



TOP QUESTIONS FOR TAX-EXEMPT HEALTHCARE COMPENSATION COMMITTEES

Our annual “Top Questions” helps compensation committees in considering key topics that will be important to directors in the coming months.

ARE WE PAYING FOR THE “RIGHT” PERFORMANCE? OR, SAID ANOTHER WAY, DO OUR INCENTIVE PLANS SUPPORT WHAT WE NEED TO ACHIEVE IN THE NEXT TWO TO THREE YEARS?

In tax-exempt healthcare, almost all organizations have a short-term incentive plan (STIP) and approximately three-quarters of larger health systems also have a long-term incentive plan (LTIP). Operating margin, EBITDA, quality, and safety dominate STIP metrics while operating margin, digital/technology strategy, and patient satisfaction scores lead the way for LTIPs (Korn Ferry 2022 Executive Incentive Survey). On the surface, these goals appear to support tax-exempt healthcare organizational missions to provide high-quality healthcare for the communities they serve while ensuring they remain financially viable for the long haul. In practice, however, many organizations focus on the operational aspects of their services, with the goal of improving short-term performance while

de-emphasizing goals that could truly transform their organizations and healthcare in their communities.

Reasons for incentive plan goals align with the realities of healthcare today: the reimbursement formulas, limited health literacy of many patients, and constant pressure to serve more people with fewer resources all drive the focus of incentive plans. These are not new phenomena. Therefore, we believe organizations have an opportunity to leverage STIPs and LTIPs to incentivize a much more ambitious agenda around transforming healthcare. When combined with appropriate leadership assessment and development, the incentive plans can provide a strong encouragement for leaders to act boldly to transform healthcare.

You might ask what does this look like in practice? At Korn Ferry, we believe boards and compensation committees should move more of today’s current metrics, like quality standards, patient satisfaction, and even short-term financial performance, into the category of “table stakes” when it comes to executive incentive plans. Setting goals in these categories as “triggers” the organization must meet before it pays any incentives can encourage leaders to take better advantage of technology

and leading practices that they imbed in operations, rather than requiring herculean efforts from their managers on a daily basis to achieve these baseline goals. Then, the STIP and LTIP goals can focus on transformative actions such as re-balancing services, driving new growth initiatives, implementing new care models, and focusing on providing true consumer-focused care.

To do this successfully, tax-exempt healthcare organizations will need to realize this type of focus requires different types of leadership than they have required of leaders in the past. As organizations transition to these types of goals, they should ensure they have clearly defined leader expectations, assess their current and future leaders for degree of alignment with their ability to deliver on those expectations, and provide meaningful development opportunities for them to grow as leaders and better deliver against those expectations.

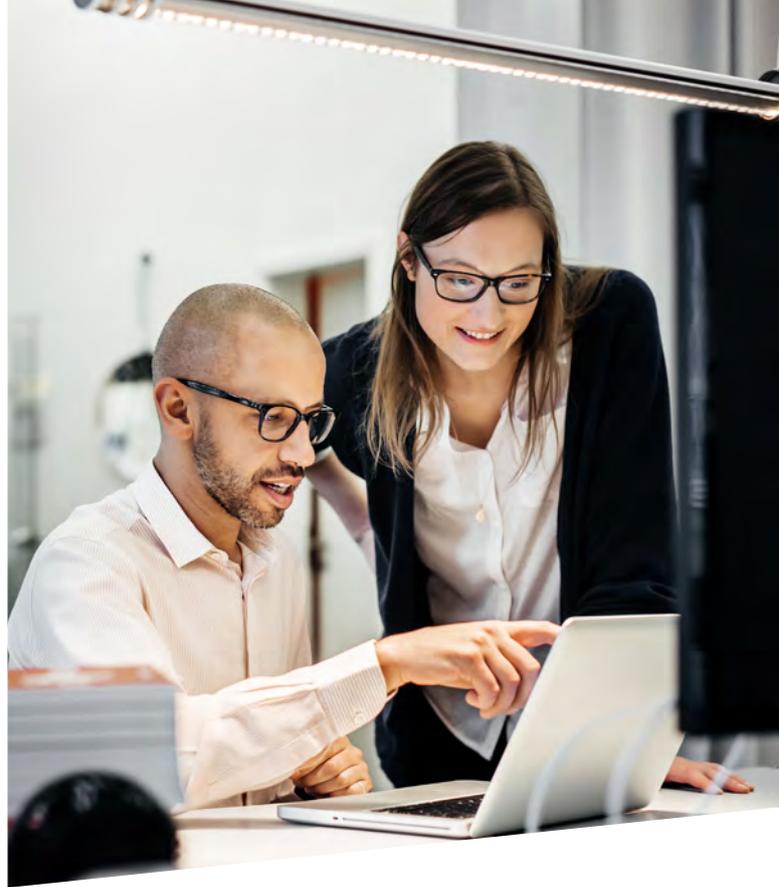
Combining more transformative incentive plans with stronger leadership expectations, assessment, and development will lead to a more significant transformation in healthcare, and we believe tax-exempt healthcare organizations should move aggressively to this space for their own survival, as well as the overall improvement of healthcare.

