# STATE OF MINNESOTA
# OFFICE OF THE ATTORNEY GENERAL

## Compliance Review of Allina Health System and Medica Health Plans

**Volume 5**
**Executive Compensation**

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# *EXECUTIVE COMPENSATION*

## I. INTRODUCTION

Both Allina and Medica are non-profit, tax-exempt organizations established pursuant to the provisions of Minn. Stat. ch. 317A. In addition, Allina is registered as a charitable organization pursuant to Minn. Stat. ch. 309 and 26 USC § 501(c)(3). The following examines the compensation and benefits paid to executives of Allina. Based on the information provided by Allina, the State questions whether the compensation paid to certain executives and the manner in which it was paid are consistent with the provisions of the state and federal laws referenced above.

## II. APPLICABLE LAW

### A. Minnesota Non-Profit Corporation Act.

The Minnesota Non-Profit Corporation Act (the "Act"), Minn. Stat. ch. 317A, is based in substantial part on the American Bar Association Revised Model Non-Profit Corporation Act adopted in 1987. The Act provides that the board of directors of a non-profit corporation is responsible for the management of the business and affairs of the corporation. Minn. Stat. § 317A.201. In carrying out their responsibilities under the Act, officers and directors have three basic fiduciary duties under the Act: (1) the duty of care; (2) the duty of loyalty; and (3) the duty to follow the law. Minn. Stat. §§ 317A.251, subd. 1. 317A.255 and 317A.011, subd. 5. These duties are owed to the corporation itself and apply to the setting of compensation as part of the business and affairs of the corporation. Indeed, the Official Comments to the ABA Revised Model Non-profit Corporation Act state that in setting directors' and officers' compensation, the board must comply with the Model Act standards of care, loyalty and obedience to the law.

Comments, § 8.12. Accordingly, the comments state that the payment of reasonable compensation for services rendered is permitted, but unreasonable levels of compensation are not permitted. Comments, § 1.40, 3.01, 8.12, 13.01.

Minn. Stat. § 317A.301 provides that a corporation must have persons exercising the functions of the offices of president and treasurer. Further, the board may elect or appoint other officers that it considers necessary for the operation and management of the corporation, each of whom has the powers, rights, duties, responsibilities, and terms provided for in the corporation's articles of incorporation or bylaws or as determined by the board. Minn. Stat. § 317A.311.

**B. "Private Inurement" Doctrine.**

To qualify for and retain tax-exempt status under §§ 501(c)(3) and (c)(4) of the Internal Revenue Code, an organization must be organized and operated so that "no part of ... [its] net earnings ... inures to the benefit of any private shareholder or individual." 26 USC §§ 501(c)(3), (c)(4). This statutory requirement is known as the "private inurement" doctrine and has been summarized as follows:

> [T]he private inurement doctrine forbids ways of causing the income or assets of a healthcare organization (or other tax-exempt organization that is subject to the doctrine) from flowing away from the organization and to or for the benefit of one or more persons (usually individuals) with some significant relationship to the organization, for noncharitable purposes.

Thomas Hyatt & Bruce Hopkins, *The Law of Tax-Exempt Health Care Organizations*, § 4.1 at p. 56 (2d ed. 2001).

The payment of reasonable compensation by a tax-exempt organization does not result in private inurement. See, e.g., *B.H.W. Anesthesia Found, Inc. v. Commissioner*, 72 T.C. 681, 685-687 (1979). Conversely, compensation in excess of what is reasonable does result in private inurement. See, e.g., *Founding Church of Scientology v. United States*, 412 F.2d 1197, 1200 (CT. CL. 1969), cert. denied, 397 U.S. 1099 (1970). Whether the compensation paid is

reasonable is a question of fact to be decided in the context of each case. *See, e.g., Jones Bros. Bakery, Inc. v. United States*, 411 F.2d 1282, 1285 (Ct. Cl. 1969). Accordingly, whether the compensation paid to an executive by a tax-exempt organization constitutes private inurement must reviewed on a case-by-case basis by reviewing the specific facts and circumstances of each situation.

**C. Limits on Compensation Paid by Tax-Exempt Organizations Under 26 USC § 4958: "Excess Benefit Transactions."**

In 1996, Congress enacted a law authorizing the Internal Revenue Service ("IRS") to impose intermediate sanctions in cases of private inurement that the statute defines as "excess benefit transactions." 26 USC § 4958. An "excess benefit transaction" is defined in the statute as follows:

> The term "excess benefit transaction" means any transaction in which an economic benefit is provided by an applicable tax-exempt organization directly or indirectly to or for the use of any disqualified person if the value of the economic benefit provided exceeds the value of the consideration (including the performance of services) received for providing such benefit. For purposes of the preceding sentence, an economic benefit shall not be treated as consideration for the performance of services unless such organization clearly indicated its intent to so treat such benefit.

26 USC § 4958(c)(1)(a). The "excess benefit" on which the sanction is imposed is simply the amount by which the value of the benefit received by the insider exceeds the value of services for which the benefit was paid. 26 USC § 4958(c)(1)(B).

In a report accompanying the new law, Congress indicated that officials of charitable organizations could avoid running afoul of the law if they adhere to the following steps in making compensation decisions:

- Salaries and benefits must be approved by an independent board or committee whose members are not related to, or likely to be unduly influenced by, the officer whose salary is being set;

- In reaching its decision, the board must rely on salary data and compensation studies that show how much money people in similar jobs earn; and

- The board must document its decision process, showing exactly how it set compensation.[1]

Section 4958 applies to any excess benefit transaction occurring on or after September 14, 1995. It does not apply, however, to revenue sharing or incentive arrangements except to the extent prescribed in regulations adopted by the IRS. 26 USC § 4958(c)(2).

Effective January 10, 2001, the IRS issued temporary regulations under § 4958. The regulations apply to all organizations exempt from federal taxes under § 501(c)(3) or (c)(4). Accordingly, the regulations apply to Allina and Medica.

The regulations are based on the existing private inurement standards for determining when compensation is unreasonable and excessive. The regulations set forth a "safe harbor" in which compensation is presumed to be reasonable if: (1) the compensation is approved in advance by an authorized body of the tax-exempt organization composed entirely of individuals without a conflict of interest; (2) the board or committee obtained and relied upon appropriate comparability data in making its determination; and (3) the board or committee adequately documented the basis for its determination, concurrently with making that determination. Temp. Reg. § 53.4598-6T(a).

