AMERICAN HEALTHWAYS INC
Form DEF 14A
December 20, 2002

SCHEDULE 14A
(Rule 14a-101)

INFORMATION REQUIRED IN PROXY STATEMENT

SCHEDULE 14A INFORMATION

Proxy Statement Pursuant to Section 14(a) of the Securities Exchange Act of 1934 (Amendment No.)

Filed by the Registrant x

Filed by a Party other than the Registrant o

Check the appropriate box:

o Preliminary Proxy Statement

o Confidential, for Use of the Commission Only (as permitted by Rule 14a-6(e)(2))

x Definitive Proxy Statement
o Definitive Additional Materials
o Soliciting Material Pursuant to Rule 14a-11(c) or Rule 14a-12

American Healthways, Inc.

(Name of Registrant as Specified In Its Charter)

(Name of Person(s) Filing Proxy Statement, if other than the Registrant)

Payment of Filing Fee (Check the appropriate box):

x No fee required.
o Fee computed on table below per Exchange Act Rules 14a-6(i)(1) and 0-11.

(1) Title of each class of securities to which transaction applies:

(2) Aggregate number of securities to which transaction applies:

(3) Per unit price or other underlying value of transaction computed pursuant to Exchange Act Rule 0-11 (set forth the amount on which the filing fee is calculated and state how it was determined):

(4) Proposed maximum aggregate value of transaction:

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o Fee paid previously with preliminary materials:

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(1) Amount Previously Paid:

(2) Form, Schedule or Registration Statement No.:

(3) Filing Party:

(4) Date Filed:

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3841 Green Hills Village Drive

Nashville, Tennessee 37215

NOTICE OF ANNUAL MEETING OF STOCKHOLDERS

Stockholders of American Healthways, Inc.:

The Annual Meeting of Stockholders of American Healthways, Inc., a Delaware corporation (the Company), will be held at the SunTrust Center, 5th Floor Auditorium, 424 Church Street, Nashville, Tennessee 37219, at 9:00 a.m., local time, on Wednesday, January 22, 2003 for the following purposes:

(1) To elect two (2) directors, to hold office for a term of three (3) years or until their successors have been elected and qualified;

(2) To consider and act upon a proposal to amend the Company s 1996 Stock Incentive Plan (the 1996 Plan) to increase the number of shares of the Company s common stock available for issuance under the 1996 Plan by 400,000 shares;

(3) To approve the Amended and Restated 2001 Stock Option Plan (the 2001 Plan); and

(4) To transact such other business as may properly come before the meeting, or any adjournment or postponement thereof.

The proxy statement and form of proxy accompanying this notice are being mailed to stockholders on or about December 20, 2002. Only stockholders of record at the close of business on December 2, 2002 are entitled to notice of and to vote at the meeting or any adjournment or postponement thereof.

Your attention is directed to the proxy statement accompanying this notice for a more complete statement regarding the matters to be acted upon at the meeting.

We hope very much that you will be able to be with us. If you do not plan to attend the meeting in person, you are requested to complete, sign and date the enclosed proxy and return it promptly in the enclosed addressed envelope, which requires no postage if mailed in the United States.

By Order of the Board of Directors

Thomas G. Cigarran
Chairman

December 20, 2002

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AMERICAN HEALTHWAYS, INC.

3841 Green Hills Village Drive
Nashville, Tennessee 37215

PROXY STATEMENT
FOR ANNUAL MEETING OF STOCKHOLDERS

Wednesday, January 22, 2003

The enclosed proxy is solicited by the Board of Directors on behalf of American Healthways, Inc. for use at the Annual Meeting of Stockholders to be held on Wednesday, January 22, 2003, at 9:00 a.m., local time, at the SunTrust Center, 5th Floor Auditorium, 424 Church Street, Nashville, Tennessee 37219, and at all adjournments or postponements thereof, for the purposes set forth in the foregoing Notice of Annual Meeting of Stockholders. Copies of the proxy, this proxy statement and the attached notice are being sent to stockholders on or about December 20, 2002.

The Company s officers and employees may solicit proxies personally or by mail, telephone or facsimile. All costs of this solicitation will be borne by the Company, including expenses in connection with preparing, assembling and mailing this proxy statement. The Company does not anticipate paying any compensation to any party other than its regular employees for the solicitation of proxies but may reimburse brokerage firms and others for their reasonable expenses in forwarding solicitation material to beneficial owners.

