Healthcare Executive Compensation

Healthcare Governance Conference

July 21, 2023

Today's Discussion

1 Industry Trends and Executive Compensation Implications

2 Regulatory Framework and Recent Updates

3 Contemporary Design Issues

4 Questions

Industry Trends and Executive Compensation Implications

The Changing Health Care Environment

Market forces in 2023…

Workforce Challenges Persist
Workforce demand continues to outpace supply

Financial Headwinds Linger
Weaker margins for many leading to the continued bifurcation of performance in the industry

Market Disruptors Enter
Retail, tech, private equity and payors are increasingly vying for the health care consumer

…continue to influence health systems' strategic and operational priorities.

Growth
Greater merger, acquisition and partnership activity

Access
Emphasis on efficiently getting patients into and through the care delivery system

Affordability
Near-term cost reduction activities and a growing focus on population health

Talent
Build talent from within, engage in targeted recruitment and optimize organization design

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Environmental Implications for Executive Compensation

Health systems are balancing significant financial and operating imperatives with a highly competitive talent market

Dynamics of the Executive Talent Market

- Demand outstripping supply
- Higher turnover and recruitment
- Continued pressure on executive compensation
- Increasing media, political and regulatory scrutiny

Executive Workforce and Governance Implications

Talent Strategy
- Succession planning
- Executive development
- Organizational structure
- Reward differentiation

Incentive Plan Effectiveness
- Focus on key performance goals
- Address market volatility in goal-setting
- Align performance/rewards

Governance
- Flexibility
- Engaged in goal-setting
- Managing scrutiny
- Pay equity

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Regulatory Framework and Recent Updates

Tax-Exempt Compensation

- **Private inurement**
  - No part of the net earnings inures to the benefits of any private shareholder or individual
  - Applies only to “insiders”
  - No minimum threshold

Intermediate Sanctions

- In 1996, the President signed into law the **"Taxpayer Bill of Rights"**
  - Permits the IRS to impose excise taxes on **excess benefits transactions** (EBT) between tax-exempt organizations and disqualified persons

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Excess Benefits Transactions (EBTs)

- Occurs when the value of **compensation provided exceeds the amount ordinarily paid**
  - For like services
  - By comparable organizations
  - In similar situations
- Must **evaluate all economic benefits** to determine reasonableness
  - All forms of cash compensation
  - All other compensation

EBTs cover:

Base Salary	**Bonuses**	**Severance Payments**	**Deferred Compensation**	**Insurance Premiums**	**Benefits and Perquisites**

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Intermediate Sanctions

IRC Section 4958

- Provides the IRS with an alternative to revocation of tax-exempt status for unreasonable compensation and other excess benefit transactions (EBTs)
- Applies to tax-exempt 501(c)(3) and 501(c)(4) organizations
- Requires that total compensation paid to executives be reasonable

If compensation is found to be unreasonable/excessive, the IRS can:

1. **Impose penalties upon the executives** who receive the unreasonable/excessive pay
   – Repayment of excess benefit, plus a penalty equal to **25%** of the excess benefit
2. **Impose penalties upon the board/committee members** who knowingly participated in the transaction
   – **10%** of excess benefit, up to $20,000 per transaction (excludes those who voted against the compensation arrangement)
3. **Revoke the organization's tax-exempt status** (remedy of last resort)

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Rebuttable Presumption of Reasonableness

Three-Step Safe Harbor

**IRS Safe Harbor for Executive Compensation Decisions
(“Rebuttable Presumption of Reasonableness”)**

1. Conflict-Free Approval Body	2. Appropriate Comparability Data	3. Contemporaneous Documentation
• A Compensation Committee (of the Board) reviews and approves compensation decisions for executives (those who significantly influence organization policy) • Committee members must be ‘disinterested’ (i.e., have no conflicts of interest): – Business or financial relationships – Directly or indirectly through family members – No material interest in transactions	• The Committee reviews and relies upon compensation data for functionally comparable positions in similarly situated organizations • Independent compensation surveys compiled by independent firms	• Adequately document terms of transaction decisions including: – Date of approval – Committee members (present, voting, abstaining) – Description of comparability data – Actions taken by members with conflicts of interest • Preparation of meeting minutes within 60 days or next committee meeting

If the process above is followed, the IRS may rebut the presumption of reasonableness ***only if it develops sufficient contrary evidence*** as to the reasonableness of the compensation

Important to establish a governance process that meets the three requirements for establishing the safe harbor rebuttable presumption of reasonableness

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Excise Tax on the Organization

Excise Tax on Excessive Remuneration

1. The excise tax applies for tax years **beginning after December 31, 2017**
2. **21% excise tax on "remuneration" above $1M** for covered employees
3. **21% excise tax on "excess parachute payments"** for covered employees
4. Excise taxes are **paid by the employer** not the employee

