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April 14, 2011

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Board of Directors  
Harvard Pilgrim Health Care  
c/o Laura Peabody, General Counsel  
93 Worcester Street, Suite 100  
Wellesley, MA 02481

David W. Hillis, Chair  
Board of Directors  
Fallon Community Health Plan  
c/o Jesse Caplan, General Counsel  
10 Chestnut Street, 9<sup>th</sup> Floor  
Worcester, MA 01608

Davey Scoon, Chair  
Board of Directors  
Tufts Health Plan  
c/o Lois Cornell, General Counsel  
705 Mount Auburn Street  
Watertown, MA 02472

Paul Guzzi, Chair  
Board of Directors  
Blue Cross Blue Shield of MA  
c/o Sandra Jesse, General Counsel  
401 Park Drive  
Boston, MA 02215

Gentlemen:

As you are aware, on September 2, 2009, this office issued a memorandum regarding compensation within the health care sector. While primarily focused on executive compensation, the memorandum called for a review of the practice of compensating independent directors for their service to charitable organizations. On November 2, 2009, we issued a letter to each of your organizations in which we restated the basis of our concern and formally requested review of this practice. As part of this process, your organizations were given two separate opportunities to respond to our concerns about this practice, with the final submissions received by March 23, 2011.

During this time period, the boards of Blue Cross Blue Shield of Massachusetts and Fallon Community Health Plan each voted to indefinitely suspend director compensation. We applaud their decision and believe it provides an opportunity for a more thoughtful and considered analysis of the practice. On March 23, 2011, the boards of Tufts Health Plan and Harvard Pilgrim Health Care advised this office that they intend to continue the practice of compensating directors. We are disappointed in their decisions and believe they are ill-advised.

The following is a final report regarding director compensation practices at these not-for-profit, charitable health care organizations.

## Background:

The practice of compensating independent directors<sup>1</sup> for service on a charitable board is extraordinarily rare in Massachusetts. In a survey we conducted in the fall of 2008 of selected charities of a significant size only four organizations compensated independent directors.<sup>2</sup> As recently as 2008, the Massachusetts Supreme Judicial Court recognized voluntary board service as a primary indicator that an organization's purposes and methods are traditionally charitable.<sup>3</sup> 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”)<sup>4</sup> states that board members are “generally expected to serve without compensation” and that the “vast majority” do so. While the Guide also acknowledges that a minority may compensate directors, it notes that in such event a “rationale” for the decision is expected.

The rarity of director compensation within the non-profit industry is entirely consistent with the purpose and structure of non-profit charitable organizations. In the for-profit world, organizations operate for the exclusive benefit of their owners (shareholders) and directors are entirely justified in requiring compensation for serving those private interests. In contrast, non-profit charitable organizations operate for the exclusive benefit of the public and the vast majority of directors view voluntary service as a primary means of giving back to the greater community the value of their skills and experience. Compensating directors is contrary to this spirit and diverts resources otherwise focused on achieving the charitable mission of the organization. Moreover, the authority of directors in the for-profit world to establish and set their own compensation is subject to the ultimate authority of the shareholders. Those who are entitled to the benefits of non-profit charitable organizations (the public) have no such authority.

Although our office is troubled that Harvard Pilgrim and Tufts have continued to compensate board members while health care costs continue to rise, compensation of independent directors is not merely an issue of cost. Compensation has the potential to impair board independence.<sup>5</sup> For example, the Guide notes that “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.” P. 23. Likewise, compensation of directors

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<sup>1</sup> For the purposes of this letter, an “independent director” is a director that is not an employee of the public charity.

<sup>2</sup> 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. This survey was designed to focus on significant charitable organizations. The Division acknowledges that among the some 22,000 active charities in Massachusetts there may well be others that compensate directors. Those will be identified pursuant to the annual report referenced at the end of this report and required to justify the practice.

<sup>3</sup> *New Habitat, Inc. v. Tax Collector of Cambridge*, 451 Mass. 729, 889 N.E. 2d, 414 (2008).

<sup>4</sup> 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.

<sup>5</sup> “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.

creates an unavoidable conflict of interest inherent in the unchecked ability to self-elect compensation with charitable funds, and is clearly contrary to this volunteer tradition that characterizes our charitable boards.

