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**To: Massachusetts Hospital Association
Blue Cross and Blue Shield of Massachusetts
Harvard Pilgrim Health Care
Tufts Health Plan
Fallon Health Plan**

From: David Spackman, Chief *DJS*
**Non-Profit Organizations/Public Charities Division
Office of Massachusetts Attorney General Martha Coakley**

Date: September 2, 2009

Re: Examination of Executive and Director Compensation; Increased Oversight

The Non-Profit Organizations/Public Charities Division ("Division") is increasing its oversight of executive and director/trustee compensation practices. We will address executive compensation through a periodic examination of the executive compensation practices, procedures and outcomes within a cross section of our larger and more significant public charities. Initially, the focus will be on a representative number of our larger health care systems and health care insurers. Based on that experience, the examination of executive compensation may be extended to other sectors. We will address director compensation through a focused examination of director compensation practices at four of our charitable health care insurers. Depending on the outcome of that examination, our inquiry may be extended to any other Massachusetts charitable organizations that compensate directors and trustees.

In the area of executive compensation we will address, among other matters, two issues of particular concern: (i) the impact of the Internal Revenue Service's ("IRS") "intermediate sanction" regulations ("Section 4958")¹ on compensation levels and (ii) the complexity, including timing and reporting variability, of executive compensation that make comparative analysis and disclosure difficult; sometimes unnecessarily so. Consistent with the expanded compensation information required by the recently amended federal information return for charitable organizations,² the Division will, pursuant to common law and statutory authority under G. L. c. 12, §§8 and 8F, substantially expedite and expand the depth and scope of compensation information the Division requires of and from the larger institutions, both providers and insurers, of our charitable health care sector. The Division intends to move from

¹ See Internal Revenue Code, Reg. §53.4958-6C.

² Federal Form 990



the current system of annually collecting, well after the fact, limited amounts of information regarding a small number of highly compensated individuals, to a broader, more timely and proactive examination of executive compensation on an organization and industry-wide basis.

In the area of director compensation, we will address the unusual practice of compensating otherwise independent directors at four of our eight charitable health care insurers. The basis for compensation has not, to the Division's knowledge, ever been clearly articulated to the public and we are asking each of the current boards to take a fresh look at the practice. If the practice is to continue at any of them, it should do so only on the basis of a sound and well considered foundation, for which the benefits and risks have been fully explored and appropriately considered, and in a manner in which the independence of the board has been preserved.

Our forward looking examination of these two issues is, in part, a natural next step from our review of certain compensation and governance matters at Blue Cross and Blue Shield of Massachusetts ("BCBSMA"). That review, commenced in response to a lump sum payment made in 2007 to the former BCBSMA chief executive officer and board chair William Van Faasen upon his retirement and to widespread public concern regarding compensation levels within the charitable health care sector, led us to conclude the Office needed to look at these issues on an industry-wide basis.³

Today's announcement should not be construed as an attempt to substitute the judgment of the Division for that of committed, knowledgeable and diligent boards. The most expensive mistake an organization can make is to place the wrong person at the helm or the wrong people in the board room. The charitable sector needs to compete for executive talent with the for profit sector in an employment marketplace often insensitive to tax or charitable status. Our most effective managers will be and should be fairly compensated and we acknowledge that the results of the most perfect of compensation systems will be found offensive by some. Members of our charitable boards should be talented, qualified and experienced. Nevertheless, unless this Division and our charitable boards address these issues head on, particularly given recent economic trends and the serious crisis in health care costs, the discretion now vested in our boards is more and more likely to be subjected to far more dramatic externally imposed limits and controls.

³ Our review also examined the BCBSMA practice of placing the same individual in the position of both the chief executive officer ("CEO") and board chair ("Chair"). While the BCBSMA Board believes the practice, first initiated with the appointment of CEO William Van Faasen to the position of Chair in 2002 and continuing to the present with CEO Cleve Killingsworth also holding the position of Chair, was both appropriate and beneficial, it has voted to end the practice and appoint an independent director to the position of Chair upon the expiration of Killingsworth's current one year term in March of 2010. On that basis, and because we believe the practice was unique to BCBSMA, it is not a subject of this memorandum and our examination of this practice has ended.