Shares represented by such proxies will be voted in accordance with the choices specified thereon. If no choice is specified, the shares represented by such proxies will be voted FOR the election of the director nominees set forth under Proposal No. 1, FOR the approval of the amendment to the 1996 Plan set forth under Proposal No. 2 and FOR the approval of the 2001 Plan set forth under Proposal No. 3. The Board of Directors does not know of any other matters which will be presented for action at the meeting, but the persons named in the proxy intend to vote or act with respect to any other proposal which may be properly presented for action according to their best judgment in light of the conditions then prevailing.

A proxy may be revoked by a stockholder at any time before its exercise by attending the meeting and electing to vote in person, by filing with the Secretary of the Company a written revocation or by duly executing a proxy bearing a later date.

Each share of the Company s common stock, $.001 par value (the Common Stock), issued and outstanding on the record date, December 2, 2002, will be entitled to one vote on all matters to come before the meeting. Cumulative voting is not permitted. As of December 2, 2002, there were outstanding 15,423,540 shares of Common Stock.

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SECURITY OWNERSHIP OF CERTAIN BENEFICIAL OWNERS AND MANAGEMENT

The following table sets forth certain information with respect to those persons known to the Company to be the beneficial owners (as defined by certain rules of the Securities and Exchange Commission (the Commission)) of more than five percent (5%) of the Company s Common Stock, its only voting security, and with respect to the beneficial ownership of the Company s Common Stock by all directors and nominees, each of the executive officers named in the Summary Compensation Table and all executive officers and directors of the Company as a group. The information set forth below is based on ownership information received by the Company as of December 2, 2002. Unless specified otherwise, the shares indicated are presently outstanding, and each of the stockholders listed below has sole voting and investment power with respect to the shares beneficially owned.

Name and Address of Beneficial Owner	Amount of Common Stock Beneficially Owned(1)	Percent of Outstanding Common Stock(1)
FMR Corp. 82 Devonshire Street Boston, MA 02109	1,917,173(2)	12.43%
Waddell & Reed Financial, Inc. 6300 Lamar Avenue Overland Park, KS 66202	1,867,500(2)	12.11
Thomas G. Cigarran**** 3841 Green Hills Village Drive Nashville, TN 37215	1,141,122(3)	7.26
Capital Research & Management Company 333 South Hope Street, 55th Floor Los Angeles, CA 90071-1447	900,000(2)	5.84
Henry D. Herr**	589,742(4)	3.79
Robert E. Stone***	292,654(5)	1.89
William C. O Neil, Jr.**	241,506(6)	1.57
Mary D. Hunter***	61,893(7)	*
Ben R. Leedle***	52,271(8)	*
Martin J. Koldyke**	51,533	*
Frank A. Ehmann**	27,086(9)	*
C. Warren Neel**	27,045(10)	*
Mary A. Chaput***	15,295(11)	*
All directors and executive officers as a group (11 persons)	2,504,165(12)	15.58%

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* Indicates ownership of less than one percent of the Company s outstanding Common Stock.
** Director of the Company
*** Named Executive Officer
**** Director and Named Executive Officer

(1) Pursuant to the rules of the Commission, certain shares of the Company s Common Stock which an individual owner set forth in this table has a right to acquire within 60 days after the record date hereof pursuant to the exercise of stock options are deemed to be outstanding for the purpose of computing the ownership of that owner, but are not deemed outstanding for the purpose of computing the ownership of any other individual owner shown in the table. Likewise, the shares subject to options held by the other directors and executive officers of the Company which are exercisable within 60 days of the record date hereof, are all deemed outstanding for the purpose of computing the percentage ownership of all executive officers and directors as a group.
(2) Information with respect to stock ownership is based upon the Form 13F dated September 2002 filed with the Commission.
(3) Includes 290,000 shares issuable upon the exercise of outstanding options.
(4) Includes 14,232 shares owned by Mr. Herr s wife and 116,596 shares issuable upon the exercise of outstanding options.
(5) Includes 101,620 shares issuable upon the exercise of outstanding options.
(6) Includes 7,598 shares issuable upon the exercise of outstanding options.
(7) Includes 60,187 shares issuable upon the exercise of outstanding options.
(8) Includes 50,438 shares issuable upon the exercise of outstanding options.
(9) Includes 2,250 shares issuable upon the exercise of outstanding options.
(10) Includes 7,598 shares issuable upon the exercise of outstanding options.
(11) Includes 11,250 shares issuable upon the exercise of outstanding options.
(12) Includes 647,537 shares issuable upon the exercise of outstanding options.

