Governing Health Podcast Series

Episode Two - Executive Compensation Trends: A Board Update
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Stephen: Hi, I'm Stephen Bernstein, global chair of McDermott's Health Industry Practice Group. I'm pleased to present our monthly podcast *Governing Health*, geared towards director education. The goal of this series is to supplement the education that directors receive in the boardroom by providing them with concise updates on leading developments and engaging conversations with industry guests that relate to the exercise of their fiduciary duties. On behalf of the Health Industry Practice Group at McDermott, it's a pleasure to have you join us.

Michael: Hello again and welcome, I'm your host Michael Peregrine. We're pleased you're with us. Today's conversation focuses on one of the most fundamental of all Board responsibilities: establishing the compensation of executives. Executive compensation programs are complex. They're highly regulated, require heightened engagement, and demand specialized expertise. They send important messages about corporate culture, expectations, and goals. They're voraciously covered by the media. So today we're going to explore this key governance duty with two industry experts.

First is my good friend Tim Cotter, Managing Director of Sullivan, Cotter and Associates. Tim is, in my experience, the most recognized name in health care executive compensation consulting. We also have my longtime partner and friend Ralph DeJong, who is exquisitely expert in the law of executive compensation in the health care industry.

Before we turn to Tim and Ralph, let's revisit for a second our conversation last month about Board attentiveness to health care policy, for as we've seen, a lot can happen in 31 days and health care directors must be alert to the implications of broader political and economic volatility. Can issues like border security, immigration restraints, trade conflict, fiduciary rules, regulatory reform, and market fluctuation affect the health system? Would a Dodd-Frank rollback have spillover effects? Could Administration pressures on key industries expand to include health care? Will the new Supreme Court justice influence upcoming health care related cases? These are all potential enterprise risks. But remember, it's not political, it's strictly business.

I'm joined now by Tim Cotter of Sullivan, Cotter and Associates and Ralph DeJong of McDermott Will & Emery, who will share with us their perspectives on executive compensation trends and practices. So, Ralph DeJong, Tim Cotter, welcome to *Governing Health*.

Ralph: Good to be with you Michael.

Tim: Thank you Michael, I'm delighted to join you and Ralph.

Michael: Tim let's start with you. I think the number one question our listeners are interested in is: What's the rate of compensation? What are you seeing as trends and data in terms of compensation increases right now?

Tim: Well thank you Michael, I'm delighted to join you and Ralph. As I give you that information, my comments on market practice are primarily those focused on not-for-profit health systems, and typically those with revenues greater than $1.0 billion. In 2016, the actual increase in total direct compensation (so that would be the combination of base salaries, annual incentives, and long-term incentives) was roughly 4% at the median, 5.5% at the average, and 7% at the 75th percentile for integrated delivery system executives. Clearly when you look at the reported rates of increases for non-executive individuals, around 3%, maybe 2.5% in some markets, these increases are above those that are seen in other parts of the health care workforce. But we do expect that they're going to be above normal increases for 2017, as well. When you look at the system-owned hospital, so the operating business units, total direct compensation there moved at a much more modest pace for those executives; approximately 3% at the 50th, and 4% at the 75th.

Michael: And why is that?

Tim: Well, I think there are there are several things at the system level. The first is, as we read the industry reports, the merger and acquisition activity that's going on, which leads to larger health systems and more complex health systems. Secondly, health systems are growing the size and scope of their executive roles; the executive roles are changing. Finally, in this period of dynamic change, there's demand for key talent and significant retention concerns; all of which are causing not-for-profit health systems to be more generous in compensation levels for their key folks

Michael: Tim when you look at total direct compensation and total cash compensation, when you include the incentive compensation element, and how that's growing at a rate that's faster than base salary, and faster than the general employee workforce; is that an indication that it's really performance-based pay that's increasing pretty rapidly? I think when we're advising Compensation Committees of tax-exempt health care organizations we're observing that performance-related pay has gotten stronger, tougher, and with a greater opportunity, and in recent years the performance has been fairly strong. Do you think that would account for the greater increase at total direct compensation and total cash compensation, especially at the 75th percentile?