Moreover, compensation of independent directors cannot be viewed in isolation from broader concerns about mission drift in certain sectors of our charitable community. Particularly in the health care arena, where non-profits organizations (both providers and insurers) often operate side-by-side with for-profit entities, are subject to the same market dynamics and regulatory requirements, provide similar community benefits and yet are granted far more favorable tax treatment, the traditional justification for granting charitable status is increasingly subject to scrutiny. Compensating independent directors contributes to this trend and further blurs the line between charitable and for-profit entities.

Because compensating independent directors departs from the charitable industry and judicially recognized norm and creates unavoidable conflicts of interest, public charities that undertake this practice should do so only if they have a sound and convincing rationale.

### **Response and Evaluation:**

Without attributing any of the following to any one of your organizations, the rationales submitted by your organizations to justify the practice were very similar. We have therefore aggregated the various rationales into 12 categories<sup>1</sup> and respond to them as follows.

(1) Our organizations are complex, heavily regulated and have thin margins and therefore require more highly skilled and experienced directors. We do not question the complexity of your organizations, the level of regulation, the size of your margins, or the skill and experience of your directors, however we have neither seen, nor are we aware of, any evidentiary basis to suggest or establish that your organizations are more complex, more regulated, have thinner margins, or enjoy more skilled and experienced directors, than (for illustrative purposes only) our large hospital systems and their uncompensated boards. We note that your boards do reflect different experience and skill sets with some reflecting a greater level of insurance and health industry experience than others. We have, however, been provided with no information that would establish that the relationship between organizational characteristics and the roster of experience and skills contained within each board is materially different from that which may be exhibited by other large, complex, heavily regulated charitable organizations with thin operating margins that do not compensate directors.

(2) Our directors commit significant time and effort to their board duties. Again, we are willing to acknowledge the significant level of commitment made by all of your respective directors. Nevertheless, no relevant comparative data has been submitted to suggest or substantiate that this level of commitment is greater than that of other large and complex Massachusetts public charities that have not found compensation necessary to attract the service of skilled and dedicated individuals. Moreover, we expect that many smaller charitable organizations, that lack the management and administrative depth of your organizations, may well demand similar levels of commitment from their directors.

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<sup>1</sup> We are not suggesting that by aggregating responses into categories that all four organizations provided all the rationales described herein or, if provided, ascribed to them the same relative significance.

(3) Our directors provide services that we would otherwise have to pay for. Again, we have been provided with no data to support this statement. Moreover, we have no basis to conclude that directors of other charitable organizations, particularly those which lack your organizations' management and administrative resources, do not provide services that might otherwise have to be paid for.

(4) Our competitors pay their directors so we must follow suit in order to be competitive. Of the eight Massachusetts based charitable health insurers, only your four organizations pay directors. In the aggregate, your four organizations represent the vast majority of the commercial insurance market in Massachusetts. If competition among the four insurers for director skill and talent is the motivation and foundation for compensation, then each organization can cease the practice. Moreover, even if such competition exists, no evidence has been submitted that compensation has played a material role in addressing such competition.

(5) Nationally health insurers (both for-profit and non-profit) overwhelmingly pay their directors so our organizations must do likewise to compete for directors. What occurs on a national level is irrelevant absent evidence that your organizations compete with these national plans for the services of your directors. No such evidence has been submitted. In fact, nearly all of your directors live and work in Massachusetts, which suggests, at minimum, that none of your organizations compete nationally for talent.

(6) Our organizations are highly regarded and nationally ranked at or near the top. Your organizations' national rankings are well known and your efforts in this regard are to be recognized and applauded. Nevertheless, Massachusetts enjoys the presence of many hospitals, universities and other large complex charities which have obtained this stature and recognition with the dedicated assistance of directors who serve without compensation.

(7) Our compensation amounts are consistent with market data and have been developed with the use of outside consultants.<sup>1</sup> The compensation amounts paid by your organizations may well be consistent with organizations that pay their directors and may also have been established with the advice of outside consultants, however we have questioned only whether there exists a sound foundation and rationale for the payment practice, not the amount.

(8) The aggregate amount paid to our independent directors is small in relationship to our overall expenses. Again, we have questioned only whether there exists a sound foundation and rationale for the practice, not the amount your organizations pay. In the current environment, where health care is increasingly unaffordable, to suggest that a cost is justified simply because it is small in relationship to overall costs, is inappropriate and unsupportable.

