

RECORD, Volume 22, No. 2*

Colorado Springs Meeting

June 26–28, 1996

Session 71PD

Conversion of Health Organizations from Not-for-Profit to For-Profit

Track: Health

Key words: Health Maintenance Organizations (HMOs), Mergers and Acquisitions

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Summary: This session discusses demutualization, mergers of health maintenance organizations (HMOs), and conversion from nonprofit to for-profit. How does an actuary value HMOs?

Mr. Harry L. Sutton, Jr.: Conversion of HMOs from not-for-profit to for-profit relates not only to Blue Cross plans, but also HMOs and possibly even hospitals or physician hospital organizations (PHOs).

Jay Gerzog is an associate in the New York office of Epstein, Becker & Green, P.C., one of the foremost law firms related to managed health care. The firm has been the counsel for the American Medical Care and Review Association (AMCRA), Professional Standards Review Organization's (PSRO) preferred provider organization (PPO) now merged into American Association of Health Providers (AAHP). Their law firm has been involved since the early 1970s with the developing HMO movement, and particularly in the beginning when almost all the HMOs were not-for-profit. Jay has done a lot of work for tax-exempt types of organizations, including working with them to maintain their tax-exempt status. He practices before the

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New York Attorney General, was a graduate at New York University (NYU) Law School, and earned his Doctor of Jurisprudence (J.D.) degree at George Washington University.

Our other two panelists are well-known to actuaries. Bob Dobson is now with Milliman & Robertson (M&R) in Tampa. He has been with Tillinghast, M&R, and Blue Cross of Alabama. He also has been Vice President of the Society of Actuaries (SOA).

Andrew Wang, also a former M&R actuary in California, is now a senior vice president and chief actuary of Health Net, which is a subsidiary of Health Systems International based in Colorado.

Bob Dobson is going to start. He is going to work his way through an example of an organization thinking about converting. Jay will discuss the background of legal issues on conversion and emphasize a particular type of conversion that he works on frequently with not-for-profit organizations. Bob will come back again and talk about valuation by normal standards. At the end, Andrew Wang will discuss the situation in California and explain how his organization has been structured and funded since the conversion from not-for-profit to for-profit.

Mr. Robert H. Dobson: I'm going to start by dividing the room into the constituencies of a board of directors of a hypothetical health plan. First are the physicians. You feel some sense of historical ownership of the plan, as doctors were involved in the original development of it. You see the traditional business within this particular plan as the last bastion of your physician/patient relationship, and you would like to maintain that. You see managed care as an out of control steam roller. You see your PHO as the wave of the future. And you believe, if there is any value to be distributed based on any transaction, it should be payable to the physicians.

The second set is the hospital administrators. You are concerned because you think that 50% of the hospitals may be gone in five years. You see aggressive managed care ruining your margins. You see for-profit competitors coming in and teaming up with managed care organizations. You are concerned about the PHO. You do feel some sense of historical ownership of this plan because of your early participation with it. You are quite certain that any value should go on to the hospitals.

The next constituency is labor. You are concerned that if this health plan changes to for-profit status, there will be layoffs. You also believe it is quite obvious that the success and surplus of this plan is a result of labor's efforts. Any value should be payable in future wage increases and benefits.

The next constituency is the employers. You see most of the prices in the marketplace holding steady or declining. This particular plan is still instituting rate increases, so you are worried about the efficiency of this plan with which you are involved. You certainly do not want to be footing the bill for any social responsibilities, and one thing you are certain of is that any value belongs to the policyholder, not the members.

Next are the consumers. You are concerned about the plan's social responsibility. You believe that any surplus and value of business in force should go to the members or maybe the state. You believe that, as a minimum, back taxes should be due and payable any time there is a conversion because there have been prior tax advantages.

I have to tell you as members of the board of directors that everybody is doing this, so it is very important for us to do it. It has gotten into the popular press. This is from the April 22, 1996 *Newsweek*. It says, "As your local Blue Cross/Blue Shield heads into the for-profit sector, it is helping along the biggest gold rush since Sutter's Mill. The question is, who will strike it rich?"

