

HEALTHWAYS, INC  
Form 10-K  
October 30, 2008  
UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

**FORM 10-K**

X Annual Report Pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934

For the Fiscal Year Ended August 31, 2008

or

o Transition Report Pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934

Commission file number 000-19364

**HEALTHWAYS, INC.**

(Exact name of registrant as specified in its charter)

Delaware  
(State or other jurisdiction of  
incorporation or organization)

62-1117144  
(I.R.S. Employer  
Identification No.)

701 Cool Springs Boulevard, Franklin, TN 37067  
(Address of principal executive offices) (Zip code)

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(615) 614-4929

(Registrant's telephone number, including area code)

Securities registered pursuant to Section 12(b) of the Act:

Title of each class	Name of each exchange on which registered
Common Stock - \$.001 par value, and related Preferred Stock Purchase Rights	The NASDAQ Stock Market LLC

Securities registered pursuant to Section 12(g) of the Act:

None

Indicate by check mark if the registrant is a well-known seasoned issuer, as defined in Rule 405 of the Securities Act.

Yes ☐ No ☒

Indicate by check mark if the registrant is not required to file reports pursuant to Section 13 or 15(d) of the Act.

Yes ☐ No ☒

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Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports) and (2) has been subject to such filing requirements for the past 90 days.

Yes ☒ No ☐

Indicate by check mark if disclosure of delinquent filers pursuant to Item 405 of Regulation S-K is not contained herein, and will not be contained, to the best of the registrant's knowledge, in definitive proxy or information statements incorporated by reference in Part III of this Form 10-K or any amendment to this Form 10-K. ☐

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer, or a smaller reporting company. See the definitions of "large accelerated filer", "accelerated filer", and "smaller reporting company" in Rule 12b-2 of the Exchange Act.

Large accelerated filer ☒ Accelerated filer ☐ Non-accelerated filer ☐ Smaller reporting company ☐

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Act).

Yes ☐ No ☒

As of February 29, 2008, the last business day of the registrant's most recently completed second fiscal quarter, the aggregate market value of the shares held by non-affiliates of the registrant was approximately \$1.2 billion based on the price at which the shares were last sold for such date on The NASDAQ Stock Market.

As of October 17, 2008, 33,614,758 shares of Common Stock were outstanding.

### DOCUMENTS INCORPORATED BY REFERENCE

Portions of the registrant's Proxy Statement for the Annual Meeting of Stockholders to be held January 29, 2009 are incorporated by reference into Part III of this Form 10-K.



Healthways, Inc.

Form 10-K

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**PART I.**

**Item 1. Business**

Founded in 1981, Healthways, Inc. (the “Company”) provides specialized, comprehensive Health and Care Support<sup>SM</sup> solutions to help people maintain or improve their health and, as a result, reduce both direct healthcare costs and costs associated with the loss of health-related employee productivity.

Designed to provide highly specific and personalized interventions for each individual in a population, irrespective of health status, age, or payor, our evidence-based services are made available to consumers by phone, mail, internet, and face-to-face interactions. To expand our Health Support offerings, on December 1, 2006 we acquired Axia Health Management, Inc. (“Axia”), a national provider of health and wellness programs.

We deliver our programs to customers, which include health plans, governments, employers, and hospitals, in all 50 states, the District of Columbia, and Puerto Rico. We began delivering our Health and Care Support programs in Germany and Brazil in January 2008 and June 2008, respectively. Our services include:

- fostering wellness and disease prevention through total population screening, health risk assessments, and supportive interventions;
- providing access to health improvement programs such as fitness, weight management, complementary and alternative medicine and smoking cessation;
- promoting the reduction of lifestyle behaviors that lead to poor health or chronic conditions;
- providing educational materials and personal interactions with highly trained nurses and other healthcare professionals that are designed to create and sustain healthier behaviors to members with chronic conditions;
- incorporating current evidence-based clinical guidelines into interventions to optimize patient health outcomes;
- developing Care Support plans and motivating members to set attainable goals for themselves;
- providing local market resources to address acute episodic interventions;
- coordinating members’ care with their healthcare providers; and
- providing software licensing and management consulting in support of health and care support services.

Our programs focus on prevention, education, physical fitness, health coaching, behavior change and evidence-based interventions to drive adherence to proven standards of care, medication regimens and physicians’ plans of care. The programs are designed to support better health and assist in providing more effective care, which we believe will optimize the health status of member populations and reduce both the short-term and long-term direct healthcare costs for participants, including costs associated with the loss of health-related employee productivity.