(9) We do not engage in fund raising and our organizations' federal tax exempt status is found in section 501(c)4 of the Internal Revenue Code rather than 501(c)3. We acknowledge

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<sup>1</sup> We also note several of your organizations concluded that because management did not establish director compensation, no conflict of interest existed. While the avoidance of management participation, direct or indirect, in director compensation decisions is absolutely appropriate, it does not eliminate the inherent conflict that exists when directors, with or without the assistance of outside consultants, establish, and then set the amount of, their own compensation.

that those characteristics distinguish your organizations from many of our public charities. We also accept that the need to generate charitable contributions may influence board characteristics. We find no basis, nor have you articulated any basis, for tying these distinctions to a need to compensate board members.

(10) Compensation of directors materially contributes to a level of commitment and attention needed to assure an attentive and engaged board that takes its responsibilities seriously. Your organizations have submitted no empirical evidence to support this assertion. Moreover, absent a clear tie between compensation and unique characteristics of your organizations, the inevitable outcome of this position would challenge the very foundation of voluntary service on the boards of our public charities throughout the Commonwealth. Neither this office, nor do we believe the public you serve, is prepared to tie responsibility and commitment to pay or to suggest that those who provide services voluntarily are less committed and attentive.

(11) The practice of director compensation is not illegal. We do not believe that the appropriate governance standard for Massachusetts public charities should be whether or not a practice is illegal.

(12) Our organizations are not typical charities, we operate in a largely for-profit industry, and both potential board members and the public do not view us as charitable. We accept that on a national basis the health care insurance industry is largely for-profit. This is not true in Massachusetts and, absent evidence to the contrary, it is in Massachusetts that the pool of potential directors exists. While we appreciate the candor, we are troubled by the statement that neither the public nor potential board members view your organizations as charitable. Assuming, for the sake of argument, that this is true and that the candidate pool views board service as it would a for-profit, compensating directors simply exacerbates that misperception and further blurs the line between for-profit and charitable institutions. Moreover, we have been provided with no evidence, by affidavits, personal statements or otherwise, that any of your organizations' directors considered compensation in agreeing to serve, or conditioned their service on the receipt of compensation, and based, in either event, on perceived lack of charitable status.<sup>1</sup>

### **Conclusion:**

Based upon the foregoing we have determined that the rationales submitted by your organizations are unsupported, the practice currently lacks an adequate foundation and, as such, the practice fails to meet the standard of good governance that this office believes should be expected of a public charity.

Accordingly, we intend to take two actions:

- (1) Commencing in 2012, the office will require annual statements from all Massachusetts based public charities that compensate independent directors setting

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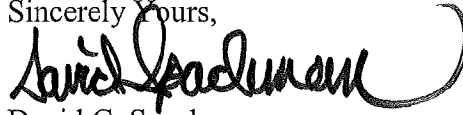
<sup>1</sup> We note that one organization provided anecdotal information about a potential board candidate declining the position due to lack of compensation. This, it is stated, was a contributing factor to the decision to institute compensation. In response we simply note that, even if verified and documented, one incident does not constitute a pattern that would establish an adequate rationale for the practice.

forth, in detail, the basis and rationale for the practice. In the interest of greater transparency, those statements, director compensation levels, and our evaluations, will form the basis of an annual public report by this office. Through this annual report mechanism, we hope your organizations, and any others that compensate directors, will continue to assess and re-assess the practice and that voluntary service will continue to be the hallmark of public charity governance.

- (2) In addition, we are filing legislation to authorize our office to prohibit your organizations from continuing to compensate directors without proper oversight. This legislation requires Massachusetts based charities that intend to compensate their directors to receive approval from this office prior to undertaking this practice and therefore ensure that only charities that have a clear and convincing rationale for compensating directors may do so. Charities that have failed to justify the practice will be prohibited from doing so.

We hope that Tufts Health Plan and Harvard Pilgrim Health Care will once again reconsider and end the practice of compensating directors and urge any other charities that compensate directors to re-evaluate the practice and maintain it only if they can demonstrate a clear and convincing rationale for the practice.

Sincerely Yours,



David G. Spackman

Chief

Non-Profit Organizations/Public Charities Division

Office of the Attorney General