I pulled out a lot of headlines and most of them concern Blue Cross plans and HMOs that have been doing this as well. I will mention a few of them just to give you an idea of how widespread this is: "Virginia Panel Sets Conditions for Blue Cross to Gain For-profit Status." "Ethical Issues, State Would Be Number One Stockholder of Health Insurer." "Blue Cross of California Public Benefit Plan Approved by Department of Corporations, \$3 billion Slated for Charitable Foundations." "Empire Blue Cross Profit Unit Gets OK." "Big Executive Bonuses Offered for Making Colorado Blue Cross For-profit."

There are a number of options on how we can go about this. First, we can simply convert from not-for-profit to for-profit. We could buy or establish a for-profit subsidiary. We could sell to a for-profit or another not-for-profit. We are faced with everincreasing competition. We need the ability to raise capital to be able to compete. We have to be able to improve our managed care.

We have lawyers; we have accountants; we have tax advisers; we have investment bankers; we even hire actuaries, but most important we have public relations specialists. It is very important to control these headlines. With that, I will turn the discussion over to our lawyer, who will tell you about the specifics of the deal, and then I will come back and tell you about the actuarial appraisal.

Mr. Jay Gerzog: First, let me just address what is meant by a conversion of a nonprofit organization. In the most general sense, a conversion is the process by

which a nonprofit entity, which may either be a tax-exempt nonprofit organization such as a hospital, or a taxable nonprofit organization such as an HMO or Blue Cross/Blue Shield plan, transforms itself and its operations, or its operations but not the entity itself, to for-profit status.

I recently had a conversation with a president of an HMO who told me about a conference attended by HMO presidents from throughout the country. A speaker asked the question, "How many of you in the room are considering conversions for your organizations?" He estimated that all but a handful raised their hands. Hospitals throughout the country are also pursuing conversions, and the Blue Cross/Blue Shield plan conversion transactions have basically become the model at this point.

What is driving this conversion wave? Perhaps foremost is the need for greater access to capital in order to have the ability to compete with for-profit entities. For-profit entities, because of their ability to access capital are able to pursue more aggressive marketing strategies, thereby being able to attract a greater number of subscribers (in the case of an HMO, Blues plan or other insurance type entity) or patients (in the case of a hospital). Further, capital allows an organization to attract better management staff, physicians and other providers, because the for-profit organization is generally not subject to the restrictions with regard to the payment of reasonable compensation under IRS rules or the state laws governing not-for-profit entities.

Overall, the need to have the ability to compete with for-profit organizations in this rapidly changing health care market requires much greater access to sources of capital. The traditional resources of capital for tax-exempt nonprofit organizations are limited: contributions, governmental grants, loans, tax-exempt bonds, and revenues from their operations.

These nonprofit capital resources have become more limited than they have been in the past and are insufficient given the rapidly increasing capital needs. Tax-exempt bond financing is no longer available for HMOs or the Blue Cross organizations that no longer qualify as Section 501(c)(3) organizations. Further, bank loans are inadequate for expansion. It is very difficult for an HMO or Blue Cross organization that has little or no tangible assets to secure asset-secured financing.

Moreover, a key component of access to capital is the ability to raise capital on the basis of earnings multiples. As a rough example, in the equity markets, \$1 of earnings permits an entity to raise upwards of \$20 of stock value. Conversion to for-profit status allows the organization to issue stock, which, in turn, gives the organization a much less expensive way to pursue transactions such as acquisitions and

mergers, as well as to compensate management, by being able to give management some form of incentive compensation, and thereby a stake in the upside in the growth of the business.

For-profit organizations have greater flexibility in engaging in joint ventures because they are not subject to the so-called private inurement and private benefit rules. Furthermore, for-profit entities, having greater overall operational flexibility as compared to nonprofit organizations, are generally more attractive to third party suitors, and thereby, are generally able to command increased market prices in acquisitive transactions.