Health and Care Support services enable health plans and employers to reach and engage everyone in their covered populations through interventions that are both sensitive to and specific to each individual’s health risks and needs. Health Support products are designed to motivate people to make positive lifestyle changes and accomplish individual goals, such as becoming more physically active through the Healthways SilverSneakers® Fitness Program, staying fit using on-line tools and a vast network of fitness centers, and quitting smoking through an on-line smoking cessation community, QuitNet®. The Care Support product line includes programs for people with chronic diseases or persistent conditions, including diabetes, coronary artery disease, heart failure, asthma, chronic obstructive pulmonary disease, end-stage renal disease,

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cancer, chronic kidney disease, depression, high-risk obesity, metabolic syndrome, acid-related stomach disorders, atrial fibrillation, decubitus ulcer, fibromyalgia, hepatitis C, inflammatory bowel disease, irritable bowel syndrome, low-back pain, osteoarthritis, osteoporosis, and urinary incontinence. We also provide high-risk

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care management through our StatusOne® product for members at risk for hospitalization due to complex conditions. We believe that creating real and sustainable behavior change generates measurable long-term cost savings.

Predicated on the fundamental belief that healthier people cost less and are more productive, Healthways' programs are designed to help keep healthy individuals healthy, mitigate and delay the progression to disease associated with family or lifestyle risk factors, and promote the best possible health habits for those who are already affected by disease. At the same time, we recognize that each individual plays a variety of roles in his or her pursuit of health, often simultaneously. By providing the full spectrum of Health and Care Support services to meet each individual's needs, we believe that our interventions can be delivered both at scale and in a manner that reflects the unique needs of each consumer over time. Further, Healthways' extensive and fully accredited complementary and alternative provider network offers convenient access to the significant number of individuals who seek health services outside of the traditional healthcare system.

### Customer Contracts

#### *Contract Terms*

We generally determine our contract fees by multiplying a contractually negotiated rate per member per month ("PMPM") by the number of members covered by our services during the month. We typically set the PMPM rates during contract negotiations with customers based on the value we expect our programs to create and a sharing of that value between the customer and the Company. In addition, some of our services are billed on a fee for service basis.

Our contracts with health plans generally range from three to five years with provisions for subsequent renewal; contracts with self-insured employers, either directly or through their health plans or pharmacy benefit manager, typically have one to three-year terms. Some contracts allow the customer to terminate early.

Some of our contracts provide that a portion (up to 100%) of our fees may be refundable to the customer ("performance-based") if our programs do not achieve, when compared to a baseline year, a targeted percentage reduction in the customer's healthcare costs and selected clinical and/or other criteria that focus on improving the health of the members. Approximately 4% of revenues recorded during fiscal 2008 were performance-based and were subject to final reconciliation as of August 31, 2008. We anticipate that this percentage will fluctuate due to the level of performance-based fees in new contracts, revenue recognition associated with performance-based fees, and the timing of data reconciliation, which varies according to contract terms. A limited number of contracts also provide opportunities for us to receive incentive bonuses in excess of the contractual PMPM rate if we exceed contractual performance targets.

We participated in two Medicare Health Support pilots, which terminated in January 2008 and July 2008, respectively. These pilots were awarded under the Chronic Care Improvement Program authorized by the Medicare Modernization Act of 2003. We began operating one pilot in August 2005 to serve 20,000 Medicare fee-for-service beneficiaries in Maryland and the District of Columbia. All fees under this pilot were performance-based. This pilot ended on its scheduled termination date of July 31, 2008. In addition, we began serving 20,000 beneficiaries in Georgia in September 2005 in collaboration with CIGNA HealthCare, Inc ("CIGNA"). CIGNA terminated its Chronic Care Improvement Program Cooperative Agreement with the Centers for Medicare & Medicaid Services ("CMS") effective January 14, 2008. The majority of our fees under our contract with CIGNA were performance-based. Both pilots were for complex diabetes and congestive heart failure disease management services and, while operationally similar to our programs for commercial and Medicare Advantage health plan populations, were modified for the special needs and conditions of this population.





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In June 2006, we signed an amendment to our cooperative agreement with CMS for our Medicare Health Support stand-alone pilot in Maryland and the District of Columbia, which, among other things, enabled us to provide congestive heart failure programs to approximately 4,500 additional Medicare fee-for-service beneficiaries for two years beginning on August 1, 2006 (the “refresh population”). This pilot also ended on its scheduled termination date of July 31, 2008. All fees for the refresh population were performance-based.

### *Technology*

Our customer contracts require sophisticated analytical, data management, Internet and computer-telephony solutions based on state-of-the-art technology. These solutions help us deliver our Health and Care Support services to large populations within our customer base. Our predictive modeling capabilities allow us to identify and stratify those participants who are most at risk for an adverse health event. We incorporate behavior-change science with consumer-friendly interactions such as face-to-face, telephonic, print materials and web portals to facilitate consumer preferences for engagement and convenience. We use sophisticated data analytical and reporting solutions to validate the impact of our programs on clinical and financial outcomes. We continue to invest heavily in technology and are continually expanding and improving our proprietary clinical, data management, and reporting systems to continue to meet the information management requirements of our Health and Care Support services.

