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3 Compensation Structures for a More Successful Transaction

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Eighty-seven percent of hospitals are considering alignment with another hospital or system as a part of their overall strategic planning, according to Dixon Hughes Goodman. This interest is primarily attributed to structural factors in the industry, including the shifting reimbursement environment and issues related to new healthcare regulations that place independent hospitals at a competitive disadvantage.

The business of governing acute care hospitals and health systems has become increasingly complex.

At the same time, there is tremendous opportunity due to the expanding range of strategic alternatives available to independent hospitals. Despite these market realities, many boards have failed to implement protective structures that incentivize senior management to objectively assess opportunities free of personal contractual distractions.

This article reviews the types of safeguards that hospital system boards should have in place to promote senior management objectivity.

Hospital systems should position themselves to evaluate strategic alternatives on their merits without succumbing to the unintended consequences of misplaced management incentives. Organizational alignment is among the most significant career inflection points that hospital executives can face. Boards that recognize these competing factors and structure contracts that promote management objectivity will position their hospital system to make thoughtful decisions for their stakeholders based on board directives — without distraction or misalignment with senior executives.

Properly structured incentives can improve transaction outcomes by promoting continuity before and after a partnership is consummated. By putting these incentives in place, boards promote open communication and trust with management. Trust is always important in the principal-agent dynamic between management and the board, but it is of particular consequence in transactions where management may feel vulnerable. By putting the right incentives in place early, objectivity is promoted and heat-of-themoment decisions are avoided.

As more organizations consider strategic alternatives with other systems, we have seen an increase in failed transactions due to unaligned board objectives and management incentives. The effect is magnified when experienced transaction advisers and transaction counsel are not involved at the outset.

These unaligned incentives manifest themselves in a variety of ways. If senior executives are unsure of the impact on their personal situation, they may not fully engage with respect to the board's directive to evaluate strategic alternatives in an ongoing and comprehensive manner. Also, uncertainty causes hospital systems to lose highperforming executives before, during and after the strategic alignment processes, even more so if the transaction is drawn out or delayed. We regularly encounter boards that "didn't know" their full range of alternatives to align with senior management, or boards that wish that they had acted sooner.

We have also had clients who lost key executives before, during and after ownership transitions. Many strategic partners place significant value on a strong leader at a health system. During the transaction process, senior management can motivate team members to move a transaction forward, and they are often best-positioned to engage with the hospital's various constituents, from physicians to community members. After the transaction is complete, they prove invaluable in assisting with transition matters and capturing transaction synergies. The departure of key management members destroys value and hurts healthcare delivery, but the likelihood of this can be minimized through contracts that align board and management interests.

While many management contracts have features to protect executives in a change of control situations, such as severance arrangements, contracts regularly miss key features. The result is a classic principal-agent problem with management's interests misaligned with the board's objectives. Given the real and perceived risks to top executives in strategic partnerships, it is at least naïve — and possibly unfair to management — for boards to expect senior executives to expose themselves to professional risk without structures in place that mitigate these risks.

Fortunately, boards can take steps to address these issues through employment contract features. In this article, we will explore three key contractual features that organizations should have in place for their top executives to align senior management and the board. These include continuity bonuses, change of control bonuses and integration bonuses. We will also discuss practical considerations in aligning management incentives with board objectives.

Types of Incentives

Continuity Bonus – Continuity bonuses are designed to retain top management during the pendency of a transaction. These are typically paid out at closing (or a brief period, such as 90 days, after the closing). After selecting a strategic alternative and starting down the path with a partner, the loss of a key executive team member can put the arrangement at risk. At worst, the partnership fails pre-closing, and the organization is left without its preferred partner or outcome. In any event, the organization ends up scrambling to consummate the relationship without a key resource. The period between partner identification and the close of a transaction is a particularly challenging time for hospital executives. They are trying to focus on the day-to-day aspects of running a hospital, while at the same time, planning and implementing a due diligence process, navigating relationships with vendors, physicians and employees, and generally driving a transaction toward its consummation. These multiple roles, combined with personal job uncertainty, inevitably leave executives more likely to depart. Organizations can help mitigate the likelihood of their departure through incentives that recognize the additional work and associated risk related to these activities.

