MEASURING SUCCESS IN A CRISIS

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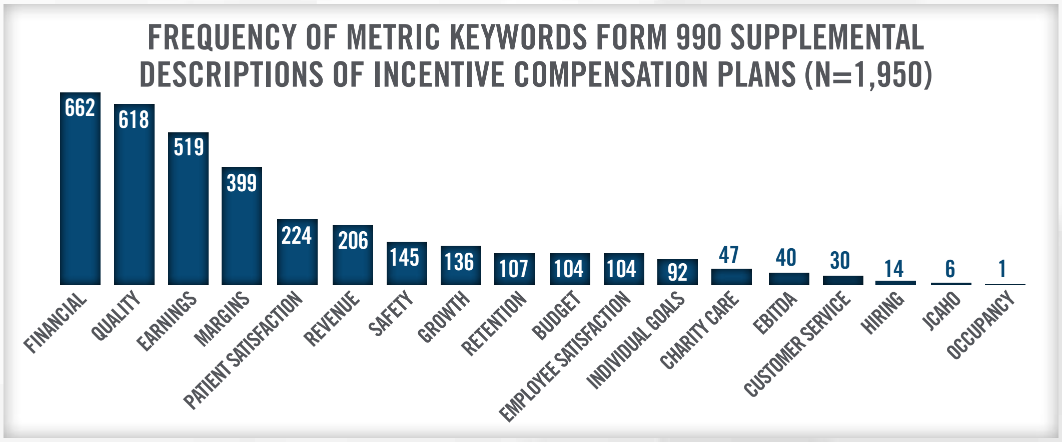
Be it government, education, business, or healthcare, the definition of "success" has been upended by COVID-19. Many hospitals and health systems are stress testing their clinical staff and executive leadership in their efforts to respond effectively to the pandemic. For executives, the metrics of success in existing incentive compensation arrangements may have been established in a now seemingly long-gone time of normalcy and, perhaps, prosperity. Is measuring an executive team's performance based on the prior "Pillars of Achievement" still appropriate?

The guiding principle of a compensation program is to align the philosophy, goals, and mission of the organization with the executive team's efforts and accomplishments on the organization's behalf. Intangible qualities like leadership, resourcefulness, and maintaining employee morale, among others, have been key to successful organizational responses to the pandemic. Considering the new hurdles associated with achieving the traditional pillars of financial and operational success, it may be appropriate to consider whether executive compensation plans should redefine success in the short term and reevaluate what success looks like in the future.

OBSERVATIONS

Hospitals and health systems may organize activities under main areas, referred to as "Pillars of Excellence", "Pillars of Achievement" or "Pillars of Success". These pillars balance organizational activities in order to focus executives on specific goal areas.

Drilling into over 17,000 Form 990 filings from 2016 to 2018 from hospitals, group practices and healthcare organizations, we found the following supplemental descriptions of incentive compensation plans in nearly 2,000 filings:



The above metrics may seem to vary greatly. However, healthcare systems, hospitals and group practices generally reference some or all of these terms within the following Pillars:

- **Quality** – the desire to improve clinical excellence, set industry standards and exceed customer expectations. This may include:
    - Enhancing quality of care
    - Increasing patient safety
    - Leading results in outcomes
    - Preparing for surveys and accreditation processes, such as by the Joint Commission
- **Safety** – Keeping patients, employees and physicians safe and free from harm. This would contain:
    - Physical safety measures
    - Adequate resource planning (staffing, equipment, etc.)
    - Defense against cyber threats (HIPAA, ransomware, etc.)
- **Service** – Providing excellent experience and service to customers, specifically:
    - Improving access to services and facilities
    - Increasing patient satisfaction scores
    - Enhancing referring physician satisfaction
    - Focusing on customer service
- **People** – Culture that attracts, retains and promotes the highest caliber employees who are committed to the organization's mission and vision. In addition, the People Pillar encompasses:
    - Becoming the employer of choice in the organization's location
    - Employee engagement
    - Developing employee reward and recognition programs
    - Improving communication at all levels
    - Increasing employee recruitment and retention
- **Finance** – The achievement of financial results to ensure an organization's ability to provide quality health care services along with new technology and reinvestment in the organization. In addition:
    - Revenue generation
    - Margin protection
    - Developing efficiencies in purchasing and materials management
    - Contracting with medical insurance companies
    - Protection of legislative funding
    - Focus on development and fundraising

- **Growth** – Growth focuses on achievement of consistent net revenue growth, market expansion, infrastructure improvements, and innovation along with:
    - Accretive acquisitions
    - Strong partnerships and affiliations
    - Long-term plans for facilities
    - Branding campaigns
    - Recruitment of staff and executives
- **Community** – broadly, the commitment to making a difference in the organization's community and supporting stewardship of the environment, social goals and good governance, comprised of:
    - Senior leadership/board that reflects the market demographic of the population being serviced
    - Addressing the environmental impact that the organization has on the community
    - Provision of charitable care and access to care