- A **"covered employee"** includes any employee (current or former employee) who is one of the five highest-compensated employees for the current taxable year or who was a covered employee for any taxable year beginning after December 31, 2016
- **"Covered employees" will not be limited to executives** and could include others who may be among the highest paid

Regulatory Activity

Recent actions of government agencies could affect executive compensation programs and governance

- **DOJ issued directives** reinforcing focus on corporate compliance program expectations; **will “reward” companies for including policies** to incentivize **compliance-promoting behavior; pilot program started March 15, 2023**
- SEC approved long-awaited final rules requiring **publicly traded companies** to have **clawback policies to recover incentive compensation** due to accounting restatement
- FTC proposed a new rule that would **prohibit employers from imposing non-competes** on workers (comment period closed April 19, 2023)

Key Takeaways

Effective board oversight of executive compensation is critical to good governance and ensuring compliance

1. **No respite** from the **ongoing scrutiny**
2. **Focus** on the role of the board and the compensation committee will increase
3. A **pristine governance process** is critical

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Contemporary Design Issues

Polling Question

What is the biggest issue you are facing with your executive compensation programs?

A. Market positioning/compensation philosophy

B. Peer groups

C. Incentive plan goals and metrics

D. Executive recruitment and retention

E. Scrutiny of executive pay levels

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Typical Roles and Responsibilities

Board	• Charters Compensation Committee • Approves Executive Compensation Philosophy • Stays informed of Compensation Committee actions annually (or as needed) • Maintains Conflict-of-Interest Policy
Compensation Committee	• Reviews Executive Compensation Philosophy, recommends changes to full Board • Establishes program policies and procedures • Reviews total compensation to ensure reasonableness and consistency with philosophy • Evaluates CEO performance and determines CEO compensation • Approves executive compensation actions recommended by CEO • Engages independent advisors • Reports to the Board on an annual basis (or as needed)
CEO	• Provides business and human capital context on executive compensation issues • Develops organizational performance goals for the Committee's review and approval; updates Compensation Committee on progress • Recommends compensation actions for executives other than the CEO
Independent Advisor	• Serves as independent consultant to the Committee • Provides guidance and education on trends, market practices, regulatory issues, governance • Prepares objective, third-party market analyses • Provides recommendations for strategy, program design and governance process • Provides reasonableness opinion for IRS Intermediate Sanctions purposes

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Best Practices in Executive Compensation Design

Executive compensation program design should consider the following factors:

People:

Recruit, motivate, reward and retain talented executives who demonstrate the skills required to effectively lead the organization

Performance:

Reinforce critical operating and strategic goals; link compensation to results

Pay:

Demonstrate a fiscally prudent compensation plan design; obtain the highest return for the dollars invested

Other considerations include **cultural fit**, "**optics**" in light of the external environment, **regulatory compliance**, and **flexibility** to respond to individual situations and the **changing needs** of the organization

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Compensation Philosophy

Compensation philosophies fall along a continuum, tailored to the culture, strategy and specific circumstances

More Emphasis on Fixed Pay

- High base salaries (P75+)
- Modest (if any) annual incentives
- Market-average or above-average deferred compensation

Industry Norm

- Competitive base salaries
- Market-competitive annual incentives
- Long-term incentives among large health systems
- Market-average deferred compensation

More Emphasis on Variable Pay

- <P50 base salaries
- At or above market annual and long-term incentives
- Market-average deferred compensation

A clear and comprehensive compensation philosophy is a critical element of executive compensation governance

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Peer Groups

Peer groups are increasingly segmented to respond to a changing talent market

1
Core Business Roles
- Not-for-profit health care systems/hospitals

2
Cross Industry Roles/Skill Sets
- General industry

3
Non-Traditional Business Roles
- Health plans
- Innovation groups
- Venture capital/private equity
- Technology companies
- Consulting/analytics firms

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Annual Incentive Plan Design

Annual plan goals reinforce key operating and strategic priorities

1 Keep it Simple

- Maintain a straightforward plan design
- Focus on high-impact goals
- Ensure the plan is well communicated

2 Measure What Matters

- Align with operating objectives, strategic plan and emerging measures of success
- Look to the future
- Do not avoid important goals just because they do not "fit"

3 Maintain Flexibility

- Include some aspect of Committee and CEO discretion
  - ✓ To adjust awards (+/-) to account for unexpected events
  - ✓ To consider aspects of performance outside of plan

4 Create a Culture of Performance

- Communicate the importance of rigorous goals
  - ✓ Critical to the health care organization's success
  - ✓ Incentive compensation must be earned

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Long-Term Incentive Plans

<u>Long-Term Incentive Plan Purpose</u>: Works in conjunction with annual incentive plan to focus on multi-year measures of value and strategic success

- **Performance achievement beyond the traditional focus** of service, quality/safety and finance needed to transform the health care organization
- **Creation of alignment** between short- and long-term performance objectives

- **“Systemness” and integration** key to longer-term health system success
- Also serves as an **executive retention** tool