Another force that is compelling nonprofit conversions is history itself, particularly that of HMOs and Blue Cross/Blue Shield plans. The incentives to be nonprofit have diminished with the elimination of federal grant subsidies for HMOs that were commissioned back in 1973, and further with the elimination of exemption from taxation. HMOs used to be eligible for tax-exempt status under Section 501(c)(3), but are often limited to tax-exempt status under Section 501(c)(4). This relates to the issue of whether an HMO actually delivers health care or merely is arranging for health care services. Generally, only staff models are eligible to obtain Section 501(c)(3) status today. The vast majority of HMOs are either for-profit taxable entities or tax-exempt under Section 501(c)(4). Blue Cross/Blue Shield plans lost their ability to obtain tax-exempt status back in the 1980s, largely on the grounds that they had become much more like commercial insurers. Basically, this movement away from tax-exempt qualification is recognition of the fact that nonprofit HMOs, Blues plans, and even nonprofit hospitals are operating on relatively the same basis as for-profit organizations. Overall, the foregoing reasons compel a tax-exempt nonprofit to give serious consideration to converting to for-profit status.

From a regulatory standpoint, the IRS has played, and will continue to play, more of a secondary role in the conversion process as compared with state regulators, such as the attorneys general. The IRS is primarily concerned with ensuring that fair market value is received in the transaction. However, one generally does not need to obtain advance approval from the IRS to engage in a conversion transaction.

The state level is really where the primary regulatory focus exists. The state attorneys general, the courts, and other regulatory agencies (for example, departments of insurance, or departments of health) play a principal role in the conversion process. The attorney general, in particular, is intimately involved in the conversion process. From the very beginning, once an organization consults with its advisors and comes up with a business plan, the organization will then find itself sitting down with the attorney general virtually every step of the way from that point on, seeking the attorney general's guidance in structuring the transaction to comply with the

charitable trust laws and other requirements, and almost certainly will ultimately need to obtain attorney general approval for the transaction. The attorney general's involvement generally focuses on the concept of a charitable trust. Once assets are placed in use for charitable or nonprofit purposes, they have to remain in that mode forever. Such assets, or at least the value thereof, cannot be removed from "charitable solution" and used for business or private purposes. There is an equitable doctrine of law in which a court will consider waiving restrictions for charitable use under certain limited circumstances. These limited circumstances are essentially when the charitable purposes become impossible, virtually impractical or illegal to carry out.

The state regulators focus on four main categories. First is the form of conversion; second is the amount of what is generally referred to as the "charitable settlement;" third is the methodology for valuing the charitable assets that are to constitute the charitable settlement; and fourth is the licensure of the new for-profit entity.

From the perspective of conversion methodology, this recent wave of nonprofit conversions has demonstrated that many state statutes are inadequate to address this issue. Most state law is completely silent and the state regulators have to create their policies out of "whole cloth," subject to their charitable trust provisions. In the case of a sales transaction in which a nonprofit organization sells all or a portion of its assets to a for-profit organization, state nonprofit laws generally have established guidelines, at least to some degree. Conversion typically requires the transaction to be approved by the attorney general, and, moreover, in many states the courts must also approve the transaction. In New York, for example, the state supreme court is required to approve the transaction.

Conversion methodologies can be classified into two main categories. One category involves a change in the structure of the nonprofit organization; the second involves the transfer of assets. In a few states one method of a "change of structure" form of conversion is simply to amend the nonprofit organization's articles of incorporation and restate them as a business corporation. Certain states, such as Michigan, generally authorize such form of conversion, provided that any charitable assets remain used for their intended charitable purposes.

In many cases, an organization's charitable purpose is more of a historical matter than one of current necessity. Often, an HMO established its purposes many years ago as a charitable organization, but may have lost that charitable focus. However, its charter still has the original charitable language in it. The very existence of such a charitable purpose is what the attorneys general and the consumer groups are wrapping their hands around, saying this organization has a charitable purpose,

notwithstanding the fact that it really has not operated on a charitable basis for some time.

A second “change of structure” conversion method is a merger. Some state laws permit a merger of a nonprofit with and into a for-profit organization, with the for-profit surviving and the assets of the not-for-profit being transferred by operation of law.

A third type of “change of structure” conversion involves a two-step process, pursuant to which the nonprofit entity, such as an HMO or Blue plan, would mutualize. A nonprofit organization is generally not considered to have any owners; rather, the public, represented by the attorney general, is considered to be the owner of a nonprofit organization. In the mutualization form of conversion, the policyholders would become members of the mutualized organization. Consequently, now you have a defined group of owners, that is, the policyholders. The second step of this mutualization process involves the former policyholders, now members of the mutual company, converting their membership interests into stock ownership.