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PROPOSAL NO. 1

ELECTION OF DIRECTORS

The Company s Restated Certificate of Incorporation provides for a staggered Board of Directors. Each director serves a three-year term until his successor is elected and qualified. The two directors to be elected at the 2003 Annual Meeting will serve until the Annual Meeting of Stockholders in 2006 (the Class III directors), two directors currently serving on the Board will continue to serve until the Annual Meeting of Stockholders in 2004 (the Class I directors), and two directors currently serving on the Board will continue to serve until the Annual Meeting of Stockholders in 2005 (the Class II directors).

Unless contrary instructions are received, shares of Common Stock of the Company represented by duly executed proxies will be voted in favor of the election of the nominees named below. If for any reason a nominee is unable to serve as a director, it is intended that the proxies solicited hereby will be voted for such substitute nominee as the Board of Directors of the Company may propose. The Board of Directors has no reason to expect that the nominees will be unable to serve, and therefore, at this time does not have any substitute nominees under consideration.

A nominee for election must receive a plurality of the votes cast to be elected as a director. Stockholders have no right to vote cumulatively for directors, but rather each stockholder shall have one vote for each share of Common Stock held by such stockholder for each director.

The following persons are the nominees for election to serve as Class III directors. Both nominees are presently directors of the Company. Certain information relating to the nominees, which has been furnished to the Company by the individuals named, is set forth below.

Name of Director	Class of Director; Annual Meeting at Which Term Will Expire	Background Information
Henry D. Herr	III; 2006	Mr. Herr, 56, has been a director of the Company since 1988. Mr. Herr served as Executive Vice President of Finance and Administration and Chief Financial Officer of the Company from February 1986 to October 2001. Mr. Herr is currently employed by the Company on a part-time basis. Mr. Herr also is a director of AmSurg Corp.
Martin J. Koldyke	III; 2006	Mr. Koldyke, 70, has been a director of the Company since 1981. Mr. Koldyke is a former Chairman of Frontenac Company, a venture capital management partnership that he founded in 1971. Mr. Koldyke is a former Chairman of the Illinois Health Finance Authority, former Chairman and a Trustee of WTTW Channel 11, Chicago, a Life Trustee of Northwestern University and Chairman Emeritus of the Golden Apple Foundation.

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The following four persons currently are members of the Board of Directors and will continue in their present positions after the Annual Meeting. The following persons are not nominees, and stockholders are not being asked to vote for them. Certain information relating to the following persons has been furnished to the Company by the individuals named.

Name of Director	Class of Director; Annual Meeting at Which Term Expires	Background Information
Frank A. Ehmann	I; 2004	Mr. Ehmann, 68, has been a director of the Company since 1991. Mr. Ehmann was a partner of RCS Health Care Partners Ltd., an affiliate of Robertson Stephens Co., from 1990 to 1994. From 1987 to 1989, he was President and Chief Operating Officer of United Stationers, Inc. He served as President and Co-Chief Operating Officer of Baxter-Travenol Laboratories, Inc. from 1986 to 1987, and as President and Chief Operating Officer of American Hospital Supply Corporation in 1985, when it merged with Baxter-Travenol. Mr. Ehmann also serves as a director of Convergent Capital Funds.
William C. O Neil, Jr.	I; 2004	Mr. O Neil, 68, has served as a director of the Company since 1985. From 1989 to 1999, Mr. O Neil was the Chairman, President and Chief Executive Officer of ClinTrials Research, Inc., a pharmaceutical clinical research services company. Prior thereto, Mr. O Neil was Chairman, President and Chief Executive Officer of International Clinical Laboratories, Inc., a national laboratory testing company. Mr. O Neil is also a Director of Advocat, Inc., Sigma Aldrich Corporation and Central Parking Corporation.
Thomas G. Cigarran	II; 2005	Mr. Cigarran, 60, has served as Chairman and Chief Executive Officer of the Company since September 1988 and as a director since 1981. Mr. Cigarran served as President of the Company from September 1981 to June 2001. Mr. Cigarran also is Chairman and a director of AmSurg Corp.
Dr. C. Warren Neel	II; 2005	Dr. Neel, 63, has been a director of the Company since October 1991. Since July 2000, Dr. Neel has served as Commissioner of Finance and Administration for the State of Tennessee. Dr. Neel is currently on leave from his position as Dean of the College of Business Administration at The University of Tennessee in Knoxville, a position he has held since 1977. Dr. Neel is also a director of Saks, Inc. and Clayton Homes, Inc.