Items included in determining the value of compensation for purposes of reasonableness include all economic benefits provided by an applicable tax-exempt organization including but not limited to all forms of cash and noncash compensation, including salary, fees, bonuses,

[1] Murawski, John, "Law Penalizing Lavish Non-Profit Salaries Causes Uncertainty", The *Chronicle of Philanthopy*. September 19, 1996.

severance payments and deferred and noncash compensation with certain limited exceptions, and payments to welfare benefit plans. Temp. Reg. § 53.4958-4T(b)(1)(ii)(B).

The regulations provide that relevant information to use for comparability in making compensation decisions includes compensation paid by similarly situated organizations, both taxable and tax-exempt, for functionally comparable positions; the availability of similar services in the geographic area of the applicable tax-exempt organization; current compensation services compiled by independent firms; and actual written offers from similar institutions competing for the services of the employee. Temp. Reg. § 53.4958-6T(c)(2)(i).

For a decision to be documented adequately under the safe harbor, the records of the authorized body must note:

- The terms of the transaction that was approved and the date it was approved;
- The members of the authorized body who were present during the debate on the transaction that was approved and those who voted on it;
- The comparability date obtained and relied upon by the authorized body and how the data was obtained; and
- Any actions taken with respect to consideration of the transaction by anyone who is otherwise a member of the authorized body but who had a conflict of interest with respect to the transaction.

Temp. Reg. § 53.4958-6T(c)(3).

As noted above, Section 4598 provides that excess benefit transactions include compensation in the form of revenue sharing arrangements to the extent provided in regulations prescribed by the IRS. The temporary regulations deleted the controversial proposed regulations on this subject, reserving this section to address the matter after further consideration. The IRS explanation states that, in the meantime, it will evaluate revenue sharing arrangements under the general rules governing excess benefit transactions.

## III. ALLINA'S STRUCTURE WITH RESPECT TO THE APPOINTMENT AND COMPENSATION OF OFFICERS.

### A. Articles and Bylaws.

While, as noted above, Minn. Stat. ch. 317A generally provides that it is the responsibility of a corporation's board of directors to appoint and oversee officers of an organization, Allina and Medica included provisions in their governing documents which modify that general rule.

Specifically, Medica's bylaws state that Allina, as the sole voting corporate member of Medica, reserves unto itself the following power:

> Through delegation to its Executive Officer and its President, the selection, appointment, evaluation and termination of the individual performing the functions of the Medica Health Plans President, provided, however, the Medica Health Plans Board of Directors shall collaborate and play a key role in such matters.

Medica Bylaws § 1.3(a)(vii) (Medica's Articles of Incorporation and Bylaws are attached as Exhibit 1). Accordingly, the president of Medica is not accountable to the board of directors of Medica but rather is appointed by and accountable to the Chief Executive Officer and President of Allina.

Similarly, Allina's bylaws modify the provisions which would otherwise be applicable to a non-profit organization under ch. 317A with respect to the appointment and oversight of officers. While Article III of Allina's bylaws generally provides that the board of directors will elect the officers of the corporation and select, appoint, evaluate and, if necessary, terminate the corporation's president and chief executive officer, other provisions in the bylaws delegate certain authorities pertaining to Allina officers. Specifically, Section 6.6 of the Allina bylaws addresses appointed corporate officers and states as follows:

> Appointed officers shall be those positions approved from time to time by the Board, including, but not limited to one or more vice presidents. There shall be as many assistant secretaries and assistant treasurers as determined necessary by the President and Chief Executive Officer. Persons serving as appointed officers are selected by and serve at the discretion of the President and Chief Executive Officer. Appointed officers shall perform such duties and have such responsibilities as may be prescribed from time to time by the President and Chief Executive Officer and shall be members of his/her staff. (Emphasis added).

Allina's Bylaws, Art. VI, § 6.6 (Allina's Articles of Incorporation and Bylaws are attached as Exhibit 2).

Section 6.7 of Allina's bylaws specifically addresses compensation of officers. That section states:

> Unless otherwise determined by the Board of Directors, the compensation, if any, of officers of the corporation shall be fixed from time to time, and reviewed at least annually by the Governance Committee or by any committee or officer authorized by the Board or Governance Committee to do so.

As a result of the above provisions, officers of Allina that are appointed, which includes officers other than the president and chief executive officer, secretary and treasurer, are selected by the President and CEO. Those officers have the duties as assigned by and report to the President and CEO. However, as required by Section 6.7 of Allina's bylaws, the compensation of those officers is to be set by and reviewed at least annually by the Governance Committee or such other committee or officer authorized by the Board or Governance Committee to do so.

## B. Personnel and Compensation Committee.

### 1. General Responsibilities

Allina has established a Personnel and Compensation Committee ("P & C Committee"). Based on the documents provided, it appears that the P & C Committee is the committee which is responsible, pursuant to Section 6.7 of Allina's bylaws, to fix and review the compensation of officers of Allina. The "committee charge" of the P & C Committee as well as the resolution establishing the committee as adopted by the Allina Board of Directors are attached as Exhibit 3.

While the documents attached as Exhibit 3 are noted to be drafts, these documents were represented to the Attorney General's Office to be the "charter documents" of the P & C Committee.

2. **Executive Compensation Philosophy**

Apparently in 1994, Allina adopted an Executive Compensation Philosophy. (Exhibit 4). The purpose of the philosophy was to establish a policy governing executive compensation programs. Among other things, the Executive Compensation Philosophy identified the peer group against which the salaries of Allina executives would be measured and how the competitiveness of such salaries would be determined.

The philosophy identified the appropriate peer group as other large, integrated health care systems, managed care organizations, hospital systems and medical group practices as well as the peer group of each operating group representing the market from which the group draws talent.

With regard to competitiveness, the philosophy indicated that the executive compensation program should provide:

- A total compensation package at or somewhat above median;
- Salaries at the median;
- Annual incentives at median level, yielding total cash compensation at median of incentive-paying organizations;
- Long-term incentives, if used at all, at or somewhat above median levels; and
- Benefits within the median range.

