appropriate.

Conclusion

A changing industry, reduced reimbursement, increased regulatory scrutiny, ongoing media coverage and excesses in other parts of the economy make executive compensation a high-risk issue for not-for-profit health systems and hospitals. By adhering to a thoughtful and comprehensive agenda focused on minimizing reputational and regulatory risk, the committee will be well prepared to confront an increasingly skeptical and challenging environment. Only independent and qualified committee members, with adequate internal and external information, can display the healthy skepticism and business judgment necessary to develop appropriate compensation arrangements and effectively defend them when necessary.

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