WHAT SHOULD WE KNOW ABOUT CLAWBACKS?

Clawbacks have been in the public's mind since at least the enactment of the Sarbanes-Oxley Act of 2002 (SOX). Section 304 of SOX allows the Securities and Exchange Commission (SEC) to sue the Chief Executive Officer (CEO) and Chief Financial Officer (CFO) of publicly traded companies, subject to the rules to recover their incentive compensation, based on misstated financial reports. This provision had limited application, both in terms of the individuals subject to it—CEO and CFO—and the reasons that compensation would be clawed back—material restatement of financial statements. Even in these situations, the SEC discovered that it was challenging to develop rules to articulate how compensation would be clawed back and how certain types of compensation (e.g., equity-based compensation) would be treated in these situations. The SEC first used the provision in 2007, and in general, its use has increased or decreased over the years depending on who is the Chair.

Even though SOX did not apply to tax-exempt healthcare organizations, their boards and committees began to discuss whether to implement clawback policies that address the philosophical issues that this type of policy attempts to address:

- Should certain actions (e.g., financial statement misrepresentations) that turn out to be detrimental to the organization result in the forfeiture of compensation if those actions resulted—directly or indirectly—in that compensation being paid?
- Should only those individuals who took those actions have to forfeit compensation paid to them, or should all individuals who received compensation—directly or indirectly—based on those actions be required to forfeit those dollars?



The collective experience of Korn Ferry advisors is that tax-exempt healthcare organizations, in general, did not adopt clawback policies. Rather, boards considered a clawback policy as a tool that could be implemented if and when determined appropriate, but determined that the challenges of articulating “for what?” “applicable to whom?” and “how?” were issues that were considered too challenging to piece together, given the (perceived) small likelihood of the policy's application.

Fast forward to 2022—the SEC finalized its clawback rule under the Dodd-Frank Wall Street Reform and Consumer Protection Act, which requires public companies to implement policies to recover erroneously awarded incentive-based compensation from current and former executive officers if the company has to restate its financials—regardless of whether the executive officer was responsible for the reasons or causes of the restatement. Based on these rules, publicly traded company boards again are wondering how far clawback policies should go, asking themselves questions that tax-exempt healthcare organizations asked when SOX was enacted: should clawback policies apply to a broader set of individuals than the executives specified in the clawback rule? Should clawback policies go beyond financial restatements, such as instances of misconduct?

We believe that boards of tax-exempt healthcare organizations should again consider whether to implement a clawback policy or review their current policy, as well as consider the guidance provided in the Dodd-Frank clawback rule as a starting point for context when answering the questions necessary to flesh out or refresh such a policy, such as:

- What are the reasons for considering a clawback policy?
- Should a clawback policy apply only to our top executive and his/her direct reports? Or should any individual who participates in our incentive plan(s) be subject to the policy?
- What actions or behaviors should be subject to the policy?
- Will the board be required to implement the policy for each identified action or behavior subject to the policy, or will the board have discretion to act?
- What should be the period of time that actions or behaviors could be subject to the policy, i.e., will there be a “statute of limitations” included in the policy?
- What is the process by which the board will apply the policy?
- What are the practical implications of applying the policy, e.g., how will incentive compensation dollars be paid back to the organization?