In connection with the design of executive compensation, the philosophy states that incentives should have enough leverage to pay well above average (75th percentile) for

"exceptionally good performance" and even higher (90th percentile) for "truly outstanding performance".

On September 29, 1999, management presented to the P & C Committee a revised Executive Compensation Philosophy, which was subsequently approved by the committee. The revised Executive Compensation Philosophy is attached as Exhibit 5.

The revised Executive Compensation Philosophy modified the peer group to include "general" industry organizations in addition to large integrated health care systems and hospitals, managed care organizations and health plans, and medical groups and practice management companies. With respect to the competitive position, the revised executive compensation philosophy simply notes that the Allina P & C Committee will approve the total Executive Compensation Competitive position submitted by each division, which positions should reflect the particular business and hiring requirements of each Allina division.

The revised Executive Compensation Policy also notes that it is the responsibility of the P & C Committee to "approve actual payments for Allina Health System".

As a result of the revisions to the Executive Compensation Philosophy, the standards against which the compensation of executives was measured became broader and less specific. However, the revised Executive Compensation Philosophy expressly states that the P & C Committee is responsible for approval of compensation to Allina executives.

## IV. COMPENSATION ISSUES

### A. Cash Compensation of Officers.

#### 1. Limited Activity of P & C Committee.

Attached as Exhibit 6 are summaries of the compensation paid to certain officers of Allina.[2] The summaries identify the total compensation paid to these executives, including base salary, incentive pay, deferred compensation and certain other benefits and perquisites, for the years 1998, 1999 and 2000. A more comprehensive list of executives and certain compensation they received is attached as Exhibit 23.

In January 1999, a purported review of the cash compensation paid to Allina's "top" executives appears to have been conducted by Allina management. The results of that review are attached as Exhibit 7. The review compares the 1998 actual compensation of certain executives in Allina with the 1998 "market median". Attached to the review is the market data relied on in connection with the review. It consists of a number of surveys which were "examined" in connection with the preparation of the market review. It is not clear from the review which specific organizations' data was actually utilized in connection with establishing market data and calculating the "market median". Further, it is not known whether the organizations included were comparable to Allina in terms of their structure and revenue; what the breakdown was between non-profit and for-profit organizations; and whether the data actually considered was reviewed by any independent source. Accordingly, it is not possible to determine whether the

[2] The positions included are President and Chief Executive Officer; President, Allina Hospitals and Clinics; Senior Vice President Law and Public Affairs and General Counsel; Senior Vice President Clinical Services and President AMG; Senior Vice President Finance and Administration; Senior Vice President Human Resources; and President, Medica.

"market" that is utilized in the compensation survey is an appropriate gauge against which to measure compensation paid to Allina executives.

It is appears that the compensation and market data was provided by management to the P & C Committee in connection with management's advising the committee that Hewitt Associates had been retained to review the Allina Management Incentive Plan ("MIP") to assure that the future focus of the plan was consistent with the Allina Business Model and "key business strategies and goals". According to management of Allina, the 1998 total cash compensation for Allina's top positions indicates that Allina is not meeting its goal of paying the 75th percentile of total cash compensation when budgeted net income is achieved.

As noted above, it is impossible to determine whether the appropriate market data was utilized for purposes of this comparison. However, even assuming that the data is appropriate, it is not possible to determine whether the goals of the Allina MIP are being achieved upon a review of the data, even though that was the purported purpose for assembling the data. For example, with respect to the 13 Allina positions studied, 10 of the positions received **more** in incentive pay than the "market median". However, without additional data, it is not possible to determine whether such pay is or is not at the 75th percentile. Second, it is interesting to note that of the 13 positions reviewed, eight positions received **more** total compensation than the market median for those positions. Indeed, the Senior Vice President of Information Systems was paid more than 150 percent of the market median, which appears to have included a significant number of for-profit organizations. Yet the survey appears to have been presented by management to the P & C Committee to support the proposition that Allina is not paying sufficient incentive bonuses to its executives.

In June 1999, a Custom Compensation Study prepared by the HayGroup was presented to the P & C Committee. A copy of the study is attached as Exhibit 8.[3] The study reviewed the compensation of five officers: the Executive Officer; the System Vice President, Allina Hospitals; the System Vice President, Clinic Services and President AMG; the System Vice President, Finance and Treasury; and the System Vice President and President, Medica. The study indicates that in comparison to non-profit secular organizations and non-profit religious organizations, the five positions are paid more, and in some cases significantly more, than the market average. However, when compared to for-profit organizations, the compensation for the five positions evaluated is, at least for three of the five positions, less than the market average. However, it appears that the majority of the for-profit organizations studied in this comparison are significantly larger than Allina. Indeed, while Allina reported net annual revenues of approximately **$2.5 billion** during the period studied, the for-profit organizations against which Allina's salaries were compared included organizations with net annual revenues exceeding **$11.6 billion**.

The market survey comparison was presented to the P & C Committee in connection with a review of the CEO's salary. The survey comparison showed that Gordon Sprenger, the CEO, made anywhere from 102% to 153% of the market median of salaries for CEOs of non-profit organizations. The survey also indicated that Mr. Sprenger made less than the market median of CEOs of for-profit organizations, including Aetna U.S. Healthcare, CIGNA and United Healthcare Corporation. The P & C Committee ultimately determined to increase Mr. Sprenger's salary.

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[3] As is apparent from Exhibit 8, the entire HayGroup study was not provided by Allina to the Attorney General's Office.

At its January 11, 2000 meeting, the P & C Committee was presented with various proposals for executive compensation, including information pertaining to the establishment of a peer group comparison, competitive position and pay mix. Attached as Exhibit 9 is a summary of the action taken by the committee in connection with those issues. Among other things, the committee reviewed the proposed market peer group definition for the Allina Health System executives as national and not-for-profit and for-profit integrated health care systems with revenues of $2 billion to $6 billion;[4] organizations with health plans and physician groups of comparable size to those within Allina; and for-profit general industry organizations for select positions where incumbents may be attracted from within those market groups. The total compensation competitive position for executive positions was established as follows:

- Cash compensation (target): 75th percentile of not-for-profit sector;
- Cash compensation (threshold): 50th percentile of not-for-profit sector;
- Base pay: 50th percentile of not-for-profit/for-profit sector, as appropriate for position; and
- Welfare and retirement benefits: 50th percentile of competitive practice.