Tim: I think that's a partial explanation. First off, the performance levels of health systems, as they report at what level they're paying incentive awards are certainly above target, so we do have a performance explanation there. Secondly, as we will talk about later in this discussion, we're seeing the greater use of long-term incentive plans. So an additional element of cash compensation is being introduced, and so I think from a performance point-of-view, those are two explanations. But on the other side, as we look at health systems that are merging, and they double in size, Compensation Committees are repositioning the pay lines to take into account the larger organizations that executives are managing because executive compensation is highly correlated with the size of the organization. Secondly, the intense competition to attract and retain key executive talent. And then finally, the dynamics and pressures of maintaining stability in executive populations, I think, are performance-related, but they aren't quite the incentive-related type explanation that the first part of your question would address.

Michael: Those are really great factors because it's been such a fluid time for the health care industry in the last couple years, given the consolidation that's occurred, the revenue pressures, the uncertainty with the Affordable Care Act (first, how it was being implemented, and now whether it will survive at all) that we're seeing reflected in executive compensation, and the need for defining and retaining and motivating the most important talent within the organization. So that's pretty reflective of that broader trend.

Michael: Tim, I guess one question a lot of our listeners are used to seeing is working with single peer groups. Is that continuing? Are you advising clients to expand their review to multiple peer groups, broader constituencies, what do you see?

Tim: Well, I think that the change in the marketplace is forcing health systems, as they become more diverse and complex, and as their talent markets extend beyond those of just the other health systems, we see health systems monitoring additional talent markets. So for example, what might those talent markets be? Well, the first are for-profit general industry talent markets, and those would be for executive roles that exists outside of health care – so the chief human resources officer, the chief information officer, supply chain, chief legal officer. We also see, as hospitals focus on innovation, taking a look at business development roles. We see a focus on for-profit insurance companies, as health systems get into the business of running health plans. While other not-for-profit health system have health plans, typically the marketplace for those kinds of skills are the for-profit insurance companies.

Stephen: Let's pivot for a moment to our regular short segment, "What's Trending Now" when we try and flag a new governance issue we see on the horizon and today that's most certainly the potential for tightened conflicts policies, given the daily headlines. This unceasing media coverage is increasing the conflict sensitivity of corporate governance stakeholders at every level, and that includes directors, shareholders, transaction partners, regulators, and the courts – not to mention the media, corporate watchdog groups, and social activists. Only the most disengaged of observers could have missed it. So, going forward, Boards may need to be looking, not just across the street, but down the block, around the next corner, and beyond the horizon, when it comes to identifying, evaluating, and managing approved conflicts of interest. And now back to Tim and Ralph.

Michael: Ralph, do you have an issue when you're called upon to support these different peer groups with regulators? Is that a tough sell?

Ralph: Well, we have to remember that the IRS has given express permission to use for-profit data in analyzing the reasonableness of an exempt organization's executive compensation. That is an appropriate source of data. But I think what's important for Compensation Committees to remember is that to get the rebuttable presumption of reasonableness under federal tax law, the highest protection that's available to support the reasonableness of compensation, one of the steps that's important to satisfy is to document the rationale for the independent approval of compensation that occurs when compensation is outside the range of market data. If for-profit data, or innovative additional sources of data to which Tim just referred, if those are being used to support compensation – perhaps for novel positions, new kinds of positions that are occurring, or positions that are more akin to the for-profit world – it's incumbent on the Compensation Committee to document the reasons why it believed, as the independent approval body, that compensation was reasonable.

Michael: When do you see problems occurring in this area? What's a red flag to you?

Ralph: The biggest problem I see is not the exercise of the Committee's independent business judgment – that is usually performed very well. It's when the rationale, the very valid rationale, that Committees frequently use to support reasonableness doesn't end up in the written record of its deliberations and decisions.

Tim: Michael, I would add the following observation, which is that we also have to be very careful about what the structure of for-profit compensation is versus not-for-profit. So if you look at a not-for-profit health system executive, the majority of compensation is fixed compensation, base salary and deferred compensation. When you look at the for-profit executive, and the higher compensation levels that exist, those are all driven by long-term performance vehicles and those are all performance-based. So while the compensation looks to be higher, there's a big risk component there that I think needs to be taken into account when we compare to and use such information.

Michael: That actually goes to my next question to both you guys – the question of the volatility of the market right now and the traditional use of incentive compensation to drive particular cultural and mission goals. What are you seeing as the direction, Tim, in terms of incentive compensation going forward with the whole business model of systems kind of up in the air right now?