1.0 EXECUTIVE COMPENSATION

1.1 The Impact of Section 4958

Compensation for the leadership of charitable, tax exempt organizations has been a topic of public and regulatory concern for some time. The most definitive action in this area was taken by enactment in 1996 of IRS Code Section 4958 and the regulations subsequently promulgated pursuant thereto. Section 4958 was developed as a means of addressing excess benefit transactions⁴ between persons holding positions of influence within a charitable organization (a so-called “disqualified person”) and the charitable organization itself. Prior to its enactment, the only remedy available to the IRS for excess benefit transactions was revocation of tax exempt status. Compliance with Section 4958, which relies heavily upon the use of market data, creates a rebuttable presumption that the compensation amounts set pursuant thereto are not excessive. In pursuit of this presumption, virtually all charitable health care organizations of significant size now use industry norms and market ranges to test and set the parameters of their executive compensation packages. These norms and market ranges include, consistent with Section 4958, both for profit entities as well as non-profit charitable corporations. Adherence to this “market” is intended to avoid or deter compensation arrangements which might otherwise be deemed excessive, thereby rendering the organization vulnerable to challenges from the IRS as disguised distributions of net income.

Section 4958 is a tax regulation, enforced solely and exclusively by the IRS. The Division does not enforce federal tax laws; however there are clear analogies between Section 4958 and the authority of the Division under state law. A “disqualified person” under Section 4958 is analogous to a “fiduciary” under Massachusetts law. Conduct leading to an “excess benefit transaction” under Section 4958 would likely constitute impermissible “self-dealing” under Massachusetts law. An excess benefit transaction under Section 4958 would give rise to penalties ranging from excess benefit taxes on the disqualified persons to revocation of the entity’s exempt status. Self-dealing under state law would give rise to a right of recovery against the self-dealing fiduciary for breach of duty; an action directly enforceable by the organization or the Division on behalf of the public served by the organization. Based on the similarities, and while the Division is not bound by the procedures or presumptions of Section 4958, as we stated in our findings regarding Citi Performing Arts Center,⁵ the Division does look to an organization’s compliance with Section 4958 as a material factor in our analysis of compensation.

Despite thirteen years of experience with Section 4958 and apparent widespread compliance with the procedures set forth therein, the compensation debate clearly has not ended. Indicative of the continuing concern, last year the Insurance Commissioner of the State of Maryland cut in half an eighteen million dollar payment to the former chief executive officer of CareFirst, Inc., a Maryland non-profit health plan. Acting pursuant to explicit authority under the Insurance Article of the Maryland Code, which required compensation to be “fair and

⁴ An “excess benefit transaction” is any transaction in which the value paid by the exempt organization exceeds the value of the services received.

⁵ See letter to John William Poduska, Sr., Chairman of the Board of Directors, Citi Performing Arts Center dated December 5, 2007.

reasonable,” the Commissioner took clear exception to Section 4958’s reliance on comparables by noting that what was “comparable” was not necessarily “fair and reasonable.”⁶ Bills to limit executive pay in certain Massachusetts public charities have been submitted in both 2008 and 2009.⁷ As recently as March 3, 2009, Senator Grassley, the ranking Republican on the Senate Finance Committee, criticized the widespread use of consultants as self serving and suggested changing presumptions and shifting greater responsibility to non-profit boards.⁸ Concern has not been limited to non-profits. A 2007 congressional report identified widespread conflicts of interest arising out of firms providing audit and other financial services to Fortune 500 companies while simultaneously providing management compensation services.⁹ On February 5, 2009, the Senate approved the Dodd amendment to Troubled Asset Relief Program,¹⁰ which provided that companies receiving TARP funds could not pay bonuses to their 25 highest paid employees.