While the P & C Committee generally approved the proposed total compensation for executive positions on January 11, 2000, the Committee did not review the salaries of executives to determine whether the compensation actually paid was consistent with the compensation standards adopted. Indeed, there is no record that at any time during 1998, 1999 or 2000 did the P & C Committee review the compensation paid to Allina officers, with limited exceptions.[5]

[4] As noted previously, Allina's annual revenue is approximately $2.5 billion, at the low end of the range.

[5] The P & C Committee minutes reflect a review of the compensation paid to the President and CEO and the approval of the compensation initially paid to the Chief Operating Officer of Medica (eleven months after its effective date).

The fact that no such review was conducted in inconsistent with Minnesota law, and Allina's own bylaws and Executive Compensation Philosophy.

2. **Compensation Survey of Integrated Health Networks.**

As noted above, the revised Executive Compensation Philosophy provides, among other things, that executives should be paid salaries at the median level and that the total compensation package available to executives would be at or somewhat above the median. However, as also noted above, it does not appear that the P & C Committee reviewed the salaries of executives to ensure that the compensation was reasonable and consistent with the Executive Compensation Philosophy.

Attached as Exhibit 21 are analyses of certain positions taken from the 2000 edition of the Integrated Health Networks Compensation Survey ("IHN") prepared by William M. Mercer, Incorporated. The IHN surveyed 142 integrated health care systems located throughout the country. Thirteen percent of participants were for-profit organizations and 87% were not-for-profits.

Because Allina is an integrated health care network, it is appropriate to compare the compensation of Allina executives to the survey results. Because titles used by Allina executives are not identical to the position titles used in the survey, it is not possible for the Attorney General's Office to compare all executives' salaries. Accordingly, the following compares the salaries of those Allina executives who occupy positions which appear to have been included in the IHN. While various breakdowns of data are provided in the IHN, the positions utilized for

comparison purposes relate only to organizations with $1 billion or more in net revenue.[6] The Allina positions compared are included in the positions attached as Exhibit 6.

| | 2000 IHN Median Salary | 2000 Allina Base Salary |
|---|---|---|
| Chief Executive Officer | $680,500 | $606,103 |
| Top Managed Care Executive | $291,200 | $434,950 |
| Top Legal Executive | $225,000 | $242,145 |
| Top Human Resource Executive | $195,000 | $222,358 |
| Top Physician Hospital Organization Executive | $159,800 | $398,337 |

The above comparison indicates that rather than paying executives at the median level of similarly situated positions, Allina may be paying some executives almost 250% of the median salary. While these results are based on only one survey, they evidence why it is important that periodic reviews of executive compensation take place. Because neither the Board of Directors of Allina nor its P & C Committee have conducted such reviews, salaries paid to Allina's executives may not be consistent with Allina's own internal standards and the reasonableness of its salaries is subject to question.

**B. Compensation of Chief Operating Officer.**

It is noted in the minutes of the September 29, 1999 meeting of the P & C Committee, a copy of which is attached as Exhibit 10, that the committee reviewed the past consulting

[6] The survey results relating to the position "Top Physician Hospital Executive" are based on all reporting organizations as data for this position was not broken down by net revenue of the reporting organizations.

relationship between Medica and Karen Vigil. The P & C minutes state that, because Ms. Vigil had been given all the responsibilities typical for a chief operating officer, these responsibilities require Allina to make her an employee of Medica in order to ensure that she is covered by director and officer insurance. The minutes indicate that the committee reviewed several documents including a summary of Ms. Vigil's employment considerations which outlined the annual value of her compensation and comparability data provided by Hewitt Associates. The minutes also state that Allina had consulted with attorneys to gain assurance that use of compensation data for an "independent contractor turnaround specialist" is appropriate for the rebuttable presumption surrounding immediate sanctions for disqualified persons under IRS provisions. Based on the documentation provided to the committee, the committee approved an outline for an employee contract with Karen Vigil pursuant to which Ms. Vigil was to receive cash compensation in the amount of $405,000 per year plus a "required deferral" of $405,000 a year. [7]

Contrary to the statements in the minutes, Allina is unable to produce any comparability data prepared by Hewitt Associates which was provided to the committee. Rather, there is a letter from Hewitt Associates, attached as Exhibit 11, which states as follows:

> Allina Health System recently hired a turnaround specialist for the Medica Health Plans. This executive is uniquely qualified to manage and oversee business changes in a health plan organization. Allina Health System designed the compensation package for this executive to reflect the market value and pay levels for an independent turnaround consultant. While the compensation package is

[7] It does not appear from the minutes that the P & C Committee was advised that Ms. Vigil was required to work at Allina only four days a week in exchange for this salary. In addition, while the committee approved payment of cash compensation of $405,000 and deferred compensation of $405,000, the written agreement entered into with Ms. Vigil authorizes payment of cash compensation of $435,250 per year plus deferred compensation of $410,250, bringing her total compensation to $845,500.

higher than that paid to other Allina executives it is consistent with the market rate that an organization, such as Medica, would pay to an outside consultant.

As noted above, while management represented to the P & C Committee that attorneys were consulted to ensure that the use of compensation data for an "independent contractor turnaround specialist" was appropriate comparative data for the rebuttable presumptions surrounding intermediate sanctions for disqualified persons, the guidelines contained in the Congressional Report pertaining to excess benefit transactions were not followed.[8] First, contrary to statements in the minutes, no comparability data was provided. Indeed, it appears that Ms. Vigil's own independent contractor rate was used as the basis upon which to compare her salary demands for employment, without regard to whether such rate was appropriate for a consultant, let alone an employee. Further, while the IRS regulations pertaining to excess benefits were not in effect at the time this contract was entered into, the Congressional Report indicated, among other things, that a governing body should rely on salary data and compensation studies that show how much money persons in similar positions earn as well document its decisionmaking process, showing exactly how it set the compensation. In this case, no such documentation of the decisionmaking process is provided. Instead, Hewitt Associates simply notes that Ms. Vigil is being paid more than other Allina executives -- including even the president and chief executive officer. There is no support in the minutes for the proposition that payments proposed to be made to Karen Vigil were reasonable and in the best interest of Allina. Further, while the arrangement was approved by the P & C Committee on September 29, 1999, written documentation indicates that the employment arrangement was to be effective January 1,

[8] While the IRS regulations pertaining to excess benefit transactions were not in effect at this time, the guidelines contained in the Congressional Report issued in connection with enactment of Section 4958 provided guidelines to be followed by non-profit organizations in the interim.