### **Domestic Commercial Billed Lives and Domestic Commercial Available Lives**

The number of domestic commercial available lives and domestic commercial billed lives as of August 31, 2008 and 2007 were as follows:

	<b>August 31,</b>	<b>August 31,</b>
<b>(In 000s)</b>	<b>2008</b>	<b>2007</b>
Available lives <sup>(1)</sup>	192,500	188,500
Billed lives	31,700	27,400

<sup>(1)</sup> Estimated based on the Atlantic Information Services, Inc. (AIS) Directory of Health Plans and publicly available information.

### **Backlog**

Backlog represents the estimated annualized revenue at target performance for business awarded but not yet started at August 31, 2008. Annualized revenue in backlog as of August 31, 2008 and 2007 was as follows:

	<b>August 31,</b>	<b>August 31,</b>
<b>(In 000s)</b>	<b>2008</b>	<b>2007</b>
Annualized revenue in backlog	\$ 13,600	\$ 39,900

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Increasing demand for our Health and Care Support services from self-insured employer accounts, which generally begin their benefit year on January 1, has historically resulted in a disproportionate amount of our new business beginning in our second fiscal quarter.

### **Business Strategy**

Our primary strategy is to optimize the health of entire populations, as well as the quality and affordability of healthcare, through our Health and Care Support solutions both domestically and internationally, thereby creating value for individuals, their families, health plans, governments, and employers. Our programs are designed to help keep healthy individuals healthy, mitigate and retard the

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progression to disease associated with family or lifestyle risk factors, and promote the best possible health for those who are already affected by disease. We plan to continue using our scalable state-of-the-art call centers, medical information content, behavior change processes and techniques, strategic relationships, health provider networks and proprietary technologies to gain a competitive advantage in delivering our Health and Care Support services.

We continue to see increasing demand for integrated Health and Care Support solutions from self-insured employers. As a result, we expect to continue adding and enhancing solutions to extend our reach and effectiveness for entire populations. The flexibility of our programs allows customers to enter the Health and Care Support market at the level of services that they deem appropriate for their organization. Customers may select from a single Health or Care Support program to a total-population approach, in which all members of the customer's population are eligible to receive the benefit of our programs.

We deliver programs that engage consumers in their health. We believe that we can achieve health improvements and generate significant cost savings and productivity improvements by addressing consumer and customer needs for effective programs that support the individual throughout his or her lifetime.

We anticipate that we will continue to enhance, expand and further integrate our Health and Care Support capabilities, pursue opportunities in domestic government and international markets, and enhance our information technology support. We may add some of these new capabilities and technologies through internal development, strategic alliances with other entities and/or through selective acquisitions or investments.

### **Segment and Major Customer Information**

We have one reportable segment, Health and Care Support services. During fiscal 2008, CIGNA HealthCare, Inc. and Blue Cross and Blue Shield of Massachusetts, Inc. comprised approximately 20% and 10%, respectively, of our revenues. No other customers accounted for 10% or more of our revenues in fiscal 2008.

### **Competition**

The health-care industry is highly competitive and subject to continual change in the manner in which services are provided. Other entities, whose financial, research, staff, and marketing resources may exceed our resources, are marketing a variety of care support, health support, and other services to health plans and self-insured employers, or have announced an intention to offer such services. These entities include disease management companies, health and wellness companies, retail drug stores, major pharmaceutical companies, health plans, health care organizations, providers, pharmacy benefit management companies, health care information technology companies and other entities that provide services to health plans and self-insured employers.

We believe we have advantages over our competitors because of our breadth and depth of health and care support capabilities, state-of-the-art call center technology linked to our proprietary information technology, predictive modeling capabilities, behavior-change techniques, the comprehensive recruitment, pre-testing and training of our clinical colleagues, the comprehensive clinical nature of our product offerings, our established reputation for providing health and care support services to members with health risks or chronic diseases, and the proven financial and clinical outcomes of our programs; however, we cannot assure you that we can compete effectively with these companies.

Consolidation has been, and may continue to be, an important factor in all aspects of the health care industry, including the Health and Care Support sector. While we believe the size of our membership base provides us with the economies of scale to compete even in a consolidating market, we cannot assure you that we can effectively compete with companies formed as a result of industry consolidation or that we can retain

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existing health plan customers if they are acquired by other health plans which already have or are not interested in Health and Care Support programs.

### **Governmental Regulation**

Governmental regulation impacts us in a number of ways in addition to those regulatory risks presented under the “Risk Factors” below.

While many of the governmental and regulatory requirements affecting health-care delivery generally do not directly affect us, our customers must comply with a variety of regulations including the licensing and reimbursement requirements of federal, state and local agencies and the requirements of municipal building codes and health codes. Certain of our services, including health service utilization management and certain claims payment functions, require licensure by government agencies. We are subject to a variety of legal requirements in order to obtain and maintain such licenses.