Change-of-Control Bonus – A change of control bonus is intended to incentivize senior management to remain with the organization through closing, by ensuring they retain their position or receive a severance package. A change-of-control bonus can have a "single trigger." That is, the change of control itself triggers the right to the bonus. Alternatively, the change of control bonus can be "double trigger," meaning that after the transaction, the executive would need to be terminated or otherwise have a reduction in title or role. These arrangements protect executives from termination by the new owner, a change in relative responsibility, or other issues related to change in employer and role. The result should be an executive who can remain focused on carrying out the board's directive with respect to a strategic transaction, while knowing that thy have a financial "safety net" in the event they are not asked to remain with the organization.
One unintended consequence of poorly written change-of-control bonus language: It can incent executives to leave even when they would prefer to stay on. If the change-ofcontrol bonus is triggered, the executive may be faced with a decision between staying on or taking the bonus and leaving. For this reason, boards often buy out change-in-control bonuses at closing with the executives rolling into new employment contracts with the partner. This allows the executives to stay on without having to make the difficult choice of forgoing the bonus.

Integration Bonus – Many boards feel strongly that their executive team, having helped identify their system-partner and guide them through a strategic transition, is best-suited to ensure that the board's objectives are realized in the new relationship. Executives can be encouraged to stay on through the transition period via integration bonuses that recognize the additional work involved in integrating the hospital with its new system partner.

The integration bonus can also help balance a shift in responsibility that C-level executives face. An independent hospital CEO, who was accustomed to reporting only to his or her board, faces a significant career adjustment in now also reporting to a system executive and possibly multiple dotted-line supervisors and boards. Similarly, an independent hospital CFO may no longer handle raising capital or other components of his or her former role. To incent these executives to stay on in their new capacities, boards can offer integration bonuses that vest over time or are based on tangible integration metrics. This feature can incent key executives to stay on through the integration with the new system.

Practical Considerations

While these incentives are all regularly used to align management's interests with those of the board, they have not been universally adopted. There are a variety of reasons for this, but two surface more often than others.

As managers of their community's largest and most complicated businesses, hospital executives can often be among the highest compensated individuals in their communities and board rooms. With respect to nonprofit and community hospitals, executives' compensation may be public and well-known. Therefore, even if the alignment of incentives would best serve the hospital and the community it serves, boards may worry about public scrutiny of these arrangements and hesitate to address these issues. The second reason is more nuanced. As outlined above, typical contracts provide a disincentive to management's objectivity. Coupled with the board's natural bias toward maintaining the status quo, this can result in myopia in the boardroom, which may result in the organization's failure to objectively assess how to serve best the community's healthcare needs over the long term. When implemented correctly, the compensation structures outlined above do not incent executives to move in favor of a transaction or maintain the status quo. These structures will balance the dis-incentives created by typical management contracts and encourage an objective dialogue in the best interests of the hospital's community. Decisions are best made by maximizing the unbiased review of the full range of strategic alternatives. The same reasoning that has led more organizations to actively consider their full range of strategic alternatives supports a fresh review of transaction-related incentives included in management contracts.

These contractual elements are appropriate for a core group of key executives. Boards look to this core group for unbiased advice, and departures at this level are most profound. A rule of thumb is that these objective-leveling incentives should apply to those executives who have employment contracts containing specific severance clauses.

While it is best practice to enter into these "objective-balancing" contracts when hiring or promoting an executive, there is never a bad time for a board to better align management contracts with organizational objectives. It is not uncommon for a board to ask why senior management has not been evaluating strategic alternatives, only to realize this result was an artifact of unrecognized dis-incentives that unintentionally quelled the conversation.

Conclusion

Management and boards want to do the right thing — objectively weigh strategic alternatives to serve best their communities over the long-term. Management contracts that misalign these incentives are often entered into with the best intentions. It is up to boards, management teams and their advisors to regularly evaluate these structures to protect valued executives. Contracts that do not favor one outcome over another ultimately support the evaluation of strategic alternatives on their own merits.

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