These are challenging questions that are worthy of consideration—but as incentive compensation becomes an ever-larger part of an executive’s total compensation package, compensation committees are encouraged to explore this as a potential tool in their governance toolbox.



DO RETENTION AWARDS WORK ANYMORE?

Retaining healthcare leaders is a crucial aspect of maintaining stability and continuity in the ever-evolving healthcare industry. One approach that tax-exempt healthcare organizations have utilized to retain these leaders is through retention agreements. However, the effectiveness of such agreements has come into question in recent years.

Retention agreements, by definition, are fairly straightforward. They are intended to retain key talent for the purpose of providing stability, quality patient and financial outcomes, and organizational continuity during times of intense demand for talent and organizational change, e.g., prior to and immediately after an anticipated transaction. These most often involve the promise of a monetary award to the executive at the conclusion of a specific time period.

In developing retention agreements, several challenges and limitations should be addressed and acknowledged. For example, the recipients of the agreements must be selected in a manner that avoids undermining organizational culture by highlighting the contributions of individual executives at the expense of the broader leadership team. This can have the unintended effect of creating division when continuity and alignment are critical to the overall success of the healthcare system. This shift in focus can lead to decreased morale and a decline in overall organizational performance.

Furthermore, issues of equity and fairness can arise. For example, if those executive(s) identified to receive a retention agreement predominantly represent one gender or race, legitimate claims of discrimination can be made in violation of

numerous federal and state anti-discrimination laws. Equity and fairness issues can also arise when retention agreements disproportionately benefit top-level executives while other healthcare workers struggle with comparatively low wages.

Additionally, the effectiveness of these agreements may be limited due to factors such as the inability of financial incentives alone to address the underlying causes of attrition. If the operating environment and overall culture are perceived as flawed or ineffective, leaders will either actively or passively seek other opportunities, despite the presence of a retention agreement. In fact, employers have been known to either partially or entirely cover the cost of a “lost” retention incentive through aggressive sign-on bonuses or other forms of compensation when recruiting key leadership talent.

Evaluating the potential effectiveness of retention agreements requires a very thoughtful examination of not only the current challenges to be addressed, but any potential unintended long-term consequences. Challenges related to negative impacts on organizational culture, equity concerns regarding fairness in compensation distribution, and limitations tied to changing industry dynamics must be considered.

To ensure continued success in retaining talented individuals within the healthcare industry, organizations should also explore approaches that focus on promoting a positive work environment. Creating a culture defined by trust, innovation, professional development, defined career paths, and a clearly defined purpose will ultimately lead to higher overall engagement and retention—which allows for the selective and precise use of retention agreements to augment the culture that already exists.

SHOULD WE BE THINKING ABOUT ESG MEASURES IN OUR INCENTIVE PLANS?

The healthcare industry and other mission-driven organizations are further along than the for-profit world, focusing on non-financial type performance measures (quality, service, people, etc.) in incentive plans. Including specific ESG (environmental, social, and governance) or DEI (diversity, equity, and inclusion) type metrics in executive incentive plans, however, is still a minority practice in tax-exempt healthcare organizations. Yet this type of metric is a growing focus as organizations strive for transformational culture change in response to societal influences.

Publicly traded companies also have recently begun to put more emphasis on ESG criteria as investors are becoming more socially conscious, looking for alignment with the purpose of a company, and using this type of criteria to screen potential investments.