The Board of Directors of the Company held six meetings during the fiscal year ended August 31, 2002. The Board of Directors has Nominating, Audit and Compensation Committees. The Audit Committee is comprised of Messrs. Ehmann, Koldyke and O Neil and Dr. Neel, each of whom is independent as defined by the NASDAQ listing standards. The Audit Committee meets with the Company s independent auditors and

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management to review the Company s consolidated financial statements. The Audit Committee held five meetings during fiscal 2002.

The Compensation Committee is responsible for the periodic review of management s compensation and administration of the Company s compensation plans. The Compensation Committee consists of Messrs. Ehmann and Koldyke and Dr. Neel, each of whom is independent as defined by the NASDAQ listing standards. The Compensation Committee held four meetings during fiscal 2002.

The Nominating Committee consists of Messrs. Cigarran and O Neil and Dr. Neel. The Nominating Committee recommends to the Board of Directors nominees for election to the Board. The Nominating Committee will consider nominees recommended by the Company s stockholders provided such proposed nominations are submitted to the Company in the manner and within the time limits for stockholder proposals as set forth on page 27 of this Proxy Statement. The Nominating Committee held one meeting during fiscal 2002.

Each of the incumbent directors of the Company attended at least 75% of the aggregate of the total number of meetings held during fiscal 2002 by the Board of Directors and each committee of which such director was a member.

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EXECUTIVE COMPENSATION

The following table provides information as to annual, long-term and other compensation during fiscal years 2002, 2001 and 2000 for the Company s Chief Executive Officer and each of the four most highly compensated executive officers other than the Chief Executive Officer who were serving as executive officers on August 31, 2002 (collectively, the Named Executive Officers). Option awards have been adjusted to reflect the three-for-two stock split effected in the form of a stock dividend on November 23, 2001.

Summary Compensation Table

		Annual Compensation		Long-term Compensation Awards	
Name and Principal Position	**Year**	**Salary($)**	**Bonus($)**	**Options(#)**	**All Other Compensation(1)**
Thomas G. Cigarran	2002	$400,000	$461,500	130,000	$73,291(2)
Chairman of the Board and	2001	360,000	175,500	37,500	58,817
Chief Executive Officer	2000	341,250	76,781	75,000	47,302
Ben R. Leedle	2002	$330,000	$298,238	175,000	$48,655(3)
President and Chief Operating Officer	2001	225,000	159,687	30,000	36,970
	2000	180,000	40,501	37,500	14,681
Robert E. Stone	2002	$240,000	$216,900	30,001	$50,835(4)
Executive Vice President	2001	225,000	77,625	30,000	40,142
	2000	210,000	47,250	36,000	30,940
Mary D. Hunter	2002	$207,000	$187,076	35,000	$38,484(5)
Executive Vice President and	2001	187,500	72,751	37,500	28,740
Chief Operating Officer Hospital Group	2000	162,000	42,769	17,250	20,577
Mary A. Chaput	2002	$183,333	$192,524	95,000	$14,317(6)
Executive Vice President and	2001	0	0	0	0
Chief Financial Officer	2000	0	0	0	0

(1) Includes $3,600 per year automobile allowance for each Named Executive Officer other than Ms. Chaput, whose allowance was $3,300 in fiscal 2002.

(2) Includes $60,839 contributed by the Company to the Company s Corporate and Subsidiary Officer Capital Accumulation Plan (the Capital Accumulation Plan), $5,332 contributed by the Company to the Company s Retirement Savings Plan (the 401(k) Plan) and $3,520 of life insurance premiums paid by the Company on behalf of Mr. Cigarran.

(3) Includes $39,910 contributed by the Company to the Capital Accumulation Plan and $5,145 contributed by the Company to the 401(k) Plan on behalf of Mr. Leedle.