Certain of our professional health-care employees, such as nurses, must comply with individual licensing requirements. All of our health-care professionals who are subject to licensing requirements are licensed in the state in which they are physically present, such as the professionals located at a call center. Multiple state licensing requirements for health-care professionals who provide services telephonically over state lines may require some of our health-care professionals to be licensed in more than one state. We continually monitor legislative, regulatory and judicial developments in telemedicine; however, new agency interpretations, federal or state legislation or regulations, or judicial decisions could increase the requirement for multi-state licensing of all call center health professionals, which would increase our costs of services.

Changes in laws governing reimbursement to health plans providing services under governmental programs such as Medicare and Medicaid may affect us. Legislative and regulatory bodies may continue to reduce the funding of the Medicare and Medicaid programs in an effort to reduce overall federal health care spending. In recent years, federal legislation has reduced or significantly altered Medicare and Medicaid reimbursements to most hospitals. These changes, future legislative initiatives or government regulation and/or changes in the administration could adversely affect our operations or reduce the demand for our services.

Federal privacy regulations issued pursuant to the Health Insurance Portability and Accountability Act of 1996 (“HIPAA”) extensively restrict the use and disclosure of individually-identifiable health information by health plans, most health-care providers, and certain other entities (collectively, “covered entities”). Federal security regulations issued pursuant to HIPAA require covered entities to implement and maintain administrative, physical and technical safeguards to protect the confidentiality, integrity and availability of electronic individually-identifiable health information. We are contractually required to comply with certain aspects of the HIPAA privacy and security regulations. In addition, we are contractually obligated to comply with any applicable state laws or regulations related to privacy that are more restrictive than the federal privacy regulations. We may also be directly subject to state requirements related to the confidentiality and security of confidential personal information. In the event of a data breach involving individually identifiable information, we are subject to laws and regulations that may require us to notify our customers or individuals affected by the breach.

Various federal and state laws regulate the relationships among providers of health-care services, other health-care businesses and physicians. The “fraud and abuse” provisions of the Social Security Act provide civil and criminal penalties and potential exclusion from the Medicare and Medicaid programs for persons or businesses who offer, pay, solicit or receive remuneration in order to induce referrals of patients covered by federal health-care programs (which include Medicare, Medicaid, TriCare and other federally funded health programs). These fraud and abuse provisions are broadly written, and the full extent of their



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application is not yet known. Therefore, we are unable to predict the effect, if any, of broad enforcement interpretation of these fraud and abuse provisions.

Further, the health care industry is highly regulated at the federal and state levels. For example, federal law contains various prohibitions related to false statements and false claims, some of which apply to private payors as well as federal programs. Violations of the federal False Claims Act are punishable by treble damages and penalties of up to \$11,000 per false claim. Actions may be brought under the federal False Claims Act by the government as well as by private individuals, known as “whistle blowers,” who are permitted to share in any settlement or judgment.

When a private party brings an action under the whistleblower provisions of the False Claims Act, the defendant will generally not be aware of the lawsuit until the government makes a determination of whether it will intervene and take a lead in the litigation. There are many potential bases for liability under the False Claims Act. Although liability under the False Claims Act arises when an entity knowingly submits a false claim for reimbursement to the federal government, the False Claims Act defines the term “knowingly” broadly. Thus, although simple negligence generally will not give rise to liability under the False Claims Act, submitting a claim with reckless disregard for its truth or falsity can constitute “knowingly” submitting a claim. In some cases, whistleblowers, the federal government, and some courts have taken the position that entities who allegedly have violated other statutes, such as the “fraud and abuse” provisions of the Social Security Act, have thereby submitted false claims under the False Claims Act. From time to time, participants in the health care industry, including our company, may be subject to actions under the False Claims Act, and it is not possible to predict the impact of such actions. As discussed under Item 3: “Legal Proceedings”, we are subject to a “whistle blower” action filed in June 1994 on behalf of the United States government by a former employee whom we dismissed in February 1994.

### Insurance

We maintain the following types of insurance for all of our locations and operations: professional liability (including errors and omissions), directors and officers, property, and general liability. While we believe our insurance coverage is adequate for our current operations, it might not be sufficient to cover all future claims. Such insurance might not continue to be available in adequate amounts or at a reasonable cost. These policies contain relatively standard commercial terms and conditions. We also maintain workers compensation insurance for all of our domestic employees.

### Employees

As of October 15, 2008, we had approximately 3,500 employees. Our employees are not subject to any collective bargaining agreements. We believe we have a good relationship with our employees.

### Available Information

Our Internet address is [www.healthways.com](http://www.healthways.com). We make available free of charge, on or through our Internet website, our annual report on Form 10-K, quarterly reports on Form 10-Q, current reports on Form 8-K, and amendments to those reports filed or furnished pursuant to Section 13(a) or 15(d) of the Securities Exchange Act of 1934, as amended, as soon as reasonably practicable after we electronically file such material with, or furnish it to, the Securities and Exchange Commission.



