Health Plan Conversions: The View From Blue Cross Of California

The chairman of a powerful Blues affiliate goes behind the headlines to discuss why a change in profit status was necessary.

by Leonard D. Schaeffer

The twentieth of May 1996 marked an important milestone for Blue Cross of California (BCC), WellPoint Health Networks, and the people of California. BCC completed its conversion to for-profit status, thus creating one of the nation's largest charitable foundations and a national health care company. This date marked the successful culmination of a three and one-half year regulatory process and set the standard by which future for-profit conversions will be judged. Unfortunately, the process lasted far too long; the delay adversely affected the value of the assets that were transferred to the two foundations created to sustain the BCC public benefit mission. This essay focuses on key events and critical issues that shaped the restructuring of BCC and its conversion to a for-profit corporation under WellPoint Health Networks. Three lessons emerge from the experience that might be of value to regulators, legislators, and consumer groups. First, no one was well served by the lack of a clear and certain process that governed restructuring and for-profit conversions. Second, a structure that mixes nonprofit and for-profit activities can cause confusion and lack of confidence for customers, employees, shareholders, regulators, legislators, and other stakeholders. Third, before a restructuring or conversion begins, two questions must be resolved: Who owns the assets of the converting company, and how are these assets valued?

Background

BCC was founded as a nonprofit public benefit corporation in 1937. As such, BCC had certain federal and state tax advantages that helped it to meet its public benefit mission: to provide Californians with high-quality, affordable health care coverage. As is the case with all public benefit corporations, all of its assets were dedicated to charitable purposes. For nearly sixty years BCC fulfilled its commitment to the people of California. Then things changed.

During the 1980s the health care industry entered a decade of tremendous growth and tumult—new alliances, reform at all levels, and intense public scrutiny, all of which continue to shape today's marketplace. While numerous competitors emerged or expanded to become key players in the industry, BCC was going through a series of unstable business cycles—periods of diminishing growth followed by deeper decline. By the mid-1980s BE's very existence was threatened.2

Toward the end of the decade new management and streamlined operating systems were in place. BCC was back on solid financial ground and recommitted to providing Californians with high-quality, low-cost health care. Still, BCC faced significant challenges: uncertainty over future government policy and regulations, limited access to capital markets, and increasing competition in a rapidly growing marketplace. BCC thus be-
gan to look for a way to compete on the same regulatory and marketing playing field with its competitors, while remaining consistent with its public benefit mission.

A New Business Strategy

In fall 1990 BCC was a nonprofit business that needed to reposition itself in the market. Changes in California law prompted BCC to apply for licensure as a health care services plan, to be regulated by the Department of Corporations (DOC) under the Knox-Keene Health Care Services Plan Act. At the same time, the company continued to explore avenues that would ensure the long-term health of the business and that would position the organization for future growth. In August 1992 BCC proposed to the DOC a restructuring plan that would augment its public benefit activities and enhance its financial capacity in an increasingly competitive environment.

The plan had four key provisions. (1) The restructuring would create a for-profit subsidiary, WellPoint Health Networks, which would be in a position to raise capital through a public offering. BCC would retain 80 percent of the equity and 97.5 percent voting control of WellPoint. This would allow the BCC Board of Directors to effectively control the for-profit entity while simultaneously continuing BCC's public benefit activities. (2) BCC would restructure, but it would not convert to a for-profit plan. As a member of the BlueCross BlueShield Association (BCBSA), BCC was governed by rules that prohibited a primary licensee of the valuable Blue Cross name and trademarks from being a for-profit entity. Therefore, BCC would retain its nonprofit public benefit status. (3) The restructuring would not result in any private inurement of nonprofit assets or private benefit to the BCC board, management, or employees. (4) The restructuring would provide BCC with the flexibility and resources to augment its public benefit activities while strengthening its ability to meet its customers' needs.

This plan was approved by the DOC in January 1993. WellPoint then went public with the initial offering, which netted $517 million. BCC now was to spend almost two years trying to reach an understanding with the DOC on the public benefit issues resulting from this transaction.

Redefining BCC's Public Benefit Obligations

The restructuring approved by the DOC in 1993 left nonprofit BCC firmly in control of its for-profit subsidiary, WellPoint. However, there was no law, regulation, or precedent that defined the public benefit obligations of a restructured nonprofit public benefit entity. Only one thing was certain: As the DOC repeatedly pointed out, the restructuring specifically was not a conversion to for-profit status. Conversions require a transfer of the value created by a nonprofit to assure the continuation of the converting entity's nonprofit mission.

