Introduction

Books on executive compensation are typically reference manuals or how-to-do-it books. Many of them are technical texts written by consultants or attorneys to show CEOs, human resources executives, and compensation professionals how to design an executive compensation program or how to improve an existing program. Some older books tell CEOs what to ask for and how to get it; some newer books tell trustees how to do a better job governing executive compensation.

This book is not a how-to-do-it manual. It is a dialogue about executive compensation addressed to CEOs and boards of directors' compensation committees. It explores their concerns about compensation philosophy, the structure of the executive compensation program, the balance among its components, the emphasis on pay for performance, the challenges of governing executive compensation, and the challenges of defending executive compensation to the public.

The purpose of this book is to help CEOs and trustees understand why executive compensation programs are structured the way they are, how to make them more effective, how to reach better-informed decisions, and how to explain their decisions to the various stakeholders who are likely to question and challenge their decisions.

Trustees and CEOs of tax-exempt healthcare organizations are expected to explain why they pay their executives as much as they do, why they pay executives more than physicians, why they

pay their executives more than public agencies do, why healthcare executives are paid more than their counterparts in privately owned businesses (those owned by the entrepreneur raising the question), and whether the money spent on executive compensation would not be better allocated to a service or product that is more central to the organization's tax-exempt mission.

So why are executives paid as much as they are paid? And why are executive compensation programs structured the way they are structured?

DETERMINANTS OF EXECUTIVE PAY

Four principal factors determine executive pay. The two most important are interrelated: the amount of responsibility inherent in the executive position and the size of the organization in which the executive works. These factors reflect the ideas, respectively, that jobs with more responsibility should be paid more than jobs with less responsibility and that management jobs in a large organization entail more responsibility than the same jobs in a smaller organization.

The third most important factor in determining pay is the organization's compensation philosophy. Few organizations intentionally keep pay below average. Many aim to pay close to average, and just as many intentionally aim to pay well above average.

Performance, the fourth factor, has less impact than the other three. Variable pay or incentive compensation is not a big component of executive pay in tax-exempt organizations. As a result, total compensation does not vary much from year to year, and no convincing evidence indicates that better-performing organizations pay more than others.

PURPOSE OF AN EXECUTIVE COMPENSATION PROGRAM

Organizations commonly explain their executive compensation programs in terms of a threefold purpose:

1. To help recruit and retain the leaders the organization needs for success
2. To motivate executives to meet the organization's most important goals
3. To reward executives for their roles in making the organization successful

The explanation is adequate but does not answer the question "Why so much?" and it obscures the challenges organizations face in finding the appropriate balance between multiple, often conflicting goals. The explanation for a pay program for nurses, for example, or for the workforce as a whole, would include keeping the cost of the program affordable and reasonable—that is, paying no more than necessary to obtain and keep the talent needed.

Because organizations have only one incumbent in each executive role, however, and because these are leadership roles that shape the success of the organization as a whole, CEOs and trustees are more concerned with paying enough to recruit and retain the right people than with controlling the overall cost of the executive payroll. And when they want to control the overall cost of the executive payroll, they generally do so by limiting the number of executive positions, rather than by limiting pay for individual executives.

As hospitals and health systems struggle to find the resources needed to support clinical programs, pay employees competitively, and improve the health of the community they serve, they should aim to explain their executive compensation program in a way that acknowledges constraints and conflicting goals, such as multiple demands on limited resources, expectations that all employees be treated fairly, respect for community values, and regulatory limits on executive pay in tax-exempt charitable organizations. Acknowledging these constraints and conflicting goals can help CEOs and trustees make better decisions about executive compensation and defend the decisions they make.

IMPACT OF TURNOVER AND EXTERNAL RECRUITING ON EXECUTIVE PAY

Considering more than 5,000 hospitals are operating in the United States, executives have ample opportunity for career advancement. Some change jobs every few years. This turnover provides plenty of occasions for employers to decide how much to pay the next incumbent or find out what it costs to hire the right person for the job.

More often than not, employers pay the next incumbent as much as or more than the last incumbent. If they recruit externally, they find out what other organizations are paying experienced executives. If they choose an external candidate, they often find they have to pay significantly more than they paid the last incumbent.

If they promote an internal candidate, they may start her at a lower salary than the last incumbent was paid, but they rarely decrease the salary range and generally bring her up to the middle of the range within a few years.

When a good executive receives an offer from another hospital and the employer wants to retain the executive, the employer often offers a higher salary. When CEOs and trustees know an executive is getting calls from recruiters, they may increase the executive's pay or institute a retention incentive to keep the executive from leaving.