**Item 1A. Risk Factors**

In the execution of our business strategy, our operations and financial condition are subject to certain risks. A summary of certain material risks is provided below, and you should take such risks into account in evaluating any investment decision involving our company. This section does not describe all risks applicable

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to us and is intended only as a summary of certain material factors that could impact our operations in the industry in which we operate. Other sections of this Annual Report on Form 10-K contain additional information concerning these and other risks.

### **We depend on payments from customers, and cost reduction pressure on these entities may adversely affect our business and results of operations.**

The health care industry in which we operate currently faces significant cost reduction pressures as a result of increased competition, constrained revenues from governmental and private revenue sources, increasing underlying medical care costs, and general economic conditions. We believe that these pressures will continue and possibly intensify.

We believe that our Health and Care Support solutions, which are geared to foster wellness and disease prevention and deliver interventions for people with chronic diseases and conditions, specifically assist our customers in controlling the high costs of healthcare; however, the pressures to reduce costs in the short term may negatively affect our ability to sign and/or retain contracts under existing terms or to restructure these contracts on terms that would not have a material negative impact on our results of operations. In addition, this focus on cost reduction may cause our customers to focus on contract restructurings that reduce the fees we receive for our services. These financial pressures could have a negative impact on our results of operations.

### **A significant percentage of our revenues is derived from health plan customers.**

A significant percentage of our revenues is derived from health plan customers. The health plan industry continues to undergo a period of consolidation, and we cannot assure you that we will be able to retain health plan customers if they are acquired by other health plans which already have or are not interested in Health and Care Support programs. In addition, a reduction in the number of covered lives enrolled with our health plan customers or a decision by our health plan customers to take programs in-house could adversely affect our results of operations.

### **We currently derive a large percentage of our revenues from two customers. The loss of, or the restructuring of a contract with, these or other large customers could have a material adverse effect on our business and results of operations.**

Because of the size of their membership and the number of programs purchased from us, CIGNA HealthCare, Inc. and Blue Cross and Blue Shield of Massachusetts, Inc. comprised approximately 20% and 10%, respectively, of our revenues in fiscal 2008. No other customer accounted for 10% or more of our revenues in fiscal 2008. We anticipate that future revenues from Blue Cross and Blue Shield of Massachusetts will decrease due to a recent restructuring in the scope of our services with this customer.

### **The Health and Care Support industry is a continually evolving segment of the health-care industry.**

The rapidly growing Health and Care Support industry is a continually evolving segment of the overall health-care industry with many entrants marketing various services and products labeled as Health and Care Support. Companies have used the generic label of health and/or care support to characterize a wide range of activities, from the sale of medical supplies and drugs to demand management services. Because the industry is continually evolving, purchasers of these services have not had significant experience purchasing, evaluating or monitoring the new

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products and services which are being developed, which generally results in a lengthy sales cycle for new contracts. As the industry matures, the number of programs that customers have been purchasing has generally expanded from one or two programs to a more comprehensive suite of programs, while also typically increasing the terms from between three to five years. These changes result in a

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We maintain a 401(k) plan for our employees to whom we did not make any matching contributions in 2008 or 2009. We do not provide for any other retirement benefit for any of our employees, including executive officers.

### Compensation of Directors

Each non-employee director receives an annual fee of \$8,000, payable in equal quarterly installments, and \$500 plus reimbursement for actual out-of-pocket expenses in connection with each Board meeting attended in person and \$200 for each board meeting attended telephonically. The head of the Audit Committee receives an annual fee of \$1,000, payable in equal quarterly installments. Each member of the audit, compensation and nominating committees receives \$500 for each committee meeting he attends in person and \$200 for each audit committee meeting attended telephonically unless the meeting immediately precedes or follows a meeting of the Board, in which case he will receive \$200 for attending in person or \$100 if he attends by telephone. At the discretion of the Board, newly elected independent directors may be granted stock options pursuant to the terms of our Stock Option Plan.

To align the interests of our non-employee directors with those of our stockholders, non-employee directors are each awarded stock options exercisable for 9,000 Common Shares upon joining the Board or 10,000 Common Shares, if at such time the director is also appointed a chairman of a committee of the Board. After three-years of service on the Board, non-employee directors are entitled to an annual award of stock options exercisable for 1,000 Common Shares. All such awards are subject to adjustment at the sole discretion of the Board.

### Director Compensation

The following table provides compensation information for the year ended December 31, 2009 for each of the independent members of the Board.

Name	Fees Earned In Cash	Option Awards \$(1)	Total (\$)
Marin H. Lager	\$ 11,800		\$ 11,800
John Gorman	\$ 9,600		\$ 9,600
Leonard J. Stanley	\$ 9,600		\$ 9,600

(1) Represents the aggregate grant-date fair value of the awards computed in accordance the FASB ASC Topic 718.