1999. There is no explanation in the minutes as to why the retroactive agreement was necessary or in the best interest of the company. Further, it is not clear whether such retroactive approval is even permissible under Section 4958 of the Internal Revenue Code.[9]

The minutes of the P & C Committee meeting held on September 26, 2000 indicate that the Committee "concurred with the Chief Executive Officer's recommendation regarding the proposed compensation for the Chief Operating Officer." While not clear, it appears that this approval pertains to an amendment to Ms. Vigil's contract which occurred on October 1, 2000 which increased Ms. Vigil's cash compensation by $130,000. As a result of the amendment, Ms. Vigil's cash compensation was increased from $425,250 to $565,250. Ms. Vigil continued to receive the $410,000 deferred compensation to which she was entitled under the terms of the original agreement. As a result, effective October 1, 2000, Ms. Vigil was earning in excess of $975,000. The minutes contain no record of any comparability data being reviewed or other basis which supports the P & C Committee's approval of the payment of $975,000 per year to the chief operating officer of a non-profit HMO.

Pursuant to a "new" employment agreement with Ms. Vigil which was signed April 10, 2001 and made effective January 1, 2001, Ms. Vigil was entitled to compensation and a living allowance totaling $1,018,800 per year. In addition, the "new" agreement provided for the early payment to Ms. Vigil of the deferred compensation set aside under Ms. Vigil's prior employment agreement.

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[9] The "safe harbor" contained in the temporary regulations adopted by the IRS requires that compensation arrangements be approved in advance by the governing body. Temp. Reg. § 53.4958-6T(a)(1).

## C. Programs and Benefits Offered to Executives.

The programs and benefits offered to Allina executives are numerous. Some of those programs and benefits are described below.

1. **Pension Plans.** Allina offers executives two employee benefit programs which would be considered pension accounts or qualified retirement plans. The programs are independent of each other and provide for tax-free contributions to two separate tax deferred accounts.

a. **The "Cash Balance" Defined Benefit Plan.** This is generally a defined contribution pension plan pursuant to which employees receive 3.25%, 4%, 5.25% or 5.75% of their salary on an annual basis depending on seniority. Employees receive benefits through choice of an annuity or lump sum payment at retirement or upon a break in service (subject to certain vesting standards).

b. **401(k)/403(b) Plan.** Allina generally offers participation in a 401(k)/403(b) Plan to all employees. This plan allows an employee to defer wages under a savings program on a tax-deferred basis. Allina matches 50% of the amount deferred by employees up to a maximum of 2% of an employee's salary.

2. **Flexible Spending Accounts.** Allina has a Cafeteria Plan which allows employees to pay expenses relating to daycare and medical expenses with pre-tax deferrals of their compensation. Maximum deferrals are $5,000 for medical and $5,000 for dependent care expenses.

3. **Allina Management Incentive Program ("MIP").** This is a bonus program which applies to certain managers and executives. Goals are established for each management participant. Depending on the position held by the individual, the goals have varying weights

assigned to them. However, the MIP is to be funded only if Allina reaches a threshold of 80% budgeted net income.[10] The following chart sets forth the amounts of bonuses that would be paid if the thresholds are met:

| | *% of Base Salary (80% of Budgeted Net Income ("BNI"))* | *% of Base Salary (100% of BNI)* | *% of Base Salary (125% of BNI)* |
|---|---|---|---|
| **Managers** | 9.6% | 12% | 15% |
| **Directors** | 20% | 25% | 31.25% |
| **Vice Presidents or Above** | 32% | 40% | 50% |

As is apparent from the above, the MIP could pay bonuses of anywhere from 9.6% to 50% of a person's base salary. As noted above, these bonuses could only be paid if Allina achieved a certain level of net income. Because Allina and Medica are non-profit organizations, their focus and mission should not be profit-motivated. Consequently, it does not appear to be consistent with the purpose of a non-profit organization that bonuses be conditioned on the organization's increasing its net income. Indeed, with respect to Medica, the tying of bonuses to net income encourages executives to increase premiums, which is clearly not in the best interest of Medica's members.

4. **Long-Term Incentive Plan.** Four of Allina's top executives participated in the Long-term Incentive Plan commencing in 1997. Additional executives were subsequently approved to participate in the plan. This program provides the executive with the opportunity to

[10] In March 1999, the MIP was revised so that three separate funding pools were established: Allina Health System, Hospitals and Clinics and Medica. Effective for fiscal year 2000, three separate MIPs were established: the Allina Health System and Shared Services Annual Incentive Plan; the Allina Health System Hospitals and Clinics Division Annual Incentive Plan; and the Allina Health System Medica Division Annual Incentive Plan.

earn a bonus equal to an additional 80% of his or her base salary. The Plan provides that once Allina reaches a performance target equal to a specified return on net assets, the "executive pool" is credited with 50% of the excess earnings (or possibly reduced by any earnings shortfall). The benchmark return on net assets was 21% in 1997, 25% in 1998 and 26% for years thereafter. In arriving at earnings to calculate the return on net assets, Allina begins with its audited net income or loss and adds back a "community benefit" that was generally described as amounts reported in Allina's financial statements for social service programs, free or reduced fee clinics, health screening, in-home care giver services, support counseling services, pastoral care, donated space and unreimbursed costs. In arriving at "net income," Allina also added all donations to its various foundations but did not deduct any charitable expenditures.

The Attorney General's Office learned that eight executives were to receive approximately $4.5 million in payments under the Long-Term Incentive Plan in 2001. Allina has since advised the Attorney General's Office that it will not be paying these bonuses and will be revising the Long-Term Incentive Plan. As noted above, it does not appear consistent with the purpose of a non-profit organization to base bonuses, some apparently equal to $500,000 or more per person, on the net income or "profit" of the organization. Such an approach encourages executives to focus on the "bottom line" of the organization rather than on its charitable mission and on its members.