The advantages of a “change of structure” form of conversion are that, although regulatory approval may be required for the whole transaction, such form of transaction typically does not require prior approval, relicensure, or assignment of contract issues because the transaction typically involves merely amending the certificate of incorporation while continuing the legal existence of the entity in question. The converted entity has really only changed its purposes, but itself remains in existence. In the merger transaction, the assets get transferred by operation of law.

As an alternative to the “change of structure” methodology, the other form of conversion methodology involves the “asset transfer” method. I would like to focus on one particular form of “asset transfer” transaction, which is what I will call the “drop-down” conversion. At the start, we have a parent and a subsidiary not-for-profit organization. Additionally, there may be one or more for-profit subsidiaries. The parent nonprofit corporation serves as a holding company, and the subsidiary nonprofit is the operating entity. That is where we see it today.

Step one involves the nonprofit operating organization transferring all of its assets to a newly formed for-profit subsidiary in exchange for all of its issued and outstanding stock. It is at this moment where the conversion occurs. This is a transfer of substantially all of the assets of the nonprofit entity. This is the point where state statutes are going to be triggered and provide that such a transaction requires some form of regulatory approval.

The next step is to merge the former operating nonprofit company, which has now become a shell since it has transferred its assets/liabilities to the for-profit subsidiary, up into its nonprofit parent so that, after such merger, we have a nonprofit parent holding the stock of the for-profit subsidiary. However, additional steps must take place in order to permit access to capital.

Consequently, the next step would be for the nonprofit parent to transfer all of the stock of the for-profit subsidiary to an intermediary for-profit holding corporation. The reason for this step is that in order to access capital, particularly in the case of public offerings, one does not want to be issuing stock from, or, from the stockholder's perspective, holding stock of a regulated entity such as an HMO or Blue plan. One would prefer to use an unregulated entity for such a purpose. Once this intermediary holding company is in place, we are ready to enter the future.

The future capital raising transaction would not necessarily take place immediately after consummating the conversion. There is often some time lag (for example, six months, a year or maybe longer), to allow the nonprofit organization, whose full operations are now in a for-profit mode, to generate some value by increased efficiencies and/or growth.

There are two ways of accessing capital: (1) the new intermediary holding company could issue stock to the public through a public offering or a private placement. Cash for issuance of such stock goes into the intermediary holding company, which, in turn, transfers such proceeds into its operating subsidiary entities, and (2) the nonprofit parent can sell some of its stock to third parties in connection with a public offering or private placement.

I think this transaction is a very viable form of converting a nonprofit organization and arguably may permit one to avoid engaging in a charitable settlement. First, the interests of the public are protected because the economic value of the nonprofit assets has not been diminished. The value of the nonprofit business, originally held in the nonprofit parent through its nonprofit subsidiary, is still, after the drop-down conversion transaction, controlled by the nonprofit parent in the form of stock of the for-profit subsidiary. The operating assets existing before the transaction began are still controlled, albeit indirectly through stock ownership, by the same nonprofit organization, the nonprofit parent. Further, there is no change in control. The same entity that controlled these organizations before the conversions still controls the organization postconversion. No employee, no trustee, no director should directly benefit in this process. Although such individuals may be eligible to participate in stock option plans and other forms of incentive compensation plans, this would all be done in arm's-length transactions, for fair-market-value consideration, and no

differently from the way any for-profit organization compensates its staff. No bonuses should be given out relating to the effectuation of the conversion.

This form of transaction is similar to what is currently being contemplated by Empire Blue Cross in New York, although differentiated by the fact that in the Empire transaction currently under discussion, arguably only a relatively small portion of Empire's current assets, its managed care business, are involved. While attorney general approval is typically required for this form of transaction involving a drop-down of substantially all assets, in the Empire transaction, it is Empire's position that it currently is only transferring less than 10% of the assets of the entity. This does not raise the threshold of attorney general participation because the assets being transferred constitute less than "substantially all" of Empire's assets. However, consumer groups are very concerned because of the potential for migration of the indemnity plan and fee-for-service businesses to the for-profit successor managed care business. The concern is that eventually virtually the entire business is going to be in a for-profit subsidiary of Empire. The argument is that, while such managed care business may only be 10% of Empire's business today, it is really of much greater value. That appears to be where the tension primarily lies in the Empire transaction.