However well-advised, well-intentioned and diligent charitable boards have been in seeking to operate in compliance with Section 4958, non-profit executive compensation levels have increased substantially since the regulation went into effect. Permissive inclusion of the for profit sector, with its now well-recognized propensity for generous, if not excessive, executive compensation, almost certainly contributed to this increase by enriching the market basket of comparables and thus the compensation of the senior management teams of those charitable organizations that could afford to keep pace. Additionally, the widespread use of market data regarding average compensation levels may have encouraged above average compensation packages from boards under pressure to reward their top executives. As each year’s above average became next year’s average, this formulaic approach may have assured, with virtual mathematical certainty, executive compensation would grow. Moreover, strict adherence to the market promoted by Section 4958 may have led to a general reluctance on the part of boards to weigh and take into account other factors.

In summary we are concerned that Section 4958, intended only to establish a ceiling, may instead have created a floor. A procedure intended to serve as a tool may have become the product. Adherence to Section 4958 has served senior management well; whether the public has benefited is far less certain.

1.2 Reporting Variability

The Division is committed to transparency in the operations of our public charities; however the capacity to assure transparency in the area of compensation is hindered by its complexity as well as timing and reporting variations. The following is an explanation of some of those complicating factors that the Division will address and clarify in the coming year.

⁶ Insurance Commissioner for the State of Maryland v. CareFirst, Inc. and William L. Jews, MIA-2007-10-027.

⁷ In 2008, SB2559- An Act Capping Non-Profit Executive Compensation, and in 2009, SD497- Regulation and Oversight of Public Charities, both sponsored by Senator Montigny.

⁸ Lisa Wangsnesse, *Nonprofit Hospitals Targeted on Leader Pay*, Boston Globe, March 4, 2009.

⁹ See “Executive Pay: Conflicts of Interest Among Compensation Consultants,” prepared for Chairman Henry A. Waxman, U.S. House of Representatives, Committee on Oversight and Governmental Reform, Majority Staff, December 2007.

¹⁰ The Troubled Asset Relief Program (TARP) is a program of the United States government to purchase assets and equity from financial institutions in order to strengthen the U.S. financial sector.

Reporting Variations. What constitutes “compensation” varies by reporting venue and purpose. For example personal income tax returns (W-2 compensation), designed for income tax calculation purposes, include only salary, incentive plan payments actually made and certain benefits actually received. The annual Form PC¹¹ submitted to the Division and the new Federal Reporting Form 990, designed solely for the purpose of disclosure and transparency, require a more detailed reporting of retirement benefits (even those not yet vested or received and which are not taxable income in the reported year). To complicate matters even further, methodologies used by our non-profit, charitable insurers for completing the annual Supplemental Compensation Exhibit submitted to the Massachusetts Division of Insurance (“DOI”)¹², differ among and between BCBSMA, Harvard Pilgrim Health Care (HPHC) and Tufts Health Plan (“Tufts”).¹³ HPHC reported amounts for years 2005 through 2008 are what we characterize as “all-in.” Consistent with this format (and the format for reporting compensation amounts on the Division’s Form PC), all compensation (from all sources and regardless of vesting, entitlement or current tax treatment) is reported by HPHC on the Supplemental Compensation Exhibit. In contrast, Tufts DOI filings do not include (i) portions of compensation allocated to non-insurance division affiliates and (ii) amounts contributed by the company to a deferred compensation plan. For Tufts this means that the amount reported to the DOI as CEO compensation in 2008 was approximately \$500,000 less than what would have been reported to DOI under an all-in methodology and what will later be reported to the Division on the Form PC. In 2007 BCBSMA filed with the DOI on an all-in basis. For 2008 BCBSMA changed its reporting methodology by excluding amounts not actually paid and received.¹⁴ Previously reported amounts for 2006 and 2007 were amended to be consistent with this methodology. For BCBSMA this means that the amount reported to the DOI as CEO compensation in 2008 was approximately \$750,000 less than what would have been reported to DOI under an all-in methodology and what will later be reported to the Division on the Form PC.