### Limitation of Directors Liability and Indemnification

Our certificate of incorporation limits the liability of individual directors for specified breaches of their fiduciary duty. The effect of this provision is to eliminate the liability of directors for monetary damages arising out of their failure, through negligent or grossly negligent conduct, to satisfy their duty of care, which requires them to exercise informed business judgment. The liability of directors under the federal securities laws is not affected. A director may be liable for monetary damages only if a claimant can show receipt of financial benefit to which the director is not entitled, intentional infliction of harm on us or on our stockholders, a violation of Section 174 of the Delaware General Corporation Law (dealing with unlawful distributions to stockholders effected by vote of directors), and any amended or successor provision thereto, or an intentional violation of criminal law.

Our certificate of incorporation also provides that we will indemnify each of our directors or officers, and their heirs, administrators, successors and assigns against any and all expenses, including amounts paid upon judgments, counsel fees, and amounts paid or to be paid in settlement before or after suit is commenced, actually and necessarily incurred by such persons in connection with the defense or settlement of any claim, action, suit or proceeding, in which they, or any of them are made parties, or

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which may be asserted against them or any of them by reason of being, or having been, directors or officers of the corporation, except in relation to such matters in which such director or officer shall be adjudged to be liable for his own negligence or misconduct in the performance of his duty.

There is no pending litigation or proceeding involving any of our directors, officers, employees or agents in which we are required or permitted to provide indemnification, except as set forth under Certain Relationships and Related Party Transactions. We are also not aware of any threatened litigation or proceedings that may result in a claim for indemnification.

Insofar as indemnification for liabilities arising under the Securities Act of 1933, as amended ( *Securities Act* ), may be permitted to directors, officers or controlling persons under our certificate of incorporation, we have been informed that, in the opinion of the SEC, indemnification is against public policy as expressed in the Securities Act and is unenforceable.

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## Security Ownership of Certain Beneficial Owners and Management and Related Stockholder Matters

The following table sets forth information regarding the beneficial ownership of our Common Shares as of the Record Date:

each person, or group of affiliated persons, known by us to be the beneficial owner of more than 5% of our outstanding Common Shares;

each director;

each Named Executive Officer; and

all of our directors and executive officers as a group.

Except as otherwise indicated, the persons listed below have sole voting and investment power with respect to all of the Common Shares owned by them. The individual stockholders have furnished all information concerning their respective beneficial ownership to us.

Name and address of beneficial owner (1)	Common Shares Beneficially Owned (2)	Percent of Common Shares Beneficially Owned (3)
<i>Directors and Named Executive Officers</i>		
Allen S. Greene	420,296(4)	8.3%
Jack Fingerhut	194,678(5)	3.9%
Joseph Fish	72,716(6)	1.5%
Martin H. Lager	30,666(7)	*
John J. Gorman	50,000(8)	1.0%
Leonard J. Stanley	9,250(9)	*
All directors and executive officers as a group(8 persons)	794,501(10)	15.4%
<i>5% Owners</i>		
John H. Lewis 388 Market Street, Suite 920 San Francisco, California 94111	360,079(11)	7.3%
Zohar Ben-Dov 2125 Hachers Mill Road Marshall, Virginia 20115	520,098	10.6%

\*Less than 1%

(1) Unless otherwise indicated all addresses are c/o SmartPros Ltd., 12 Skyline Drive, Hawthorne, New York 10532.

(2) According to the rules and regulations of the SEC, Common Shares that a person has a right to acquire within 60 days of the date of this Proxy Statement are deemed to be beneficially owned by that person and outstanding for the purpose of computing the percentage ownership of that person, but are not deemed outstanding for the purpose of computing the percentage ownership of any other person.

(3) Based on 4,926,305 Common Shares outstanding as of the Record Date.

(4) Includes 145,915 Common Shares underlying outstanding options and 58,634 Common Shares that are subject to vesting.

(5) Includes 10,000 Common Shares underlying options and 23,787 Common Shares are subject to vesting.

(6) Includes 49,897 Common Shares underlying options and 21,773 Common Shares are subject to vesting.

(7)

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Includes 10,000 Common Shares underlying options and 20,666 Common Shares beneficially owned by Mr. Lager as trustee of the Lager Family Realty Trust and the trust U/W/O Irwin Lager.

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- (8) Includes 9,000 Common Shares underlying options.
- (9) Includes 6,750 Common Shares underlying options.
- (10) Includes 241,562 Common Shares underlying outstanding options and 104,194 Common Shares are subject to vesting.
- (11) 358,879 of these Common Shares are deemed beneficially owned by Mr. Lewis as the controlling member of Osmium Partners, LLC, a Delaware limited liability company, which serves as the general partner of Osmium Capital, LP, Osmium Capital II, LP and Osmium Spartan, LP, Delaware limited partnerships and the registered holders of the Common Shares. The information with respect to this stockholder is derived from the Schedule 13G/A filed by the stockholder on February 16, 2010 with the Securities and Exchange Commission, reporting shares beneficially owned at December 31, 2009

#### Securities Authorized for Issuance Under Equity Compensation Plans

To attract and retain the personnel necessary for our success, we adopted our 2009 Incentive Compensation Plan (the 2009 Plan ) which was approved by stockholders at the 2009 annual meeting of stockholders and replaced the 1999 Stock Option Plan.