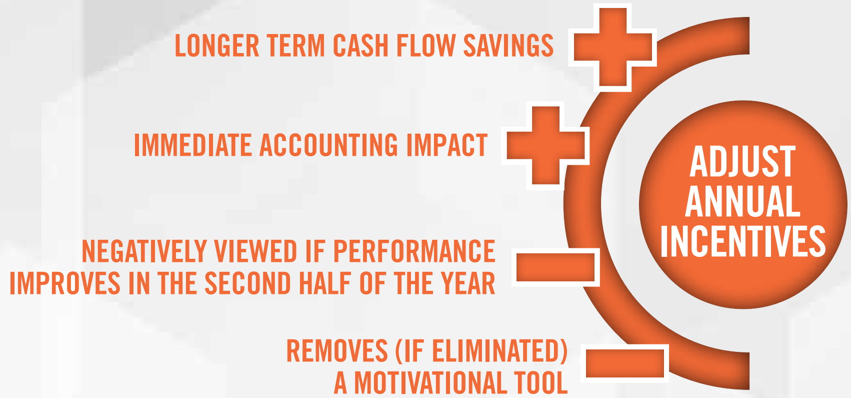
While these goals have appropriately served to measure executive and organizational success in the past, many of them may not reflect organizational success in 2020 due to the response to the COVID-19 pandemic. The pandemic has had an impact on all of these metrics. Whether incentive goals should remain the same going forward will depend on the expected length of the pandemic and its effects, taking into consideration uncertainty and an organization's ability to appropriately forecast the likelihood of achievement. Certain goals and related targets may no longer be relevant, and organizations should reexamine all Pillars of Achievement and their related targets to determine if this is the case.

With their focus on the immediate needs of patients, and with the impact of the shelter-in-place orders and lack of elective surgery, many organizations have not had the opportunity to reevaluate the relevance of current metrics and whether executives are on track to achieve annual goals. In addition, it is likely that neither boards nor executives have considered whether these goals should be reconfigured in light of what will become the "new normal" – for at least the short term. It is important for organizations to ensure that any actions taken will be in the best interest of the organization, rather than mimicking the actions of a competitor organization that has garnered a favorable response from stakeholders and the public. Organizations should consider how COVID-19 is affecting their business specifically and how the business may evolve once the world emerges from the pandemic.

IMMEDIATE IMPACT AND OPTIONS

Organizations that have experienced significant negative financial consequences as a result of the pandemic may need to revisit executive compensation plans for financial reasons. In doing so, they will be thinking through the who, the how much and the how long: who will receive compensation adjustments, how much those adjustments will be and how long the adjustments will remain in place.

Options available to immediately alter executive compensation are limited. These options include adjusting base salaries, and/or adjusting annual incentives/bonuses for the current year. Organizations may have contractual obligations that preclude changes to executive base salaries or compensation. In cases like this, the board may ask executives to voluntarily agree to alter base salary or incentive commitments. However, the board should consider using its discretion at any point to make appropriate awards given the financial resources of the organization as a result of COVID-19. Ideally, it should do this with the advice of legal counsel, given the potential of significant legal and regulatory implications to major compensation adjustments.



LONG-TERM CASH INCENTIVES

Adjusting annual and long-term incentive programs (either in addition to or in lieu of base salary adjustments) may give organizations a wider range of alternatives with longer term effects if economic uncertainty continues. Altering long-term cash incentives allows the most flexibility in modifying and setting goals in uncertain times. An option for companies worried that the COVID-19 pandemic will cause full year results to be well outside of the performance range is to implement a split performance year. Breaking the year into two performance cycles could alleviate worries that the plan will have zero reward for participants and thus cause a loss of motivation through the remainder of the 2020 fiscal year. In addition, this strategy will allow for more accurate goal setting as subsequent performance metrics can be determined once there is more information on the economic outlook. Other adjustment options addressed in the table below include: (i) Resetting In-Cycle Incentives; (ii) Setting Discretionary Goals; (iii) Utilizing Quarterly or Semi-Annual Goals; and (iv) Flattening and Lengthening the Payout Curve:

ADJUSTMENTS		OPPORTUNITIES (+) / CHALLENGES (–)
RESET IN-CYCLE INCENTIVES	+	Increases ability to motivate and reward performance
	+	Provides flexibility to change metrics, targets, timeframe, and/or pay opportunities
	–	The re-set goals could become irrelevant as the crisis continues to evolve
DISCRETIONARY GOALS	+	Avoids need to set explicit goals in time of uncertainty
	+	Provides maximum flexibility when it comes to setting and shifting strategic priorities
	–	Could cause expense variability due to subjective nature
SPLIT PERFORMANCE YEAR	+	Alleviates worries that plan will have zero reward for participants
	+	Removes potential motivation loss
	+	More accurate goal setting
	–	Could create additional administrative burden
	–	Goal setting may still be inaccurate for second half of the year
QUARTERLY OR SEMI-ANNUAL GOALS	+	Maintains explicit goals
	+	Allows for course correction for metrics and targets
	–	Could reward lower levels of performance
	–	Increases administrative burden
FLATTEN & LENGTHEN PAYOUT CURVE	+	Provides more opportunity for payout
	+	Decreases pressure to decide on new goals
	–	Rewards lower levels of performance
	–	Potentially demotivating