For the next twenty-one months, from January 1993 through mid-September 1994, BCC tried to clarify its status and obligations as a nonprofit public benefit corporation with a series of regulatory filings and responses to legislative and regulatory initiatives. In April 1993 BCC stated its intent to expand its nonprofit public benefit activities in three main areas: making available affordable and accessible health care coverage, providing health care services to medically underserved persons, and supporting state and local government programs.

Following discussions and an agreement with key California legislators, BCC filed a plan with the DOC to fund its public benefit activities, committing a contribution of $100 million over twenty years to health-related activities. After that, a new DOC commissioner, Gary Mendoza, took office, bringing a different perspective to the entire process.
December 1993 the DOC informed BCC that the agreement it had reached with the legislators was not sufficient to satisfy the DOC. However, the DOC did not specify a dollar amount or other measure that was suitable.”

In January 1994 BCC amended its DOC filing describing how BCC intended to implement its commitment “to continue and augment its public benefit activities.” The filing also pointed out a lack of clarity in law, regulations, or any court decisions defining the term augment or the obligations of nonprofit public benefit corporations.

In April 1994 the DOC put a dollar amount to its expectations—not less than $100 million to be spent on charitable activities in 1994 and not less than 40 percent of WellPoint stock ($1.2 billion) to be contributed to a newly formed foundation. BCC responded affirmatively to part of the DOC’s request by committing a second $100 million in charitable contributions in addition to the $100 million committed as a result of discussions with members of the California legislature.

However, there was no legal basis to justify a donation of WellPoint stock or BCC’s resulting loss of control of WellPoint. While the DOC’s position was now clear, it created fiduciary problems for BCC’s board and had no statutory basis.

The Difficult Nonprofit/For-Profit Mix

The lengthy period of debate and filings that followed the DOC’s January 1993 approval of BCC’s restructuring resulted in widespread confusion among BCC’s and WellPoint’s key stakeholders. Customers ... it not just refund those funds to its customers? Employees did not understand clearly whether they were working for a nonprofit or a for-profit company. WellPoint stockholders were concerned about the time it was taking BCC, WellPoint’s principal stockholder, to resolve this issue with the DOC. They believed that this protracted process was hurting WellPoint in the marketplace, depressing the value of the company’s stock, and distracting the board and senior officers. Legislators attempted to agree to a dollar amount that resolved the public benefit issue, only to be second-guessed by Mendoza.

A policy change at the BCBSA offered a way out of this confusion. In May 1994 the BCBSA amended its rules to allow for-profit organizations to hold the primary Blue Cross license. (Until then, the primary license had to be held by nonprofit BCC.) This event, along with concerns emerging among BCC stakeholders, led BCC to file a plan with the DOC 15 September 1994 to completely separate its commercial business from its public benefit activities through a conversion to for-profit status.

Under the proposal, BCC and WellPoint would merge, and BCC would contribute all of its assets to a new, tax-free charitable foundation. The plan also proposed six foundation initiatives to reduce health care costs and improve access to care for Californians.

Public Benefit Obligations: Dealing With The Assets

Throughout the restructuring and subsequent conversion process, two central questions emerged regarding assets: Who owned them, and what was their value?

ASSETS OWNERSHIP. As previously described, the search for a clear understanding of its public benefit obligations began when BCC received approval to restructure in January 1993. It also grappled over the question of assets ownership. By the time Mendoza was appointed DOC commissioner in August 1993, BCC had already restructured and was discussing its public benefit activities and commitments with the DOC. Much to everyone’s surprise, the new commissioner took the position that the people of California were the “shareholders” of nonprofit BCC. The BCC Board of Directors countered that the company remained a nonprofit public benefit corporation, and, as stewards of BCC’s nonprofit assets, it was their responsibility to operate Blue Cross in furtherance of its public
benefit mission. With regard to the ownership of a non-profit's assets following a conversion, it was clear that BCC had an obligation under California law to transfer the value of the assets held by the nonprofit entity to another public benefit entity, which then would carry out the converting entity's nonprofit purposes. This would ensure that the assets would continue to be dedicated to charitable purposes. Two charitable foundations were set up as recipients of the value of BCC's assets.