LTIPs typically designed to reinforce the importance of the strategic plan and leverage more compensation to variable pay

Evolution of Nonqualified Deferred Compensation (NQDC)

NQDC plans have evolved over time as the profile of health care executives has changed

- **10+ years ago**:
  - Focus on achieving an overall target benefit on retirement
  - Defined benefit arrangements
  - Full benefit vests on retirement
- **Contemporary**:
  - Focus on retention
  - Defined contribution arrangements
  - Annual contributions vest every 3 to 5 years until a defined retirement age (full vesting)

Common Nonqualified Deferred Compensation Plan Structure

NQDC Plans are commonly used to meet retention and supplemental retirement objectives

Eligibility

- CEO and other senior executives

Structure

- Defined contribution plan with participant-directed investments
- Contributions are a percentage of base salary or total cash compensation
- Contributions vary by job level

Vesting/ Payouts

- NQDC plan benefits are **taxed immediately upon vesting** (regardless of distribution).
- **Contributions before retirement age**: each year's contribution vests 3 to 5 years after the contribution is made (e.g., 2024 contribution vests in 2029; 2025 contribution vests in 2030; etc.)
- **Contributions after retirement age**: vested at the end of each year
- Vested benefits are paid out upon vesting (i.e., payouts while employed)

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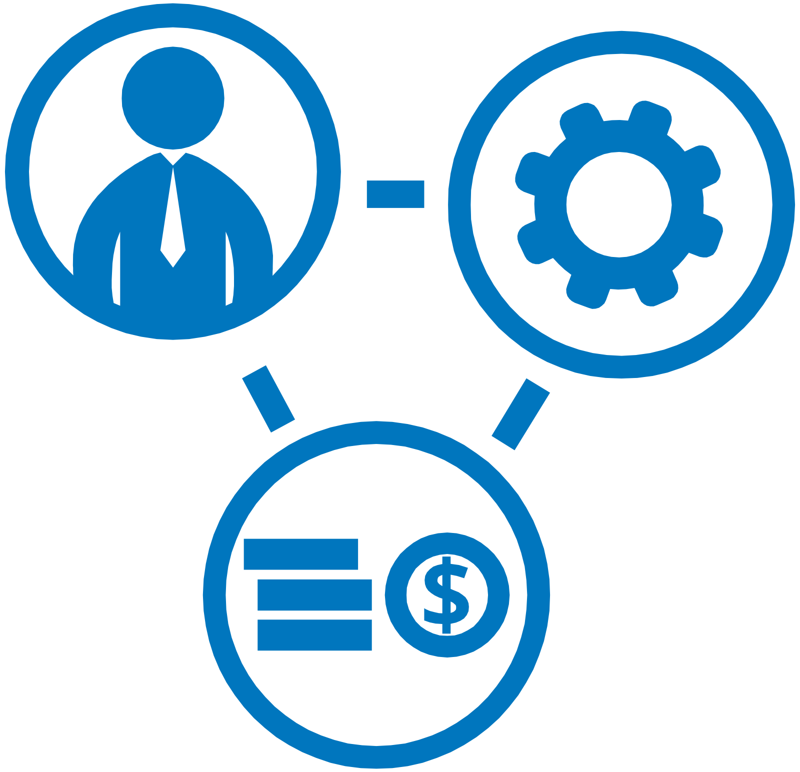
Retention Incentives

- Used **selectively**
- Encourage leadership **stability and engagement**
  - Merger/acquisition
  - Organization realignment
  - Succession planning
  - Key initiatives
- Provided to **key executives only**
  - Annual value: 20% to 50% of salary
  - Design and terms are situation-specific



Outlook for 2023 and Beyond

Base Salary

- The **talent market remains highly competitive**
- **Above-market base salary increases** will continue for **high-performers** and **hot jobs**

Incentives

- Metrics will **focus on key operational priorities** (quality, finance, patient experience, and people)
- Growth will be a strategic imperative (primarily reflected in long-term incentive plans)

Committee Focus

- Compensation committees will increase their focus on **performance improvement, talent management** and **broader human resources issues** such as DE&I and culture transformation

Leadership Structures

- Organizations will closely **examine the leadership structure** to ensure **efficiency** and **operating model alignment**

External Scrutiny

- **External scrutiny of executive compensation will intensify** as pay transparency is legislated, union activity increases and inflation persists

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Tips for Responding to Media Inquiries

- Identify a spokesperson (typically the Chair of the Board or the Compensation Committee) along with a public relations representative to respond to inquiries consistently
- Inform other Board members on how to direct questions if approached by the media
- Identify outside advisors, such as public relations representatives, consultants and/or legal counsel, to assist with talking points
- Answer media calls as soon as possible
- Prepare for potential "triggers" that could lead to inquiries (e.g., Form 990 filing, merger and acquisition activity, union activity, workforce reductions)
- Reinforce the executive compensation governance process
- Reinforce the mission and the many ways that health care organizations benefit the community

Answering Your Questions