The dynamics of the labor market also drive pay upward. Executives learn that they can increase their pay by moving to another organization. CEOs and trustees learn that they need to keep pay competitive to retain talented executives. They also learn that it can cost more to hire a replacement than to hold onto the current incumbent.

IMPACT OF NOT-FOR-PROFIT STATUS ON EXECUTIVE PAY

Owners of private businesses know how to control costs. If they pay someone more than necessary, it comes out of their profits. If

the business is a sole proprietorship, it comes out of the owner's own pocket.

Executives of firms with publicly traded stock know how to control costs, too, as paying more than necessary can reduce their gains on stock options.

Not-for-profit hospitals and health systems need to control costs as well, but neither the trustees nor the CEO lose much if they pay an executive more than necessary. They have little reason to constrain growth in executive pay because they have no ownership stake in the profits of the organization.

IMPACT OF GOVERNANCE ON EXECUTIVE PAY

Executive compensation is shaped by trustees as they set policies, decide whom to hire as CEO, adopt incentive plans and executive benefits, and approve employment agreements. With no ownership stake in the hospital or health system, trustees are often more focused on retaining executives and maintaining morale in the executive suite than on controlling the cost of executive compensation. The trustees are volunteers, after all, and do not want to lose good leaders to better paying jobs if they can retain them by paying them well.

Trustees generally want to keep pay competitive because they want to be able to recruit and retain experienced, high-performing executives. They often set a policy of paying executives well above average to make it easier to recruit and retain talented leaders. Trustees typically defer to recruiters when deciding what to pay a new CEO, and they have little reason to engage in hard-nosed bargaining. They generally defer to consultants in deciding how much to increase salaries or contribute to executive retirement plans to keep them competitive.

More often than not, trustees want an exceptionally good leadership team to make their organization exceptionally good. That desire often leads to decisions to position pay above average to make it easier to recruit and retain first-rate leaders.

Trustees tend to regard CEOs as peers, not employees. CEOs, after all, are also trustees and effectively lead the board in most areas, even though they do not chair the board. Trustees tend to follow the lead of the CEO in most areas because the CEO knows more about running a healthcare organization than trustees do. Trustees socialize with the CEO. They have a hard time maintaining an arms'-length relationship with the CEO when it comes to setting executive compensation because they do not maintain an arms'-length relationship with the CEO on most other matters. As long as trustees are reasonably satisfied with performance, they have a hard time saying no to the CEO.

IMPACT OF INFORMATION ON EXECUTIVE PAY

One of the most important determinants of executive pay is information about how much executives are paid at other institutions. The information is readily accessible in published surveys, magazine articles, IRS Form 990, and the compilation of Form 990s on the Internet at www.guidestar.com. Compensation committees hire consultants to provide the information, then act on it by increasing salaries to keep them at the intended level specified in the board's policy on executive compensation. Executives look at Form 990s from other organizations and expect to be paid as much as their counterparts at those organizations. Human resources staff buy surveys to determine how to keep pay competitive.

Little real arms'-length bargaining on pay in executive compensation takes place, even when hospitals hire new executives. Even then, boards and CEOs depend on recruiters, consultants, or human resources staff to tell them how much they should expect to pay, and that information determines starting pay as much as what the recruit requests.

IMPACT OF REGULATIONS ON EXECUTIVE PAY

Regulations pertaining to executive pay are generally intended to limit pay, or at least discourage pay above a certain level or

limit the way pay and benefits can be delivered. Regulations have unanticipated effects, however, and the abundance of professionals who advise boards and executives on compensation, taxation, and financial planning ensures an abundance of creative responses to many of these regulations.

Executive compensation in the tax-exempt environment is subject to the following regulations:

1. Any compensation earned is subject to tax, and tax is due when the compensation is definitively earned and no longer subject to contingencies or risks of forfeiture.
2. Any compensation paid by a tax-exempt organization to a trustee, an officer, or a key employee must be disclosed to the public on the organization's Form 990.
3. A tax-exempt charity may not give any portion of the organization's revenues, income, or charitable assets to a private individual (known as private inurement) and may not pay an insider (anyone in a position to exercise substantial influence over the affairs of the organization) more than fair market value for services rendered.

   Because this regulation was difficult to enforce (the only penalty was revocation of tax-exempt status), Congress added a fourth regulation (see below) that made it possible to punish private inurement with penalties known as intermediate sanctions.
4. Intermediate sanctions regulations (Internal Revenue Code § 4958) allow the Internal Revenue Service (IRS) to require executives (and other "disqualified persons"—trustees, officers, and others in a position to exercise substantial influence over the affairs of the organization) who have been paid more than fair market value to repay the excess benefit, pay a fine of 25 percent of the excess, and pay an additional penalty of 200 percent of the excess amount if they do not repay the excess benefit and the fine within the tax year. It also allows the IRS to impose a smaller fine on anyone (executives or trustees) who knowingly approved the excess benefit.