Tim: Well clearly, if you look at the market data, the direction is greater movement toward incentives. If we look at annual plans, nearly 90% of not-for-profit health systems have an annual incentive plan. If we look at long-term, they're beginning to grow. And, when we look at the largest not-for-profit health systems (in a category of $3.0 billion and over) we're running 50%-60% of those now have long-term incentive plans. So clearly the market is moving toward the use of incentives. But I will observe that several of the leading and high-performing health systems in the United States have a policy of using base salaries only. So there's clearly much for a Committee to discuss in that context.

Michael: Let me turn to Ralph, because Ralph I guess one of the questions is, as you are drafting an employment agreement that has incentive goals, what's the shelf life of that right now? If we see a dramatic change in the health insurance market within the next year, what should the Committee be thinking about in terms of the validity of the current types of incentives for their senior executives?

Ralph: That has a lot of implications to it, so I really appreciate that question. One implication is that even annual incentive plans can get out of step with the organization, out of step with the opportunities and crises that will exist during the coming year. As a result, when you get to the end of the year, often an organization will say: Our incentive plan isn't truly reflective of the kind of year that we had, and the kind of things that we asked our executive leadership to tackle. They had a good year, but it's not really reflected in these metrics that we've been tracking, and at the end that we've used to calculate incentive pay. So, oftentimes Committees have to use their judgment at the end of the year to ask: Is this really reflective of the year that we had? Were these goals sufficiently rigorous? Were they understandable and achievable? Should we do something different, or additional, to recognize, reward and keep the true star talent that we have leading this organization? And as a result, we often see Committees considering modifications or enhancements or ad-hoc performance bonuses when the year is done.

Michael: Tim, do you see the need for Committees to kind of place on the calendar three months, six months, nine months – you pick a date in the future – the possibility that they'll have to restructure these incentives to respond to whatever the ultimate fix to the Affordable Care Act is passed?

Tim: I think it's a good practice to, halfway through the performance period, sit down and look, even in a relatively stable market, to look if there any environmental factors or internal factors that are impacting the performance measures and standards that have been set, and I think it becomes increasingly important in this very dynamic period we have now to do that. In my experience, good Compensation Committees periodically monitor and assess the utility of the performance measures and standards that they have established.

Michael: Before we leave this subject of incentive compensation, which I think is just fascinating, let me ask Ralph, in the broader corporate world, over the last six months, there have been significant, what we call, compliance controversies with respect to the implications of incentive compensation that were driving what are alleged to be improper goals or that there was a failure to link the executive compensation incentives to those of the organizational culture. Are people revisiting the role and function of some of these incentive compensation challenges with the Compensation Committee now? Are there lessons learned from some of these challenges in the financial services industry?

Ralph: That's a great question because it gets to one of the issues that we wrestle with in advising Compensation Committees, and that is staking out the appropriate role and scope of the Committee's oversight role. We want to make sure that the Committee is engaged in governance and oversight, but not in management. So, the Committee's role is not to come up with the incentives and to do that micro-incentive management that we look to executive management to conduct. But it's to determine the rigor of those goals, to make sure that when the goals are calculated and incentive awards are provided, that those are aligned with the mission of the organization, that they are consistent with the organization's executive philosophy, that they meet and are aligned with the organization's strategic plan, and that they're consistent with the organization's values. When the Committee confines itself to issues of reasonableness of pay, alignment with strategy, consistency with the compensation philosophy, that frames the appropriate role of the Committee, I believe.

Michael: But let me just confirm this because our Compensation Committee members are reading the papers. Should they be asking the question, stepping back from the numbers, stepping back from the actual goals, and saying: Does this work? Is it the Committee's responsibility to ask management, or to ask the question: Do these incentives align with overall corporate and cultural goals, or is that really the responsibility of management?

Ralph: I believe that's a dialogue between governance and management. It's certainly appropriate, just as governance and management, together, work on the strategic plan for the organization and how that gets carried out, so that it boils down to things like – annual and long-term incentive compensation arrangements – and it's appropriate for the Committee and management to have a dialogue about how we're using things like our compensation structure to achieve the important elements of the organization's strategic plan, to enhance the organization's culture, to satisfy the organization's mission, and to be consistent with the organization's values.

Michael: Tim, let’s pivot for a little bit and look at the bigger picture and draw on your experience. What are you seeing Committees do to enhance their ability to exercise oversight over compensation decisions?