Many tax-exempt healthcare organizations are committed to meaningful action now as a starting point for a sustained effort to fully embrace equity going forward. Three areas emerging for empowering internal DEI improvement include: 1) aspiring to have an organization's workforce mirror the communities the organization serves; 2) beyond inclusive leadership, creating a culture of belonging where employees are lifted up, supported, or sponsored; and 3) revisiting diversity at the board and senior leadership levels to reinforce how important these initiatives are for the future of the organization.

Depending on where the organization is on the continuum of building ESG and DEI into its culture, we are seeing the following short- and long-term goals being considered as metrics within executive incentive plans.

Short-term

- Developing a comprehensive, principle-based DEI strategy aligned with organizational and talent priorities
- Conducting baseline data analytics (hiring statistics, promotion rates, turnover, etc.)
- Educating all leaders on anti-bias and anti-racism to create transformational change that lasts
- Developing and optimizing employee resource groups (ERGs)
- Creating and optimizing a Diversity or Inclusion Advisory Council or Committee
- Conducting pay equity studies and addressing any gaps
- Conducting DEI-specific engagement surveys internally to test culture and continually monitor progress

Long-term

- Shaping behavioral inclusion through training journeys (all staff levels) to include peer and upward review/feedback
- Updating Human Resources policies and practices to ensure they are fair and equitable and to prevent unconscious bias from occurring (fixing structural inclusion)
- Updating recruitment strategies to ensure they can attract, retain, and elevate all employees, including under-represented minorities (URM)
- Developing community partner collaboration programs (focused on suppliers, local businesses, etc.)

While the majority of health equity (HE) and DEI measures being used in incentive plans today are qualitative (or process) measures, as the organization matures on its DEI journey, more quantitative or outcomes-based measures tend to be included, which are focused on specific areas in need of improvement. With the new CMS requirements, healthcare organizations are being called to prioritize equitable care, reduce health disparities, define specific actions and goals related to addressing those disparities, and prioritize historically underserved communities.

Examples include:

External focus

- Reducing obstetric complications in select URMs
- Lowering incidences of colorectal cancer in African Americans

Internal focus

- Lowering turnover in the African American employee group in first three years of employment
- Improving diversity of faculty (not just hiring, but also measuring progress/growth)
- Increasing racial ethnicity population in leadership (supervisors and above)

In order for HE/ESG/DEI goals to be successful, they must be championed by CEOs and senior management and be tied to the strategic objectives of the organization. The goals then become priorities for the board, resulting in more successful levels of achievement. Ultimately, not achieving improved outcomes become a brand or reputational risk for organizations, and therefore, accountability becomes a business imperative. Organizations should think about what they want to focus on and be known for. To incorporate these types of goals in components of pay (such as performance incentive plans) effectively, organizations must first have a clear HE/ESG/DEI strategy and mechanisms in place to measure success against that strategy.



ARE WE LOOKING AT THE “RIGHT” MARKETS WHEN COMPARING PAY FOR THE EXECUTIVES?

The description or definition of “market” is a foundation on which compensation data is developed and used for benchmark comparisons in a variety of ways: executive pay job pricing, short-term incentive and long-term incentive design research, analysis of board pay (if used), and even assessment of financial and non-financial performance. Developing peer group(s) and using compensation survey data are part of how that market is constructed. Given the talent challenges across various industries, including healthcare, and the added scrutiny associated with executive compensation, devising a definition of “market” and defining how the data is developed is an important activity for the compensation committee and senior management. Getting it “right” is not only important to ensure the ability to recruit and retain talent but is also the basis of establishing reasonableness of executive pay for a tax-exempt healthcare organization. Defining the “market” properly and striking the right balance in applying the resulting data for context to allow the flexibility needed is an exercise that takes diligent review and analysis.

So what happens when an organization is smaller or larger than its competitors? What if the markets that this organization competes in have vastly different pay mixes for base salary, short-term incentive and executive benefits, and they have compensation delivery vehicles not available to tax-exempt healthcare organizations (i.e., equity)? Expanding the definition of market to include other industries and looking at the resulting data is an obvious solution, but this may create an unsatisfactory collection of companies and data in which the resulting composites of the market data can be misleading.

