



Determining executive compensation is a big responsibility

By Jay Justice

Years ago, I served on the board of a tax-exempt, community service organization. My human resources background caused the board to appoint me chair of the compensation committee.

My initiation came when my predecessor took me to his car, opened the trunk and removed a large cardboard box. The box, he said, contained everything I needed to know to effectively lead the committee. I put it in my trunk, took it home and occasionally dug around in it to try to look at the CEO's employment agreement, benefit plan information or performance reviews. It was never a very useful resource for me. When my term ended, I passed the box on to my successor.

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Back then, the Internal Revenue Service, Congress and the state attorneys general were not actively scrutinizing executive compensation in tax-exempt organizations. Wall Street scandals over executive pay had yet to break, and the financial press was not engaged in debates over a board's responsibility to oversee executive compensation. Intermediate sanctions legislation was new, and we did not appreciate how much boards would need to change to meet Section 4958 of the Internal Revenue code's tougher governance standards.

These days, determining executive compensation is one of the most important things a board can do. When done right, a well-designed plan can provide a set of guidelines to align compensation with an organization's mission.

So What's the Right Formula?

As a consultant, I often work with hospitals and health systems across the country on executive compensation and governance issues. To this day, I am amazed by the number of clients I work with who have armed their compensation committee members with nothing more sophisticated than that old cardboard box.

Today's hospitals can expect to be asked to defend their CEOs' compensation packages. CEOs will be challenged like never before to demonstrate that they are earning their pay. With the heightened focus on executive compensation in healthcare, the increased likelihood of audit and the near certainty of annual press coverage of executive salaries, every compensation committee must be deliberate in the way it goes about setting compensation. It cannot rely on human resources because such assistance raises red flags about conflict of interest. That means the committee must be in control of the process of setting compensation policies, appraising performance, designing and administering pay-for-performance plans, approving supplemental benefits and perquisites, and making sure that the organization's resources devoted to executive pay are not excessive.

To do an effective job of managing executive compensation, compensation committee members need to have a sophisticated understanding of their responsibilities under Internal Revenue Code Section 4958. The committee must have a thorough knowledge of the organization's process for setting pay for the CEO and other influential executives. It must understand what these individuals are being paid and why. This is only possible if the board has good resources at their fingertips throughout the year to help them do their jobs.

Some Guidelines to Follow

There are several things that should be done *before* putting an executive compensation package together. They include the following:

- **Create a compensation philosophy** so the organization will have a clear set of guidelines by which to determine and explain executive compensation and how it is linked to the organization's mission.
- **Establish a board committee composed of independent trustees.** This enables the organization to avoid any potential conflicts of interest, either real or perceived.
- **Decide how to measure performance.** The evaluation process needs to be clearly linked to the organization's mission.
- **Use benchmarking data.** This is one of the trickiest parts of the process. Current executive compensation levels should be a reflection of market data for positions paralleling the complexities of managing large-scale healthcare enterprises and achieving progress toward the organization's goals and community mission. In interpreting market data, it is important that members of the compensation committee critically evaluate the information presented to them.
- **Documentation.** Adequate documentation will make dealing with the IRS and your committee and filling out those Form 990s go more smoothly.
- **Transparency and disclosure.** For-profits believe there is a need to adopt greater transparency and disclosure about compensation packages. It should be the same for nonprofit organizations. Even though the nonprofit

sector is subject to public disclosure through the annual 990 filing, there often is the perception that organizations are not forthcoming about compensation issues. Do your organization a favor by putting the information out there first.

Work With the Media

Don't be surprised by media interest when you hire a new executive. Expect it. Anticipate calls from local reporters. Building a trustful and working relationship with television and print reporters can benefit you in the long run. Talk to them regularly, not just when you're promoting something. Determine in advance who your spokesperson will be on this matter.

Although hostile media inquiries and negative coverage regarding executive compensation are always a

possibility, there are a number of strategies that can be adopted to lessen the probability of adverse media exposure. If the executive compensation plan is structured to reflect reasonable market comparisons and reward mission-relevant performance and is managed by a board compensation committee of independent trustees, then the organization should be confident in providing information that goes beyond the basic reporting of IRS Form 990. Before any interview, the spokesman should be thoroughly prepared with responses to sample questions and the core messages to communicate.

It is incumbent upon healthcare organizations to implement structures and associated processes that can be used to determine appropriate executive compensation and respond to challenges should they arise.

The actual determination of compensation should be based on a well-documented, data-driven process. It should not be determined or evaluated in isolation; rather, it should reflect the complexity of the organization, operational challenges at hand, the unique attributes and contributions of the CEO, and anticipated return on the investment in the chief executive both in terms of the organization's performance and overall progress in achieving its community mission.

We've come a long way since the days of passing documents in cardboard boxes. No organization should rely on the compensation committee chairperson's trunk.

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