LONG-TERM EQUITY INCENTIVES

For for-profit organizations that utilize equity or equity equivalents in their compensation structure, many of the above adjustments may raise concerns amongst shareholders, who cannot restructure their investments due to Coronavirus-related losses. The risk of angering shareholders may hamstring organizations and remove these potential adjustments from their consideration. However, if these organizations effectively communicate with their shareholders, there are additional levers to pull in the form of altering Equity Incentives. These adjustments can include: (i) Modifying Performance Share Goals; (ii) Exchanging Stock Options for New Options; and (iii) Exchanging Stock Options for RSUs:

MODIFY PERFORMANCE SHARE GOALS

OPPORTUNITIES	CHALLENGES
+ Creates potentially more attainable goals	– Requires employee consent
+ Avoids lost performance period	– May create an issue with IRC Section 409A
	– Generally disliked by shareholders

STOCK OPTION EXCHANGE: NEW OPTION

OPPORTUNITIES	CHALLENGES
+ Brings exercise price to current market levels	– Requires shareholder approval and tender offer
+ Increases retentive and motivational power	– Generally dislikes by shareholders

STOCK OPTION EXCHANGE: CASH OR RSUs

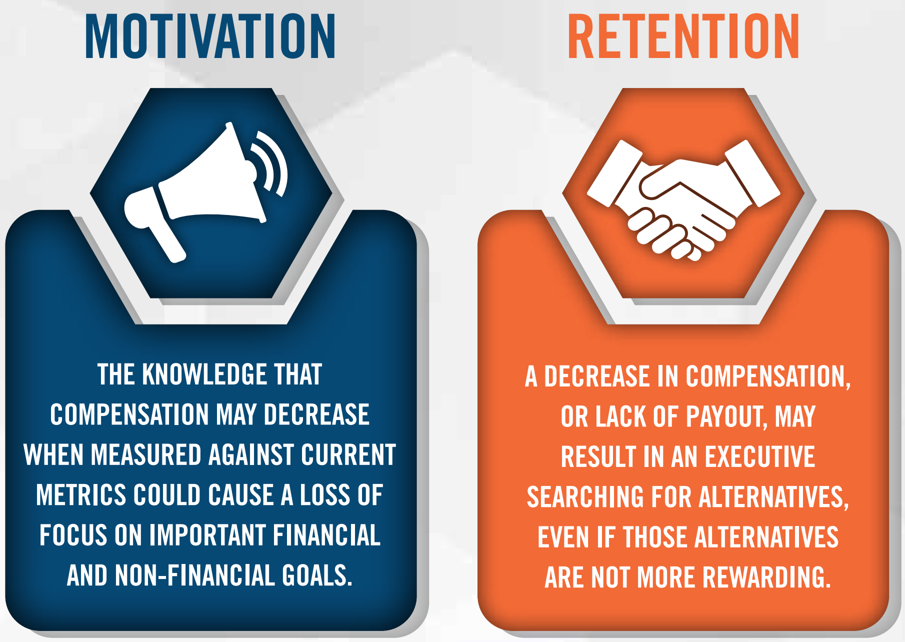
OPPORTUNITIES	CHALLENGES
+ Increases retentive power	– Requires shareholder approval and tender offer
+ Provides more downside protection	– Less shareholder friendly than replacing with new options

In addition, for-profit organizations can take further actions to adjust their future equity incentive plans including: (i) More frequent, but smaller, grants; (ii) Time-based awards with longer vesting periods; and (iii) Targeted, retention-focused awards:

ADJUSTMENTS	OPPORTUNITIES (+) / CHALLENGES (–)
MORE FREQUENT, SMALLER GRANTS	+ Better predictability
	+ Higher likelihood of realistic goal setting and achievement
	– Increases administration burden
TIME-BASED AWARDS WITH LONGER VESTING	+ Eliminates need to set performance goals
	+ Increases retention and alignment with shareholders
	– Performance-vested awards are generally preferred
PROVIDE TARGETED RETENTION AWARDS	+ Increases retention
	– Could be received negatively by stakeholders and the public

BEYOND INCENTIVES

Many executives have "answered the call" of the pandemic and have increased their working hours and experienced a significant shift in responsibilities. As a result, an organization's inability to meet goals determined at the beginning of the year and compensate executives in line with expectations could seriously impact an organization in terms of two significant issues: retention and motivation. It could also lead to legal or regulatory liabilities for a variety of reasons, depending on the organization's governing documents and laws and its contractual obligations.



Redirecting efforts to ensure executives are concentrating on the activities that will most strongly correlate to both financial and non-financial success for the organization will empower executives, contribute to organizational success and help minimize organizational risk.

CONCLUSION

There are many options for organizations to consider as they traverse both the current economic environment and the post-COVID-19 pandemic economic environment. Regardless of the adjustment(s) organizations are considering, open and ongoing communication with executives, stakeholders, the governing board and their counsel is of paramount importance. For those organizations that have not made changes to their compensation programs, they should consider this to be an opportune time to undertake a review of their executive compensation program. Finally, it is important for organizations to look past this time of uncertainty and take a long-term view to best position themselves for future success.