(4) Includes $35,953 contributed by the Company to the Capital Accumulation Plan, $5,347 contributed by the Company to the 401(k) Plan and $5,935 of life insurance premiums paid by the Company on behalf of Mr. Stone.

(5) Includes $29,564 contributed by the Company to the Capital Accumulation Plan and $5,320 contributed by the Company to the 401(k) Plan on behalf of Ms. Hunter.

(6) Includes $9,975 contributed by the Company to the Capital Accumulation Plan and $1,042 contributed by the Company to the 401(k) Plan on behalf of Ms. Chaput.

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Option Grants Table

The following table provides information as to options granted to the Named Executive Officers during fiscal 2002. No separate stock appreciation rights (SARs) were granted during fiscal 2002.

Option/SAR Grants in Last Fiscal Year

Name	Options Granted(1) (#)	% of Total Options Granted to Employees in Fiscal Year	Exercise or Base Price ($/Sh)	Expiration Date	Potential Realizable Value at Assumed Annual Rates of Stock Price Appreciation for Option Term 5%($)	10%($)
Thomas G. Cigarran	50,000	4.45%	$23.15	10/8/2011	$ 727,946	$1,844,757
	80,000	7.12	$14.48	8/27/2012	728,512	1,846,191
Ben R. Leedle	75,000	6.68	$23.15	10/8/2011	1,091,918	2,767,135
	100,000	8.91	$14.48	8/27/2012	910,639	2,307,739
Robert E. Stone	10,001	0.89	$23.15	10/8/2011	145,604	368,988
	20,000	1.78	$14.48	8/27/2012	182,128	461,548
Mary D. Hunter	15,000	1.34	$23.15	10/8/2011	218,384	553,427
	20,000	1.78	$14.48	8/27/2012	182,128	461,548
Mary A. Chaput	45,000	4.01	$23.15	10/8/2011	655,151	1,660,281
	50,000	4.45	$14.48	8/27/2012	455,320	1,153,870

(1) All options granted to the Named Executive Officers generally vest at the rate of 25% per year over a four year period beginning on the date of the grant. If there is a change in control or a potential change in control (as defined in the 1996 Plan), any stock options which are not then exercisable, in the discretion of the Board, may become fully exercisable and vested, and stock options will, unless otherwise determined by the Compensation Committee in its sole discretion, be cashed out on the basis of the change in control price, as defined in the 1996 Plan.

Option Exercises and Year-End Value Table

The following table provides information as to options exercised by the Named Executive Officers during fiscal 2002. None of the Named Executive Officers has held or exercised separate SARs. In addition, this table includes the number of shares covered by both exercisable and unexercisable stock options as of the record date. Also reported are the values for in-the-money options, which represent the positive spread between the exercise price of existing stock options and the fiscal year-end price of the Company s Common

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Stock. Option exercises have been adjusted to reflect the three-for-two stock split effected in the form of a stock dividend on November 23, 2001.

Aggregate Option Exercises in Last Fiscal Year and Fiscal Year End Option Values

Name	Number of Shares Acquired on Exercise(#)	Value Realized($)	Number of Unexercised Options at Fiscal Year End		Value of Unexercised In-the-Money Options at Fiscal Year End($)(1)	
			Exercisable	Unexercisable	Exercisable	Unexercisable
Thomas G. Cigarran	33,750	$ 378,338	240,000	205,000	$3,167,738	$1,180,138
Ben R. Leedle	116,079	2,788,576	7,500	225,438	91,669	917,559
Robert E. Stone	73,125	1,423,740	79,432	75,189	1,142,491	645,049
Mary D. Hunter	0	0	42,562	73,438	565,708	562,189
Mary A. Chaput	0	0	0	95,000	0	129,500

(1) Based upon the 4:00 p.m. closing price of the Company s Common Stock on The Nasdaq Stock Market on August 30, 2002 of $17.07 per share.

Directors Compensation

Directors who are officers or employees of the Company receive no compensation, as such, for serving as members of the Board.

During fiscal 2002, directors who were not officers or employees of the Company (Outside Directors) each received (i) a $15,000 cash retainer annually; and (ii) pursuant to the 1996 Plan, a restricted stock award of Common Stock with a fair market value (as defined in the 1996 Plan) of $11,335, which was awarded on the date of the Annual Meeting of Stockholders.