Additionally, conflict of interest issues can play a significant role here in that those persons who are serving on the board of directors of the for-profit organization may often be the same people who are serving on the board of the nonprofit parent. Serving in both capacities, they often will have competing interests between the two entities with regard to various circumstances that come up in the future.

Even when the entity eventually issues stock to third parties, the argument can be made, and I think it is a good one, that there has been no reduction in economic value of the nonprofit parent's stock in its for-profit subsidiaries. When the intermediary holding company issues stock, even though it may dilute the nonprofit parent's stock ownership therein, and perhaps voting control, it is not diminishing the economic value, because the shares retained by the nonprofit parent now have proportionately greater value. For example, if 20% of the intermediary holding company's stock is issued to the public, the parent now owns 80% of the stock of the larger company—larger in the sense that it has the cash proceeds from the stock issuance. Moreover, because the stock will generally be valued on a multiple of earnings basis, the parent actually owns stock that has a much greater value than it did even on a 100% ownership basis.

The conversion transaction has created a new taxpayer, at least on the state level. We have taken an operating entity that, while it may not have been exempt from federal taxes, may have been exempt from various state taxes, and now, as a for-

profit, it no longer qualifies for such exemption. Hence, additional revenues are made available for the state.

It is important to note that the nonprofit parent generally will not be able to justify its continued nonprofit and/or tax-exempt status merely through its stock ownership in the for-profit HMO or Blues plan. Rather, the nonprofit parent will generally be required to engage in some form of direct conduct of charitable activities. When the nonprofit parent sells its stock in the intermediary holding company, it will have cash to use for charitable purposes.

I think this drop-down conversion approach should work, but regulators are currently evaluating it, and there is no real decision as yet. New York is considering it. New Jersey and Illinois are struggling to support this approach.

Another form of "asset transfer" conversion is what may be called a "parallel" conversion or "side-step" conversion. This involves a transaction in which you create a "parallel" for-profit entity unaffiliated with the existing nonprofit entity or, alternatively, a controlled for-profit subsidiary of a nonprofit parent. We will call this "parallel" entity Newco. Newco obtains its HMO license, and both HMOs, the existing nonprofit HMO and Newco, continue to operate simultaneously. As the nonprofit HMO's managed care contracts come up for renewal or expiration, the nonprofit HMO does not pursue renewing them, but instead, the for-profit HMO does. Essentially the managed care contracts migrate over to the for-profit HMO, and all of a sudden at a certain point in the future, the business is now in the for-profit entity, and the nonprofit eventually dissolves.

The argument made in support of this transaction is that no charitable settlement should be required because no transfer has occurred; rather, this is simply a normal migration of business. From a legal advisor's perspective, I have concerns with these forms of transactions for a number of reasons.

First, the board of directors of the nonprofit organization has a fiduciary duty to protect the business and assets of such an entity. By allowing the organization's principal assets, the managed care contracts to expire without actively pursuing their renewal, but rather, permitting such business to migrate to another corporation, arguably constitutes a breach of their fiduciary duties for the nonprofit organization.

Second, the fact that the nonprofit organization acquiesces in the migration of the contracts, quite often has an overlapping board of directors with the for-profit HMO, and typically has a very similar, if not identical, name, to that of the for-profit HMO, may in reality mean that a transfer of goodwill has taken place, which, in fact, is

where a large part of the value may be. Accordingly, it can be argued that there has in fact been a transfer of assets. It may be a “stealth” or perhaps constructive transfer, but nevertheless, it’s a transfer.

Another form of “asset transfer” is a straight sale of assets. I do not personally consider this a conversion. It is very distinct from a conversion in the sense that the nonprofit is simply just selling its business assets for consideration that must be used in furtherance of its tax-exempt nonprofit purposes. What often is involved in a sale of assets conversion is that the management of the nonprofit entity creates an independent for-profit corporation, buying stock therein relatively inexpensively. The new for-profit enters into purchase contracts with the nonprofit to buy the nonprofit’s assets for cash and/or installment notes. That asset purchase is consummated, and at some point in the future, a public offering takes place with respect to the stock of the for-profit entity. In this transaction, relicensing would generally be required, assignment of contracts would be required, but here you have a situation where the transaction itself creates the charitable settlement in the form of the consideration received in exchange for the assets sold.