In these cases, we often look at more than one set of data:

- **Primary**—This would be the traditional market(s) in which the organization competes for talent.
- **Secondary**—This is a supporting group of data to give insights on pay mix, incentive metrics, and other pay vehicles for non-traditional market(s).

How the data from the market is developed may depend on how variable the primary and secondary markets are. Two common ways to review the data from different markets are:

- **Separate**—The primary market would be used for pay decisions, and the secondary market would be supplemental and informative. In these situations, blending the markets (or tax status) may not give an accurate view of the market that the committee wants.
- **Blended**—Management and the committee work with their advisors to determine the right approach to create a composite set of market data (e.g., 50% healthcare and 50% for-profit, retail) that accurately portrays data for comparable jobs.

As tax-exempt healthcare organizations compete for talent across a variety of industries that are comprised of both for-profit and tax-exempt entities, these alternative approaches allow data views to be transparent for more informed pay decisions. One group may provide appropriate pay amounts, while the other gives awareness to competitive practices. Alternatively, reviewing data from different industry sources, and then combining them into a composite, designating primary and secondary sets of market data to be used for context when reviewing compensation of the organization, is also a common approach to developing what an organization considers to be the market.

The use of multiple views of market data is not for everyone, however. To determine if this is right for an organization, these are key questions to ask:

- Are the right market(s) for talent represented in the data used for context?
- Does the current market definition capture all sources of talent, or only traditional core competitors?
- Is the desired data publicly available? (For example, privately held organizations are not.)
- Would using general industry data—compensation provided to comparable jobs in for-profit companies regardless of industry—be consistent with certain sources of talent?
- Are survey and peer group data providing solid job matches for the “disqualified persons” in the organization?
- Is the current comparative data defensible to the IRS and other stakeholder groups?

Depending on the answer to these questions, it may be time to rethink the current survey data approach and composition of the comparative peer group(s). This exercise should lead to a well-defined market and a defensible process for collecting the appropriate survey and peer group data, as needed, categorizing the resulting data into primary and secondary data for review, and agreeing on whether these sets of data should be combined into a composite set of data. The result should be the appropriate context for considering whether and to what extent the compensation philosophy and program are meeting the organization’s goals and supporting the organization’s strategy.



ARE WE PREPARING OUR NEXT GENERATION OF LEADERS?

The mandate of compensation committees continues to expand. CEO succession is one topic that has tended to land on the committee agenda, but is succession enough? It implies merely being prepared with a successor to the current CEO. But what happens when strategies and priorities change for an organization? Will the chosen successor fit with the new direction of the organization?

Increasingly, organizations are confronted with the need to drive short-term performance while simultaneously transforming the fundamental nature of the business. The standard approach is to elevate a person who is competent today to lead. That individual may or may not be fully prepared to lead the organization in a constantly evolving world with changing economics and business models.

In place of the traditional process, boards should consider a CEO “progression” approach that puts identified candidates onto developmental paths to prepare them to lead in fast-changing and ambiguous environments. Under progression planning, CEO candidates are confronted with a wide range of situations and challenges, in order to develop the skills, experiences, and perspectives they will need to drive strategy, transformation, and performance. Unlike the transition planning of traditional CEO succession processes, progression planning is a continuous process in which CEO candidates are identified and developed based on the strategic priorities that will define success.

To succeed, it is critical that the board, CEO, and Chief Human Resources Officer (CHRO) establish progression mechanisms to assess the progress of CEO candidates—particularly around the dual

accountabilities of driving current performance and transforming the organization. This process and its oversight are often secondary concerns of boards and committees. However, progression of executive talent can pose a risk to the organization and rightly should be overseen by the board or committee. Done well, progression planning will not only improve the ability to select the best CEO, but it will also ensure that an organization is developing executives who fit the business strategy as it evolves, which also increases the likelihood of high performance. Further, this strategy mitigates the risk posed by a stumbling CEO transition. The progression model will develop not just an individual but a high-performing executive team of complementary leaders who help to ensure the success of the next CEO and the organization overall.



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