Controversy over who is entitled to the assets of a company that restructures or converts to for-profit status continues to be an issue in several states. This issue needs to be addressed explicitly in any restructuring/conversion transaction if the process is to proceed smoothly.

**ASSETS VALUATION.** Once it is decided who is entitled to receive the assets, the value of those assets must be determined. Several methods can be and have been used, including a value calculated on the basis of traditional valuation approaches, such as projected financial performance, or value determined by market forces and reflected in bids from potential purchasers.

If the assets held by the nonprofit entity include stock that is publicly traded, its value, established by competitive market forces, is the price that investors are willing to pay for that stock. Since WellPoint was publicly traded, BCC, in a 15 September 1994 DOC filing, proposed to value its WellPoint holdings on the basis of its publicly traded price. The DOC expressed the view that the company could be better valued by putting it up for auction through a “market assessment” process. The DOC implied that the BCC board somehow had an obligation to auction the company. The BCC board, however, did not agree with this approach. They viewed it as unorthodox, destabilizing, and unsupported by California law or precedent. However, to challenge the position in the California courts would have taken years—too much time for the good of the company. So, the company was put up for sale.

This so-called market assessment was extremely costly and resulted in no tangible gain. Millions of dollars were paid in fees to lawyers and investment bankers, including lawyers and bankers hired by the DOC but funded by BCC. The process consumed six months and culminated with a plan that included the combination of WellPoint with Health Systems International (HSI). In late December 1995 the combination was terminated when the DOC appropriately refused HSI’s request to renegotiate terms. In an effort to reach final resolution, BCC filed a recapitalization and reorganization plan with the DOC in February 1996 based on its original September 1994 filing. The company would be valued based on the selling price of the stock.

On 20 May 1996 the conversion and recapitalization was completed, marking the complete separation of BCC's public benefit activities from its commercial business and creating a $3 billion endowment for two independently managed foundations. The marathon regulatory process was finally over.

**Conclusion**

Moving through uncharted territory entails inefficiencies that cannot be avoided. In this instance, however, the delays and costs were excessive. They resulted in lost opportunities to increase the value of WellPoint and thereby the value of the assets to be contributed to the charitable foundations. Because of the long delay, potential unrealized value may not be recouped by the charitable foundations. Only time will tell. We do know, however, that while the restructuring and then conversion were under consideration, investors became concerned, and the value of the company's stock was depressed. In addition, we know that WellPoint lost out on opportu-
nities to form business combinations with other important entities that did not wish to be enmeshed in the protracted regulatory proceedings.

The state of California has learned from this process as well. The BCC conversion and the state law that memorializes this transaction, Senate Bill 445, now serve as a model for future restructurings and conversions. Perhaps others can benefit from our experience and avoid the extensive delays and unnecessary costs that can erode the value of assets that could go to charity, customers, the state, or a combination of these.

Despite the delays, the public eventually benefited greatly from the BCC conversion. Our experience, however, is not a blanket endorsement of conversions to for-profit status. Such decisions should emerge only after a careful weighing of a company’s circumstances, its business objectives, and the potential benefit to the public that could be derived from a conversion. My goal in this essay has been to identify key issues by providing examples from the BCC conversion process. For those pursuing a restructuring or conversion and for the elected officials and the regulators overseeing the process, a sound and predictable process is essential if the appropriate benefit is to be realized by and for the public.

I am proud of the $3 billion legacy that BCC has created. I hope that those who choose to follow our example will benefit from our experience.

NOTES
1. Blue Cross of California, Articles of Incorporation, 1937.
3. Presentation by Leonard D. Schaeffer, National Association of Insurance Commissioners, Special Committee on Blue Cross and Blue Shield Plans, 26 April 1996.
17. The first, the California Health Care Foundation, was established as a 501(c)(4) and was the recipient of the WellPoint stock. The second, the California Endowment, was established as a 501(c)(3) and received cash as part of the conversion. By establishing both foundations, the federal tax liability resulting from the transfer of assets was eliminated. Under the terms of incorporation, as the 501(c)(4) begins to liquidate its holdings in WellPoint, the 501(c)(3) will become the beneficiary of some or all of the funds.
21. S.B. 445, Legislative Counsel’s Digest, chap. 792.