800,000 Common Shares are authorized and available for issuance under the 2009 Plan upon adoption of which a maximum of 200,000 Common Shares can be issued pursuant to awards in the form of restricted stock and restricted stock units; *provided, however*, the number of Common Shares available for new awards under the 2009 Plan are reduced by the number of shares issued on or after January 1, 2009 upon the exercise of outstanding stock options, covered by outstanding stock options and restricted stock awards granted under the 1999 Plan. Any outstanding stock options granted under the 1999 Plan that are cancelled or expire unexercised and any restricted stock awards granted under the 1999 Plan that are forfeited will increase the number of Common Shares available for new awards under the 2009 Plan up to a maximum of 800,000 Common Shares. The number of Common Shares authorized and available for issuance under the 2009 Plan is subject to adjustment in the event of a stock split, stock dividend, recapitalization, spin-off or similar action.

Awards under the 2009 Plan may take the form of stock options (either incentive stock options or non-qualified options), restricted stock, or restricted stock units. The 2009 Plan is administered by the compensation committee of the Board and provides for equity awards to our employees and others who perform services for us, which would include directors and consultants. Stock options granted under this plan must be exercised within a maximum of 10 years from the date of grant at an exercise price that is not less than the fair market value of the Common Shares on the date of the grant. Options granted to stockholders owning more than 10% of our outstanding Common Shares must be exercised within five years from the date of grant and the exercise price must be at least 110% of the fair market value of the Common Shares on the date of the grant.

The following table sets forth the information about our 2009 Plan as of December 31, 2009:

#### Equity Compensation Plan Information

	Number of securities to be issued upon exercise of outstanding options and warrants	Weighted average exercise price of outstanding options and warrants	Number of securities remaining available for future issuance under equity compensation plans
Equity compensation plans approved by stockholders	410,121 (1)	\$4.40	253,869

(1) Does not include 136,010 restricted Common Shares issued under the 2009 Plan.



## Section 16(a) Beneficial Ownership Reporting Compliance

Section 16(a) of the Exchange Act requires SmartPros' officers and directors, and persons who own more than 10% of a registered class of our equity securities to file reports of ownership and changes in ownership with the SEC. Officers, directors and greater than 10% stockholders are required by SEC regulations to furnish us with copies of all Section 16(a) forms they file.

To the best of our knowledge, based solely on review of the copies of such forms furnished to us, or written representations that no other forms were required, we believe that all Section 16(a) filing requirements applicable to our officers, directors and greater than 10% stockholders were complied with during 2009. With respect to any former directors, officers, and 10% stockholders, we do not have any knowledge of any known failures to comply with the filing requirements of Section 16(a).

## MISCELLANEOUS

### Other Matters

We know of no business that will be presented for consideration at the Annual Meeting other than that stated in the notice of meeting.

### Stockholder Proposals

Stockholders interested in presenting a proposal for consideration at the annual meeting of stockholders in 2011 must follow the procedures found in Rule 14a-8 under the Exchange Act and our bylaws. To be eligible for inclusion in our 2011 proxy materials, all qualified proposals must be received by our Secretary no later than December 28, 2010. Stockholder proposals submitted thirty (30) or more, but less than sixty (60), days before the scheduled date for the 2011 annual meeting may be presented at the annual meeting if such proposal complies with our bylaws, but will not be included in our proxy materials; PROVIDED, HOWEVER, that if less than forty (40) days' notice or prior public disclosure of the date of the scheduled annual meeting is given or made, notice by the stockholder, to be timely, must be so delivered or received not later than the close of business on the tenth (10th) day following the earlier of the day on which such notice of the date of the scheduled annual meeting was mailed or the day on which such public disclosure was made. A stockholder's notice to the Secretary shall set forth the following: (i) as to each person whom the stockholder proposes to nominate for election to the Board, all information relating to such person that is required to be disclosed in solicitations of proxies for election of directors in an election contest, or is otherwise required, in each case pursuant to the Exchange Act including, without limitation, such person's written consent to being named in the proxy statement as a nominee and to serving as a director if elected; (ii) a brief description of the business desired to be brought before the annual meeting and the reasons for conducting such business at the annual meeting and, if such business includes a proposal or nomination to amend our bylaws, the language of the proposed amendment; (iii) the name and address of the stockholder making the proposal or nomination and any other stockholders known by such stockholder to be supporting such proposal; (iv) the class and number of shares of stock owned by the stockholder on the date of such stockholder's notice and by any other stockholders known by such stockholder to be supporting such proposal or nomination on the date of such stockholder's notice; and (v) any financial interest of the stockholder in such proposal or nomination.

### Solicitation of Proxies

We will bear the cost of this Proxy solicitation and any additional material relating to the meeting which may be furnished to the stockholders. In addition, solicitation by telephone, telegraph or

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other means may be made personally, without additional compensation, by our officers, directors and regular employees. We also will request brokers, dealers, banks and voting trustees and their nominees holding shares of record but not beneficially to forward Proxy soliciting material to beneficial owners of such shares, and upon request, will reimburse them for their expenses in so doing.