The first regulation has led to an enormous investment of time and effort to find and promote ways to defer taxation or to deliver compensation or benefits in ways that avoid taxation altogether and to define contingencies and risks of forfeiture that almost ensure payment.

The second, the requirement to disclose compensation on Form 990, has led some organizations to eliminate forms of compensation they would rather not report to the public, such as payment of bonuses to cover executives' taxes on certain benefits or perquisites. But it has also led to a lot of effort to find ways to deliver compensation that would not need to be reported or that could be reported at less than the true cost. It has fed executives' impressions that they are underpaid by giving them access to information on higher-paid jobs; led the public to believe executives are paid more than they are, by requiring that certain elements of compensation be reported twice; and persuaded compensation committees to raise pay more than they otherwise would, by presenting compensation information in a way that is easy to misunderstand and misuse.

The prohibition of private inurement has generally kept tax-exempt organizations from introducing compensation programs similar to stock options and profit-sharing arrangements for executives, but it has also led to designing programs that disguise what would otherwise be gifts or a share of the organization's income as compensation or benefits earned through service.

The fourth regulation, with its threat of intermediate sanctions, has encouraged trustees to keep compensation within the bounds of competitive practice (what other organizations pay executives in comparable positions) and given CEOs and trustees a persuasive reason to say no to requests for higher compensation. However, it has also led to a lot of work finding isolated instances of higher compensation to help justify unusually high pay and developing compelling rationales for paying someone above the high end of the usual range for a job. It has also changed the definition of reasonable pay from appropriate pay for the job or for services rendered to the highest level of pay that can be justified.

The regulations have not been effective constraints on executive compensation. Their biggest impact has been in changing the way pay is structured, delivered, and rationalized.

CHALLENGES OF MANAGING PERFORMANCE IN TAX-EXEMPT HEALTHCARE ORGANIZATIONS

Pay for healthcare executives is as high as it is because the jobs are unusually difficult and few people can handle them well. Most executive jobs in healthcare require specialized knowledge and skills that can be developed only by spending years working in healthcare.

Many critics of executive compensation assume that the jobs of healthcare executives are easy enough that plenty of people could perform them well. Some hospital trustees who run their own businesses assume that they could run the hospital just as well as they could their own businesses.

These critics overlook two facts about hospitals. They are extraordinarily complex organizations, and their margins for error are extraordinarily thin. Operating margins (operating profit as a percentage of revenues) are thinner than in most other businesses, making it difficult to break even and more difficult to earn enough to replace aging facilities and equipment. Hospitals' customers—doctors and patients—want and expect more service than they or anyone else is willing to pay for. The cost of an error is greater in healthcare than in most other businesses—a patient's death, a lifetime disability, or a large malpractice liability.

The hospital has a huge staff and operates 24 hours a day, 365 days a year. It needs to recruit constantly to fill open positions, and it depends more than most organizations on new employees, part-time employees, and temporary workers. Healthcare differs from virtually every other business in that few of its core activities are routine, systematized, or regularly repeated. Almost all patient care activities need to be tailored to the patient: her health, condition, medical history, drug regimen, age, and other factors.

Managing operations in an environment in which the demand for services is totally unpredictable and changes by the minute is harder than running a grocery store, an auto dealership, or an insurance brokerage. Managing a hospital is more difficult than managing a bank or a manufacturing firm or administering a school district, a police force, or the county's operations. Because healthcare administration requires exceptionally good management, interpersonal, and political skills, healthcare executives are paid well.

ORGANIZATION AND CONTENTS OF THE BOOK

Chapter Highlights

Chapter 1: Issues in Executive Compensation. Addressed in this chapter are important issues concerning executive compensation in tax-exempt healthcare organizations: why executive pay is so high, whether it is too high, how to make it more effective, and how to govern it well. Also discussed are pay for performance, causes of inflation in executive pay, and the difficulty of striking the right balance between competitiveness and fairness in an environment of limited resources and narrow margins.

Chapter 2: Compensation Philosophy. Compensation philosophy is the foundation for decisions made about executive compensation. The chapter highlights the importance of the peer group to be used in evaluating the competitiveness and reasonableness of executive compensation and in determining the level of compensation needed to attract and retain talented leaders. In addition, it addresses decisions related to pay for performance; the balance between current and deferred compensation; the role of benefits in a well-rounded compensation package; and the importance of compensation philosophy in explaining the program to stakeholders—executives, trustees, physicians, regulators, the press, and the public.