Tim: Well one of the things, Michael, that we're seeing is Compensation Committees beginning to develop scorecards that go over multiple years. Looking at outcomes, both programmatic outcomes as well as executive outcomes. So, for example, we see people monitoring what's the age distribution of our executives? What are measures of executive diversity and gender equity? I can tell you those two are major topics on the minds of most of the Compensation Committees. You want to have data year-after-year that look at the ratios of whites and non-whites, look at male and female, but also look at the compensation differences in those vis-a-vis target market position. I think in this regard, focus on cost and the concern that do we have too many executives by monitoring, over time, the number of executives we have: How is that growing or shrinking? What our executive payroll is, as a percentage of our expenses or our net operating revenue? How's that changing over time? What do our market positions look like over time? And by looking at these things, in addition to our annual process of making sure that the compensation is competitive and reasonable, we take a little broader look and make sure that other important outcomes that are supported by the executive compensation program are being achieved. So that, to me Michael, is one of the bigger activities I see Compensation Committees beginning to take a look at.

Michael: Tim, I think this is consistent with a trend that we've seen in working with Compensation Committees, and that's the growing sophistication of these Committees, and the growing awareness that it's more than merely looking at annual compensation market data. Committees frequently are asking: What do we need to do to make sure we're not out-of-bounds? Show us more ways to compare ourselves to our peers; and, as you've described, there are numerous possible ways of doing that. So one of my questions, Tim, is: Are some of those scorecard approaches that you've just listed more useful, or more available, than others? Some of those might just be that we wish such a metric were available. Are some of these really, in your experience, more useful than others?

Tim: Well I think it's going to be dependent on Committee need and perspective. I think the area where Committees are most interested is where the data are most weak are: What are we spending on our executive population versus what our competitors are spending? Also, how many executives are they using versus what we're using? That information is difficult to get. Some of the other information, though, in terms of outcomes – and so again, I'm a heavily focused today on diversity and gender equity – those data are easily assembled and are really critical pieces of information in the minds of most Committees today. The number of people who voluntarily resigned is something we can easily track, and then link back to our compensation. Ratios of our executive expenditures to measures of operating revenue. But again I would say the one answer that I think most organizations would like to know is: How do our executive expenditures compare to others? That's often a challenge putting that together.

Michael: Fellas, before we wrap things up, let's put ourselves in the boardroom. The Committee meeting is coming to a close, people are putting their papers away, and they're moving away from their chairs and they turn to you and the Chairman asks: Ralph, Tim, you've got 30 seconds – what is the number one issue each of you want these Committee member to think about before the next meeting?

Ralph: I would encourage the Committee to focus on the issue of asking management: Do you have all the tools that you need to appropriately reward, recruit, retain, your key executive talent; the most important executive leaders of this organization? And then I would encourage the Committee to do everything it can to document clearly, thoroughly, contemporaneously, the decisions that it makes and the rationale for those decisions in that regard.

Tim: I am supportive of Ralph's suggestions. For me, it's moving over one step. I think it's the Committee stepping back and making sure it's comfortable with the compensation levels that it's offering, in the environment of scrutiny and criticism that we're facing today on executive compensation levels. As I look at the data, compensation levels are continuing to move at a faster than normal pace. We are facing attraction and retention issues that are embedded in trying to address and thrive in this dynamic market. And I think our Committees have to be comfortable that we're going to have to continue to evolve our programs, continue to use unique devices – retention incentives, carried interest plans for those in our innovations businesses, as two examples – and that these, again, are likely to lead to continuing fast-moving compensation. We need to be comfortable that we can make such decisions and then to defend them, both from a regulatory point of view, but more importantly to the public, and to defend our reputation.

Michael: Ralph, Tim, that was terrific. Thanks so much for joining us on *Governing Health*.

Ralph: Thank you good to be with you.

Tim: I appreciate the opportunity Michael.

Michael: Thanks again. As Tim and Ralph have just told us: executive compensation is absolutely an evolving and complex Board concern. In so many ways that offers a tremendous opportunity for the attentive director to make a meaningful difference on behalf of the health system. Whether through the Compensation Committee itself, or through the oversight and commentary of the full Board.

By the way, a written summary of Tim and Ralphs thoughts will be available through your General Counsel, as we sent a copy ahead of this link.

Thanks so much for joining us for today's episode of *Governing Health*. Be sure to subscribe to the full complimentary podcast series. You can find us on iTunes, Pocket Casts, SoundCloud, and YouTube. There you'll be able to stay up-to-date with all of our future episodes and re-listen to the old. Until next time I'm your host Michael Peregrine.