Timing Variations. Timing issues arise in three areas: (i) reporting schedules, (ii) fiscal year variations and (iii) payment schedules. In the case of reporting schedules, the annual filing with the DOI occurs on March 1st, two months after the end of the insurers’ fiscal year. In the case of the Division, the filing occurs simultaneously with Federal Form 990 filings which, with extensions, are often not submitted until over ten months subsequent to the end of the reported year. What is thus “new” news to the public is often “old” news to the company. In the case of

¹¹ The “Form PC” is the annual financial report submitted by public charities, including BCBSMA, to the Division pursuant to the requirements of G. L. c. 12, §8F. It is due four and one-half months after the end of an organization’s fiscal year. With extensions, the filing date may be extended for an additional period of up to six months.

¹² All insurers doing business in Massachusetts make an annual filing with the DOI on or before March 1st for and with respect to the year then ended. The Supplemental Compensation Exhibit was first required as part of this annual DOI filing for fiscal year 2007 and covered years 2005, 2006 and 2007.

¹³ We emphasize that none of the reporting methodologies described herein appears to be contrary to the requirements of the DOI which defines compensation as “any and all remuneration paid to or on behalf of an officer, employee, or director covered by this requirement, including, but not limited to, wages, salaries, bonuses, commissions, stock grants, gains from the exercise of stock options, and any other emolument.” Our point is simply that they vary by filer, cannot be compared without further inquiry and diligence, and can be materially misleading.

¹⁴ We are advised that actuarially estimated supplemental retirement plan earnings, which because they are neither vested nor paid had been reported for 2007 in the “All Other Compensation” column, were not included in the 2008 filing calculations.

fiscal year variations, the insurers and the hospitals report on a fiscal year basis, however the insurers' fiscal years end December 31st while the hospitals' fiscal years end September 30th. As a result comparability within the broader health care sector is diminished. In the case of payment schedules, compensation derived from incentive performance plan payments, while determined in a given year, are not paid out until the subsequent year or even later. Consequently compensation in a given year is not necessarily related to performance in that year, even to the extent compensation may be paid to an individual who has left the company or retired. The impact of these delays, and their potential to create confusion, is particularly acute in the area of retirement benefits. While a retirement payout may have been determined, and in some cases reported, on an annual basis for many years, when paid it is reflected as compensation for that year.

Double Counting. An additional, or related, problem results from what can be viewed as "double counting." This occurs when an amount that is potentially earned but not actually paid, is annually reported as "deferred," "contingent" or "other compensation." Later, when the previously reported amounts are vested and actually paid, the payments are again reported. As previously discussed, this is a particularly acute problem in the deferred compensation area when certain non-vested, non-paid retirement benefits are calculated on an actuarial basis for the year and then reported on a current basis. When later paid out in a lump sum, the full amount is then again reported as compensation.

1.3 Next Steps

Consistent with, although not limited by, the greatly expanded scope of compensation information being collected by the IRS under the new Federal Form 990, this Division intends to initiate significantly more expansive and robust reporting requirements for our larger health care related public charities. For these organizations, this reporting will supplement and replace certain sections of the current Form PC and will be due on or before March 1st of each year for and with respect to the calendar (not fiscal) year then ended.¹⁵ The purpose of this new reporting requirement will be to address and capture organization specific and industry wide information regarding, but not necessarily limited to, the following.

- Compensation in a standard reporting format and methodology designed to capture salary, bonuses, retirement contributions, deferred compensation (vested and unvested) and benefits, of senior management.
- A measurement of compensation increases against related industry performance standards and indicators including, without limitation and by way of example, increases in overall medical costs to consumers or compensation changes within the medical work force.
- The process employed to review and set compensation including, without limitation (i) the use, identity and qualifications of consultants including safeguards to assure independence, (ii) board and committee review and decision making structure on compensation matters, (iii) the comparables used including their source, aegis and the specific basis for comparability,

¹⁵ The full Form PC, with accompanying materials, will remain due 4.5 months subsequent to the end of the organization's fiscal year.

particularly when national data is relied upon, (iv) copies of reports submitted to and reviewed by the board as well as testimony regarding board discussion, response and actions and (v) the basis for and weight accorded market data as opposed to other factors.