The dollar value of the annual restricted stock award to Outside Directors under the 1996 Plan is adjusted annually by the percentage change from the previous year in the Consumer Price Index, Urban Wage Earners and Clerical Workers (1982-1984=100), All Cities Average (the Consumer Price Index); provided, however, the annual increase shall in no event be more than 6%. The Company may also grant options to Outside Directors pursuant to the Discretionary Stock Option Plan for Outside Directors. No such grants were made during fiscal 2002.

Beginning in fiscal 2003, in addition to the cash retainer and restricted stock discussed above, committee chairmen will receive $4,500 for each Audit Committee meeting attended and $4,000 for each Compensation Committee or Nominating Committee meeting attended. Other Outside Directors will receive $2,500 for each Audit Committee meeting attended and $2,000 for each Compensation Committee or Nominating Committee meeting attended.

Employment Agreements

The Company has employment agreements with all of its executive officers. The employment agreements, as amended and restated, with Mr. Cigarran, the Company s Chairman and Chief Executive Officer, and Mr. Stone, the Company s Executive Vice President, currently expire in August 2005, but contain a provision that automatically extends the term for one year on each successive anniversary date of the agreements (so that the term on such anniversary date will always be three years) unless canceled by the Company. In addition, the agreements are renewable for an additional five years at each executive s option

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upon the acquisition (as defined in the agreements) of the Company by an unrelated third party and provide that upon such an acquisition the executive may resign and receive up to 30 months of his base salary in a lump-sum payment. The agreements provide that if the Company elects not to extend the executive s employment or to otherwise terminate the executive without just cause as defined in the agreements, the executive will receive his base salary, reduced by any salary earned by the executive from another employer, plus certain benefits for a period of the greater of two years or the remaining term of the respective agreement. The agreements also provide for certain payments upon the disability of the executive and require the Company to purchase a term life insurance policy on each executive s life in a minimum amount of $500,000 which is payable to the executive s estate or beneficiaries upon his death. The agreements contain restrictive provisions relating to the use of confidential information and competing against the Company within one year after termination of the executive s employment. The agreements expire in all respects on the date the executive becomes 65 years of age.

The Company s employment agreements with Mr. Leedle, the Company s President and Chief Operating Officer, and Ms. Hunter, the Company s Executive Vice President and Chief Operating Officer Hospital Group, currently expire in August 2005, but contain a provision that automatically extends the term for one year on each successive anniversary date of the agreements (so that the term of the agreements will always be three years) unless canceled by the Company. The agreements provide that if the Company terminates the employment of Mr. Leedle or Ms. Hunter without just cause (as defined in the agreements), or if Mr. Leedle or Ms. Hunter terminates the agreement for good reason (as defined in the agreements) within 12 months following a change in control of the Company, he or she will receive his or her base salary, reduced by any salary earned from another employer, plus certain benefits for the greater of two years or the remaining term of the agreement. In addition, the agreements provide that if Mr. Leedle or Ms. Hunter terminates the agreement for any reason within 12 months following a change in control of the Company, he or she will receive his or her base salary, reduced by any salary earned from another employer, for one year. The agreements also provide for certain payments upon the disability of the executive. The agreements contain restrictive provisions relating to the use of confidential information and competing against the Company during the period while any amounts are being paid to executive and for a period of one year thereafter. The agreements expire in all respects on the date the executive becomes 65 years of age.

The Company s employment agreement with Ms. Chaput, the Company s Executive Vice President and Chief Financial Officer, currently expires in September 2004, but contains a provision that automatically extends the term for one year on each successive anniversary date of the agreement (so that the term of the agreement will always be two years) unless canceled by the Company. The agreement provides that if Ms. Chaput is terminated without just cause (as defined in the agreement) or if the Company elects not to extend Ms. Chaput s employment she will receive her base salary plus certain benefits for the greater of one year or the remaining term of the agreement. If Ms. Chaput terminates the agreement for any reason within 12 months following a change in control of the Company, she will receive her base salary plus certain benefits for the greater of two years or the remaining term of the agreement. The agreement contains restrictive provisions relating to the use of confidential information and competing against the Company during the period while any amounts are being paid to Ms. Chaput and for a period of one year thereafter. The agreement expires in all respects on the date Ms. Chaput becomes 65 years of age.