5. **The Executive Short-Term Disability Program.** Allina executives are entitled to participate in a salary continuation plan which provides a 100% salary benefit for 180 days for short-term disability and permits coverage to begin one day after paid time-off is exhausted.

6. **Supplemental Retirement Program.** This non-qualified compensation program, also known as the SERP, provides certain executives with an additional 2.75%, 3.5% or 4.75%

of base salary, the particular percentage dependent upon the number of years in executive service. Additional SERP amounts are also paid to executives who earn more than the statutory limit on their 401(k)/403(b) Plan and are limited to the amount that they can contribute to those tax deferred programs. (The IRS rules generally capped the salary amount that can be applied to these programs at $160,000 during 1998 and 1999). Any amount that would have been contributed to the company's 401(k)/403(b) Plans had there been no statutory limitation is added to the SERP account of the executive. In addition, certain executives have "grandfathered" arrangements providing substantially more benefits than the contributions outlined above.

7. **Executive Survivor Life.** Management is also entitled to participate in a Survivor Life Insurance benefit which provides additional life insurance on the employee up to twice the employee's salary.

8. **Execu-Flex Benefit Program.** Executives are offered additional benefits which are equal to 9%, 11% or 15% of their base salary under what is known as the Execu-Flex Benefit Program. Certain executives are provided with the ability to purchase additional disability coverage, survivor benefits and spousal life insurance under this program. Funds not used to purchase such benefits may be used by the executive to purchase mutual fund shares through the Key Share program described below.

9. **Key Share.** This benefit allows executives to purchase options to buy interests in mutual funds. The executive uses a deferral of his or her salary to acquire key share mutual fund option interests. The executives are able to exercise those options in the future if the funds appreciate. The tax advantages of investing pre-tax dollars and the potential appreciation of the investment make this option a potentially attractive one to executives.

10. **Miscellaneous Perquisites and Programs.** Executives are provided with the ability to receive an annual physical and be reimbursed up to $200 for the visit. In addition, certain executives are entitled to receive up to $400 reimbursement for health care club memberships, a $3,000 automobile allowance, and golf club memberships.

The above benefit plans provide executives the ability to receive more than an additional 150% of their base salary in the form of incentives, benefits and perquisites. The minutes of the P & C Committee do not reflect any review of the package of benefits and perquisites offered to executives and whether such benefits are reasonable when compared to benefits offered to similarly situated persons. Indeed, based on the documents provided to the Attorney General's Office, it does not appear that the P & C Committee was even aware of certain benefits such as the golf club memberships and health club reimbursements. Consequently, it does not appear that any assessment of the reasonableness of these benefits and perquisites provided to executives was conducted by Allina's Board of Directors or the P & C Committee during the period reviewed.

**D. Establishment of Goals to be Met Under Bonus Programs.**

**1. Modification of MIP Goals**

The philosophy of the MIP is to:

> Focus attention on the attainment of financial and non-financial results, as well as individual goals, which are all necessary so that the corporation's charitable purpose and strategic business objectives are met each plan year. (Exhibit 12).

In connection with the goal stated above, the P & C Committee establishes goals and measurements for the bonus programs in which executives participate. In connection with the MIP, incentive payments are not to be paid unless Allina reached 80% of its budgeted annual net income. When it became clear in 1998 that Allina would not meet the funding threshold of 80%, management approached the P & C Committee to suggest that the funding threshold be reduced

from 80% to 60% of budgeted net income. The P & C Committee granted management's request and reduced the funding threshold. It does not appear consistent with the goals of Allina or the purpose of an incentive program such as the MIP for a reduction in the goals to be attained to be made during the course of the year. As a result of the reduction in the threshold, approximately $2.6 million in incentive payments were made to management of Allina which would not have otherwise been paid had the original goals been enforced. This included payments of $65,000 to Jim Ehlen and $100,000 to Gordon Sprenger.

Similarly, with respect to FY'99, the MIP required Medica to show an adjusted income of $5.9 million in order for the executives to be paid a bonus. Medica's adjusted income under the MIP was $7.8 million and, accordingly, bonuses were paid. It appears that the only reason Medica reported a $7.8 million adjusted MIP income was because $6 million in 1999 premium taxes were allocated to the 1998 financial statement. (Exhibit 22). In fact, had the gross premium tax been properly allocated, the executives would not have entitled to a bonus. Because the company failed to deduct the amount of the gross premium tax, a bonus was paid to executives to which they would not otherwise have been entitled. While not clear, it does not appear that the P & C Committee was aware of this irregularity when it approved the funding of the MIP for Medica executives for FY'99.

2. **Modification of Long-Term Incentive Plan Goals**

The goals established for bonuses under the Long-Term Incentive Plan were also modified mid-way through a plan year. Specifically, at the July 1, 1998 meeting of the P & C Committee, management suggested that the committee modify the health plan service excellence measure in the FY '98 Long-Term Incentive Plan from FY'97 actual performance to the FY'98 budgeted level. According to the Systems Vice President, this was due to the "expected and

desired turnover of some enrollment groups." As a result, this goal was modified by the P & C Committee.[11] One questions why, if the turnover of certain enrollment groups was "desired and expected", such a turnover was not factored into the goals of the plan at the beginning of the plan year.

As noted above, officers and directors of a non-profit organization have a duty to discharge their duties in good faith and in a manner which is in the best interest of the corporation. It is unclear how those duties were fulfilled under the circumstances described above where the incentive standards established for the betterment of the corporation are not reached by the executives, but yet the executives are rewarded by reducing those standards.

## IV. RETENTION AND SEPARATION AGREEMENTS

### A. Retention Agreements.

1. **Generally.** Since at least 1997, a number of executives have entered into Retention Incentive Agreements with Allina pursuant to which the executives are paid significant sums of money simply for remaining employees of Allina. Indeed, in 1999 and 2000 alone, Allina paid more than $1 million to employees simply as a result of the employees remaining employees of Allina. (Exhibit 13). An additional approximately $600,000 is shown as a liability for future retention payments at December 31, 2000. During 1997, at least three executives entered into retention arrangements: the System Vice President of Law and Public Affairs and General Counsel received a retention payment of $100,000; the President of Medica received retention payments of $300,000; and the System Vice President of Human Resources received a retention payment of $125,000.