### Householding

The SEC's rules permit companies and intermediaries such as brokers to satisfy delivery requirements for proxy statements and annual reports with respect to two or more stockholders sharing the same address by delivering a single proxy statement and annual report addressed to those stockholders. This process, which is commonly referred to as "householding," potentially provides extra convenience for stockholders and cost savings for companies. Some brokers household proxy materials and annual reports, delivering a single proxy statement and annual report to multiple stockholders sharing an address, although each stockholder will receive a separate proxy card. Once you have received notice from your broker that they will be householding materials to your address, householding will continue until you are notified otherwise or until you revoke your consent. If at any time you no longer wish to participate in householding and would prefer to receive a separate proxy statement and annual report, please notify your broker. If you would like to receive a separate copy of this year's Proxy Statement or Annual Report from us directly, please contact us by writing to our Secretary, Karen Stolzar, at our principal executive offices or calling her at 914-345-2620.

### Availability of Proxy Materials

We will provide without charge to each person being solicited by this Proxy Statement, on the written request of any such person, a copy of our Annual Report on Form 10-K for the year ended December 31, 2009 (the "Annual Report"), including the financial statements and financial statement schedules included therein. All such requests should be directed to our Secretary, Karen Stolzar, at our principal executive offices.

### **Important Notice Regarding Internet Availability of Proxy Materials for the Annual Meeting to Be Held on June 17, 2010:**

**The Proxy Materials for the Annual Meeting, including the Annual Report and the Proxy Statement are available at <http://ir.smartpros.com>.**

**EVERY STOCKHOLDER, WHETHER OR NOT HE OR SHE EXPECTS TO ATTEND THE ANNUAL MEETING IN PERSON, IS URGED TO EXECUTE THE PROXY AND RETURN IT PROMPTLY IN THE ENCLOSED BUSINESS REPLY ENVELOPE.**

BY ORDER OF THE BOARD OF DIRECTORS

/s/ Karen S. Stolzar

Karen S. Stolzar, Secretary

Dated: Hawthorne, New York  
April 30, 2010

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**SMARTPROS LTD.  
PROXY  
FOR ANNUAL MEETING OF THE STOCKHOLDERS  
To Be Held on June 17, 2010  
THIS PROXY IS SOLICITED ON BEHALF OF THE BOARD OF DIRECTORS**

The undersigned hereby appoints Allen S. Greene and Jack Fingerhut, and each of them, with full power of substitution, as proxies to vote the shares which the undersigned is entitled to vote at the Annual Meeting of the Stockholders of SmartPros Ltd. ( SmartPros ) to be held at the Comfort Inn, 20 Saw Mill River Road, Hawthorne, New York 10532, on Thursday, June 17, 2010 at 11:00 A.M. Eastern Time and at any adjournments thereof, hereby revoking any proxies heretofore given, to vote all shares of common stock of SmartPros held or owned by the undersigned as indicated on the proposals as more fully set forth in the Proxy Statement, and in their discretion upon such other matters as may come before the meeting.

**Important Notice Regarding Internet Availability of Proxy Materials for the Annual  
Meeting to Be Held on June 17, 2010:  
The proxy materials for the Annual Meeting, including the Annual Report and the  
Proxy Statement are available at <http://ir.smartpros.com>.**

Please mark ☒ your votes as indicated:

1. Election of Class III Directors: Allen S. Greene and Leonard J. Stanley.

☐ **FOR** ☐ **WITHHOLD**

2. Advisory approval of the appointment of Holtz Rubenstein Reminick LLP as independent auditors for SmartPros for the year ending December 31, 2010.

☐ **FOR** ☐ **AGAINST** ☐ **ABSTAIN**

*(Continued, and to be signed, on the Reverse Side)*

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**FOLD HERE**

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THIS PROXY WHEN PROPERLY SIGNED WILL BE VOTED IN THE MANNER DIRECTED HEREIN BY THE UNDERSIGNED STOCKHOLDER. IF NO DIRECTION IS MADE, THIS PROXY WILL BE VOTED FOR PROPOSALS 1 AND 2.

The undersigned hereby acknowledges receipt of the Notice of, and Proxy Statement for, the aforesaid Annual Meeting.

Dated: \_\_\_\_\_, 2010

\_\_\_\_\_  
Signature of Stockholder

\_\_\_\_\_  
Signature of Stockholder

NOTE: When shares are held by joint tenants, both should sign. When signing as attorney, executor, administrator, trustee, or guardian, please give full title as such. If a corporation, please sign in full corporate name by President or other authorized officer. If a partnership, please sign in partnership name by an authorized person.

IMPORTANT - PLEASE FILL IN, SIGN AND RETURN PROMPTLY USING THE ENCLOSED ENVELOPE.

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