Chapter 3: Determining the Market Value of Executive Positions. This chapter discusses the methods and techniques compensation

professionals use to determine the market value of executive positions. It explores the challenges involved in identifying a reasonable estimate of market value and the need to study the data to determine if it is reliable.

Chapter 4: Getting Base Pay Right: Salary, Salary Structure, and Salary Administration. The principles of salary administration are discussed, as are the issues involved in determining appropriate salaries for executives and explaining the decisions to executives and trustees. The chapter also addresses the challenges involved in shaping and satisfying executives' expectations, maintaining defensible pay relationships, and signaling to employees that executives are paid appropriately.

Chapter 5: Incentive Compensation. The principles of designing and administering incentive compensation plans—both annual and long term—and the challenges involved in making incentive plans effective are the subjects of this chapter. It also explains trustees' role in shaping and controlling incentive compensation plans.

Chapter 6: Benefits. The issues involved in designing, evaluating, and governing executive benefit plans are explored, including the reasons for providing each type of benefit and the relationship between all-employee benefits and supplemental benefits. The chapter also discusses the role of benefits in a well-rounded compensation package, the usefulness of retirement benefits in retaining executives, and the public relations risks inherent in providing large retirement packages to executives. It touches briefly on the regulations that give rise to and limit supplemental benefits for executives.

Chapter 7: Perquisites. This chapter addresses the issues involved in deciding whether or not to provide perquisites to executives—the reasons for providing them, the reasons for avoiding them, the trend to eliminate them, and the difficulty of defending them as an appropriate use of resources.

Chapter 8: Employment Contracts and Severance. In this chapter we discuss the issues involved in structuring employment agreements and severance policies—the advantages and disadvantages of using employment agreements, the relationship between severance and contract duration, terms for contract renewal and extensions, and the connection between employment agreements and contractual arrangements for supplemental benefits. It identifies the typical elements of an executive contract; explains their purpose; and focuses on severance, the principal compensatory element of a contract.

Chapter 9: Governance of Executive Compensation. The board's role in overseeing executive compensation is explored in this chapter. It identifies best practices in governing executive compensation, the rationale for them, and the relationship between the CEO and the board in shaping and administering executive compensation. In addition, it explains why boards are now exerting more control in governing executive compensation, highlights the most widespread weaknesses in governance practices, and identifies steps every board should take to strengthen its process for governing executive compensation.

Chapter 10: Addressing Public Perceptions About Executive Compensation. Tax-exempt organizations, their boards, and their executives face special challenges related to public attitudes toward executive compensation. This chapter helps guide boards and executives in successfully responding to criticism and overcoming skepticism about executive pay.

Best Practices in . . .

Most chapters end with a set of best practices pertaining to the topic covered in the chapter. They are addressed to trustees as advice on governing executive compensation and to CEOs as advice on managing compensation for other executives.

Select Terminology

Throughout the book the following terms are central to understanding the text.

Expected total compensation: Level of total compensation an employer intends or expects to pay, on average, over time and across all executives, for on-plan performance (meeting all or most of the goals set for the year).

Opportunity: Potential to earn compensation at a certain level, such as maximum incentive opportunity of 20 percent of salary, or enough incentive opportunity to reach the 75th percentile of total compensation. Compensation opportunity can be expressed either as maximum opportunity (the most that can be paid when all goals are met or exceeded) or as an expected amount of pay (the average or typical level of compensation paid over a ten-year period for good performance). Often used to describe incentive opportunity; sometimes used to describe total compensation.

Percentage: When referring to incentive opportunity, percentage always refers to salary, as in "He was paid a bonus of 20 percent of salary." When referring to benefits, it usually means percentage of salary but may refer to percentage of pay (meaning salary plus bonus).

Percentile: Position relative to a data set; that is, position above a certain percentage of the other data, as in 90th percentile, meaning above 90 percent of the data points in the data set. For example, if General Hospital positions salaries at the 50th percentile of its peer group and maximum total compensation opportunity at the 75th percentile, its salary range midpoints fall at the middle of all the salaries in its peer group, below the higher half and above the lower half, and its maximum total compensation opportunity is set above the total compensation paid by 75 percent of its peers but below the total paid by the highest-paying 25 percent of its peers.

Positioning/position: Intention to pay at a certain percentile, on average, across all jobs and over time. Positioning salaries at median means the intention to set the midpoint of the salary range for each job at median and to pay salaries that are, on average, approximately at median. It does not mean the intention to pay everyone at median. Individuals can be paid anywhere within the salary range, which for executives typically runs from 80 percent to 120 percent of the salary range midpoint.