[11] Despite the reduction in the goals of the Long-term Incentive Plan, no bonus payments were made under that plan for fiscal year 1998.

As is apparent from previous sections, the management of Allina appears to be particularly cognizant of ensuring that compensation paid to Allina executives is more than competitive. Accordingly, it is not clear how the payment of "retention" compensation is in the best interest of Allina as the salaries paid to Allina executives are intended to be sufficient to retain quality employees. It certainly appears that such retention payments could be challenged under the excess benefit transaction standards of the IRS. Indeed, an excess benefit transaction is defined as any transaction in which an economic benefit is provided to a person where the value of the benefit exceeds the value of the consideration (including the performance of services) received for providing such benefit. Here, the only consideration provided is continued employment, for which the executive is otherwise compensated.

2. **Retention Incentive Agreement with President of Medica.** David Strand, President of Medica, entered into a Retention Incentive Agreement with Allina on December 23, 1997, a copy of which is attached as Exhibit 14. The agreement states that Allina desired to enter into such an agreement because it "desires to continue to retain the services of [Mr. Strand] during a period of potential uncertainty and transition in the company's history".

Under the terms of the Retention Incentive Agreement, Mr. Strand received a "signing bonus" equal to $100,000 and was entitled to receive an additional $200,000 if he remained an Allina employee on November 1, 2000. However, rather than adhering to the terms of the agreement, on December 1, 1999, Allina accelerated payments under the incentive agreement in order to make an early $100,000 payment to Mr. Strand (Exhibit 15). This accelerated payment is inconsistent with the very purpose of the agreement as stated on its face. Further, there is no record in the minutes of the P & C Committee that it approved the modification of Mr. Strand's Retention Incentive Agreement or the accelerated payment made thereunder.

3. **Retention Agreement with Former Senior Vice President of Finance.** Another Retention Agreement of particular note is that entered between Allina and Richard Blair, the former Senior Vice President of Finance and Treasurer, entered into as of January 1, 1999. A copy of this Retention Agreement is attached as Exhibit 16. The Retention Agreement with Mr. Blair commits Allina to employing Mr. Blair as an "executive consultant" or a period of three years beginning January 1, 2000. Mr. Blair is to transition and mentor his successor as Senior Vice President of Finance in his role as an executive consultant.[12] [13]

As an executive consultant, Mr. Blair was to be compensated at the rate of approximately $280,000 a year. For this compensation, Mr. Blair was to work at least 700 hours a year (less than 18 weeks). In addition, Mr. Blair was entitled to receive up to $25,000 travel allowance as well as 24 months of severance following the three-year period, in the amount of almost $16,000 per month. Accordingly, over the five-year period, Mr. Blair was guaranteed to receive a minimum of $1.2 million.

While employed as Senior Vice President of Finance and Treasurer, Mr. Blair received a base salary of $269,745. Interestingly, in his role as an "executive consultant" who is required to work less than half-time, he is entitled to $280,000 per year. Considering that Mr. Blair's successor was a current executive of Allina, it is unclear why three years of transitioning and

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[12] While the agreement requires Mr. Blair to transition and mentor his successor as Senior Vice President of Finance, the person who succeeded Mr. Blair in that position was David Jones, another Allina executive who had been employed by Allina for years.

[13] While the agreement entered into with Mr. Blair is entitled "Retention Agreement," payments made to Mr. Blair pursuant to the agreement are referred to as "severance payments." See Exhibit 24. Accordingly, it is unclear exactly what was the purpose of the agreement between Mr. Blair and Allina.

mentoring was required. It is unclear how it could be concluded that this agreement was in the best interest of Allina.

**B. Severance Plans and Separation Agreements.**

1. **Generally.** Allina offers its employees severance benefits which vary depending upon the position held by the employee. Attached as Exhibit 17 is a summary of Allina Health Systems Severance Plans. Persons entitled to participate in the Severance Plans are those persons (1) who have been employed for at least one year, (2) whose jobs have been eliminated without an offer of a comparable and (3) who do not have employee contract with the company.

Executives are eligible to participate in Severance Plan 100 or Severance Plan 200. Persons who are eligible to participate in Severance Plan 100 include executives who are in the Execu-flex benefit plan at an 11% rate or greater. Among other things, Severance Plan 100 provides participants with 18 months salary continuation with continuation of pension, life, health, dental and other benefits in the executive benefit plan during the period of salary continuation.

Eligible participants in Severance Plan 200 are those persons who participate in the Execu-flex benefit plan at the 9% level. Benefits provided under Severance Plan 200 include 12 months salary continuation and continuation in the pension, life, health, dental and other executive benefits in accordance with each plan's terms.

Allina has three other severance plans for its employees with varying ranges of severance pay and continuation in benefit programs.

As noted above, in order to participate in a severance program, an employee must meet three requirements: the employee must have been employed for at least a year, he or she must not have been offered a comparable position and he or she must not have had an employment

contract with Allina. A review of certain executive separation agreements indicates that Allina has paid millions of dollars to executives upon their termination of employment with Allina, even though those executives would have been entitled to no payments under Allina's Severance Plans. Further, there is no record that these separation or salary continuation payments have been approved by the P & C Committee or the board of directors. Certain of these separation arrangements are discussed below.

2. **Separation Agreement with Jim Ehlen.** On September 15, 1999, Allina and Jim Ehlen entered into a Separation Agreement confirming Mr. Ehlen's resignation effective September 1, 1999. A copy of Mr. Ehlen's Separation Agreement is attached as Exhibit 18. Because Mr. Ehlen voluntarily resigned his position, he was not entitled to severance pay under Allina's Severance Plan. Nonetheless, the Separation Agreement provides Mr. Ehlen with gross payments of $832,977.60 over a period of 18 months. Other benefits provided to Mr. Ehlen under the terms of the Separation Agreement include Mr. Ehlen's entitlement to post retirement medical coverage for 10 years under the terms of Allina's Employee Benefit Plan.