Compensation Committee Interlocks and Insider Participation

During fiscal 2002, the Compensation Committee of the Board of Directors was composed of Messrs. Ehmann, Koldyke, O Neil and Dr. Neel. None of these persons has at any time been an officer or

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employee of the Company or any of its subsidiaries. In addition, there are no relationships among the Company s executive officers, members of the Compensation Committee or entities whose executives serve on the Board of Directors or the Compensation Committee that require disclosure under applicable Commission regulations.

Compensation Committee Report

The Compensation Committee of the Company s Board of Directors makes decisions on compensation of the Company s executive officers. Each member of the Compensation Committee is a non-employee director. It is the responsibility of the Compensation Committee to determine whether in its judgment the executive compensation policies are reasonable and appropriate, meet their stated objectives and effectively serve the best interests of the Company and its stockholders.

Compensation Philosophy and Policies for Executive Officers

The Compensation Committee believes that the primary objectives of the Company s executive compensation policies should be:

to attract and retain talented executives by providing compensation that is, overall, highly competitive with the compensation provided to executives at companies of comparable position in the health care services industry, while maintaining compensation within levels that are consistent with the Company s annual budget, financial objectives and operating performance;

to provide appropriate incentives for executives to work toward the achievement of the Company s annual financial performance and business goals based on the Company s annual budget; and

to more closely align the interests of executives with those of stockholders and the long-term interests of the Company by providing long-term incentive compensation in the form of non-qualified stock options or other equity-based long-term incentive compensation.

The Compensation Committee believes that the Company s executive compensation policies should be reviewed annually in light of the Company s financial performance, its annual budget and its position within the health care services industry, as well as the compensation policies of similar companies in the health care services industry. The compensation of individual executives should then be reviewed annually by the Compensation Committee in light of its executive compensation policies for that year.

In reviewing the comparability of the Company s executive compensation policies, the Compensation Committee periodically reviews executive compensation for other comparable companies. Some of the comparable companies the Compensation Committee reviews are included among the composite group used in the Performance Graph presented in this proxy statement, consisting of the Center for Research in Security Prices Index (CRSP)for NASDAQ Stock Market and the CRSP Index for NASDAQ Health Services Stocks. In light of factors that are unique to the Company, the Compensation Committee believes that, while the Company competes generally with such other health care service companies, the position of the Company as a leading provider of disease management and care enhancement services for health plans in the United States provides unique circumstances. These differences are important factors that the Compensation Committee expects to consider in determining executive compensation and in analyzing comparable financial performance.

The Compensation Committee believes that in addition to corporate performance, it is appropriate in setting and reviewing executive compensation to consider the level of experience and responsibilities of each executive as well as the personal contributions a particular individual may make to the success of the corporate enterprise. Qualitative factors such as leadership skills, analytical skills, organization development, public affairs and civic involvement are deemed to be important qualitative factors to take into account in considering levels of compensation. No relative weight is assigned to these qualitative factors, which are applied subjectively by the Compensation Committee.

Compensation of Named Executive Officers

The Compensation Committee believes that the compensation of executive officers should be comprised of base compensation, annual incentive compensation and intermediate and long-term compensation and has applied the policies described herein to fiscal 2002 compensation for executive officers as described below.

Base Compensation. In determining whether an increase in base compensation for the executive officers was appropriate for fiscal 2002, the Compensation Committee reviewed recommendations of management and consulted with the Chief Executive Officer. The Compensation Committee determined on the basis of discussions with the Chief Executive Officer, its experience in business generally and with the Company specifically what it viewed to be appropriate levels of base compensation after taking into consideration the contributions of each executive and the performance of the Company. The Compensation Committee did not assign any relative weight to the quantitative and qualitative factors it applied in reaching its base compensation decisions. The minimum increase mandated by employment agreements with the Company s executive officers is the annual CPI increase.

Annual Incentive Compensation. The Compensation Committee believes that compensation should primarily be linked to operating performance. To achieve this link with regard to short-term performance, the Compensation Committee for fiscal 2002 relied on cash bonuses awarded under the Annual Incentive Compensation Plan under which cash awards could be earned by the executive officers based upon a comparison of actual earnings per share of the Company and targeted earnings per share approved by the Compensation Committee for fisca