- The performance targets for bonuses or other incentive based payments including, without limitation, how they were set, how they were funded, the conduct to be rewarded and how the overall targets promote both fiscal health and charitable mission.
- A full description of all retirement benefits and other deferred compensation arrangements including, without limitation, the justification for their use and applicability as well as evidence that without them the organization's ability to recruit and retain qualified executives would be materially impaired.

The detail and scope of this expanded reporting requirement will be developed over the next four to five months with the input of impacted organizations and the public. It is anticipated that the first expanded reports will be due March 1, 2010 for and with respect to the calendar year ending December 31, 2009.

2.0 DIRECTOR COMPENSATION

2.1 Background

The practice of compensating otherwise independent directors for service on a charitable board is extraordinarily rare in Massachusetts. In a survey we conducted last fall (the "October Survey") only BCBSMA, HPHC, Tufts and Fallon Health Plan ("Fallon") compensated independent directors.¹⁶ As recently as last year our Supreme Judicial Court recognized voluntary board service as a primary indicator that an organization's purposes and methods are traditionally charitable.¹⁷ Principle 20 from the Panel on the Nonprofit Sector, Principles for Good Governance and Ethical Practice: A Guide for Charities and Foundations (Independent Sector, Washington DC: 2007 – hereinafter the "Guide")¹⁸ states that board members are "generally expected to serve without compensation" and that the "vast majority" do so. While Principle 20 also acknowledges that a minority may compensate directors, it notes that in such event a "rationale" for the decision is expected.

Compensation of independent directors of a charitable organization is not, standing alone, either illegal or a breach of fiduciary duty. Compensation does, however, potentially impair

¹⁶ During November of 2008, the Division surveyed every non-profit acute care hospital, all eight Massachusetts based non-profit insurers, Amherst College, Boston College, Boston University, Harvard University, College of the Holy Cross, MIT, Smith College, Tufts University, Williams College, Boston Museum of Fine Arts, Museum of Science, Children's Museum, Isabella Stewart Gardner Museum, and the Massachusetts Museum of Contemporary Arts Foundation with respect to compensation practices for independent directors and whether the Chair was an independent director.

¹⁷ *New Habitat, Inc. v. Tax Collector of Cambridge*, 451 Mass. 729, 889 N.E. 2d, 414 (2008).

¹⁸ The Independent Sector is a nonpartisan coalition of approximately 600 organizations with the stated purpose of leading, strengthening, and mobilizing the charitable community. Principles incorporated in the Guide do not have the force of law, but have widespread recognition in establishing and evaluating good governance practices.

board independence,¹⁹ and is clearly contrary to this volunteer tradition that characterizes our charitable boards.²⁰ To depart from the industry and judicially recognized norm, and thus create issues avoided by the overwhelming majority of our charitable organizations, requires, in the view of this office, a clear and convincing case.

2.2 Next Steps

Each of the four insurers which compensate independent directors has agreed to cooperate with the Division in reviewing their respective practices. We anticipate completing our review prior to December 31, 2009.

¹⁹ “Individuals who have a personal financial interest in the affairs of a charitable organization may not be as likely to question the decisions of those who determine their compensation or fees or to give unbiased consideration to changes in management or program activities...It is important to the long-term success and accountability of the organization that a sizeable majority of the individuals on the board be free of financial conflicts of interest.” *Guide*, page 23.

²⁰ Most charitable boards not only decline to compensate their directors but implicitly or explicitly make clear that directors are expected to donate funds, in amounts consistent with their personal financial resources, to the charitable organization they serve.