The Separation Agreement with Mr. Ehlen states as follows:

> Employee was offered those amounts and benefits as provided in Severance Plan 100, without the requirements that Employee refrain from competition with the Employer and release and forfeit claims pursuant to Exhibit A to this Agreement, which offer Employee rejected. Employee was offered those benefits and payments described in paragraph 2 of this Agreement with the requirements that Employee refrain from competition as described in paragraph 9 of this Agreement and release claims pursuant to Exhibit A, which offer Employee accepted.

The above language appears to indicate that Mr. Ehlen rejected the benefits provided under Severance Plan 100 and refused to release and forfeit claims that he may have against Allina in exchange for those benefits. Since Mr. Ehlen was the President of Allina, it is unclear what claims he may have against the company, and if he did have any such claims, why there is

no record of him discussing those issues with the board of directors or the P & C Committee. In any event, upon his departure from Allina, Mr. Ehlen received benefits which were not available to other employees and which do not appear to have been approved by the board of directors or the P & C Committee.

3. **Separation Agreement with Lynda Goldman.**

Lynda Goldman was employed by Allina as "Senior Vice President of Organizational Effectiveness, Medica Health Plans". Ms. Goldman was apparently hired by Allina on or about October 17, 2000.

Just five months after she was hired, on March 16, 2001, Ms. Goldman's employment with Allina terminated. Despite the fact that, in order to participate in the Allina Severance Plan employees had to have been employed for at least one year, Ms. Goldman was paid separation payments under the term of the Separation and Release Agreement attached as Exhibit 19. While Ms. Goldman was employed by Allina for only **five months**, Ms. Goldman received severance payments for **nine months**. The benefits paid to Ms. Goldman include the following:

- Severance payments pro-rated in an amount equal to employee's base annual salary payable for a nine month period;
- Payment by Allina of its portion of COBRA expenses for medical and life coverage;
- Reimbursement of Ms. Goldman's temporary housing expenses through July 31, 2001;
- Reimbursement of Ms. Goldman's moving, business, temporary living and business expenses provided that moving expenses may not exceed $30,000; and
- Payment of employee's MIP for fiscal year 2001 in an amount equal to $75,000.

Based on the information provided, it is unclear how the Separation Agreement entered into with Ms. Goldman was in the best interest of Allina.

### 4. Separation Agreements Entered into with Various Other Executives.

Allina entered into separation arrangements with a number of executives between 1998 and 2000. In certain cases, it appears that the executives' positions were eliminated and that, accordingly, those executives were entitled to severance payments under the Allina Severance Plans. However, in the 13-month period from July, 1999 to August, 2000, there are at least ten cases where the executive resigned his or her position, thereby disqualifying himself or herself from receiving benefits, where Allina still agreed to continue the salary of these executives. (Exhibit 20). With respect to these ten executives alone, Allina paid a total of approximately $2.7 million in severance and lump sum payments. There is no record that any of these Separation Agreements were approved by the P & C Committee or the board of directors of Allina.

The pattern of payment arrangements that was undertaken with former executives raises significant questions. First, as noted above, these agreements do not appear to have been approved by the P & C Committee. Second, either something was amiss in the management of Allina that such a significant number of executives had potential claims against the company that it was reasonable to compensate them for a release of such claims or alternatively, monies were being paid upon the departure of executives for which Allina received no meaningful consideration. Either scenario raises serious concerns.

## V. ANALYSIS AND CONCLUSION

As noted above, Minn. Stat. ch. 317A states that the board of directors of a non-profit corporation is responsible for the management of the business and affairs of the corporation. With respect to the compensation of officers, Allina's own bylaws state, in effect, that the compensation of officers is to be fixed and reviewed at least annually by the P & C Committee.

The official comments to the ABA Revised Model Non-profit Corporation Act state that in setting directors' and officers' compensation, a board of directors must comply with the standards of care, loyalty and obedience to the law. Comment, § 8.12. In that regard, the Comments state that the payment of "reasonable compensation" for services rendered are permitted, but unreasonable levels of compensation are not permitted. Comment, §§ 1.40, 3.01, 8.12 and 3.01.

In addition, as noted above, laws and regulations enforced by the IRS set forth certain processees and considerations that should be undertaken by a tax-exempt organization in connection with payment of compensation to its officers. These laws and regulations generally require that the board of directors, or a committee acting in its stead, follow certain guidelines to avoid intermediate sanctions arising out of the payment of excess benefits.

With respect to the financial transactions described above, Allina violated the principles and guidelines set forth in state and federal law on numerous occasions.

The P & C Committee did not review the compensation of executives as was required and was simply ignored by management with respect to many compensation decisions. As a result, the following monies appear to have been spent with little or no director oversight or approval:

- The payment of approximately $38 million to Allina executives from 1998 to 2000;
- The payment of a total of at least $3.5 million in salary continuation payments to executives under terms inconsistent with Allina's severance plans.
- The offering of approximately ten different benefit plans to executives which can increase an executive's compensation by up to 150 percent of base salary; and
- The early payment of $100,000 to the President of Medica pursuant to an amendment to the Retention Incentive Agreement.

Further, as noted above, there is no record that the P & C Committee utilized any comparability data in analyzing the amount of compensation paid to Allina's highest paid employee -- the chief operating officer of Medica, Karen Vigil. As a result, the P & C Committee had no basis upon which to evaluate whether the compensation proposed to be paid to Ms. Vigil was reasonable. Second, the P & C Committee did not follow the general guidelines articulated by Congress in connection with its enactment of Section 4958 of the Internal Revenue Code in evaluating and approving Ms. Vigil's compensation.

Even where the P & C Committee was consulted by management on compensation issues, it does not appear that complete and meaningful information necessary for the committee to evaluate the issues was provided to or requested by the committee. Indeed, the quality of the "comparability data" against which the salaries of certain executives was measured was questionable in at least one case and totally nonexistent in another.

Officers of Allina are entitled to reasonable compensation as determined by the board of directors or its P & C Committee. While it is generally beyond the scope of this review to determine whether the specific compensation paid to any particular executive is reasonable, it is apparent that Allina failed to ensure that the compensation of its officers was established and reviewed in the manner required by its own governing documents, as well as by state and federal law.

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