The positive aspect of the sale is certainty as to procedure. You generally know how state authorities are going to treat the transaction. The downside is that the attorney general’s office is typically focused on getting liquid value; therefore, the people there often want to see the nonprofit receive a large percentage of the purchase price in the form of cash upfront. This accelerates the need to issue stock publicly sooner than may be optimal. Furthermore, the operating entity, now having its shares publicly traded, is put “into play” and subject to unwanted offers to acquire control of the entity. As a result, you have this entity that is for-profit, not controlled by the nonprofit, and now outsiders potentially can attempt a hostile acquisition and take the company away from management. Management has to be concerned about that, although it owns the stock and may not mind too much, but this is a risk.

Overall, in a conversion transaction when assets are leaving the nonprofit organization, a great deal of attention is put on the terms of the charitable settlement that may be required. Someone has to compensate the public for the loss of those assets. That someone generally is the for-profit entity. The charitable settlement issue focuses on the for-profit organization having to transfer consideration of sufficient value to compensate the public.

What is sufficient value? There are two primary theories. The first is the tax benefit theory, valuing the historical tax and other benefits realized by the nonprofit organization by reason of its nonprofit status. The other theory is the charitable trust doctrine, which focuses on the value of the organization’s nonprofit assets as a

whole. The charitable settlement would typically involve a transfer or contribution of consideration either to a nonprofit charitable organization that is controlled by the same individuals who control the former nonprofit operating entity, although such continuing control is sometimes challenged by public interest groups who want the charitable settlement proceeds to be controlled by independent community leaders, or alternatively, to an independent existing charity that the state has mandated.

This is really what is going on in California right now. In pending legislation that will set up a single state-sponsored foundation for the purpose of receiving charitable settlements from conversion transactions, one form of charitable settlement would be cash. A public stock issuance is generally required to generate the cash. Deferred charitable payment obligations can be paid out of operational revenues. Alternatively, the for-profit organization's stock may be attractive to an attorney general to satisfy all or a portion of the charitable settlement because of the attorney general's concern as to valuation. Although an initial valuation is performed at the time of conversion, soon thereafter, sometimes within six months or a year after the conversion, the value of the entity may skyrocket as demonstrated by the stock price realized in the public offering. For example, while the entity may originally be valued at \$1 million, in the relatively near future, the company is valued at \$20 million through the public offering. This is where the attorney general is concerned and where a great deal of the attorney general's sensitivity is focused.

Bob is going to talk about valuation in greater detail. I want to focus on one aspect of valuation for a moment. On what basis do you value organizations? Do you value the organization as a nonprofit or as a for-profit entity? When do you value the organization? In a drop-down situation, do you perform the valuation at the time of the asset transfer, or do you perform the valuation at the time when the public issuance takes place, which may be a year or two down the road where values may be greater. State regulators are highly focused on these issues. Many state regulators do not know what to do. In July 1996 in Boston, there will be a 50-state conference of state attorneys general and charity officials; the topic of the conference is conversions of nonprofit health care organizations. They are going to discuss these very issues because they are not sure what to do about them. The National Association of Insurance Commissioners (NAIC) is about to issue a white paper on this topic. There are public hearings that are taking place about these conversions all the time.

One last point to mention on valuation is that this is where actuaries are very much involved. This is where the public concern is focused. As a legal advisor, under certain circumstances, I might advise organizations to go out and not only get one appraisal, but also possibly two. This way you go to the attorney general and are

able to say that you have independent appraisers, independent valuations, that support your proposed transaction. In New York, the attorney general's office does not go out and hire its own appraisers. It relies, in large part, on the appraisals that are submitted by the converting entity. The attorney general will look at the appraisal, analyze it, and look for weak spots. The attorney general may hire someone to focus on the weak spots, but he or she is not going to do independent valuations. The organization should go out and hire actuaries and investment bankers to really produce air-tight valuations.

That is the legal and regulatory picture, and I will turn it back to Bob to talk about the investment banker/actuarial perspective of the valuation.

From the Floor: Under the tax benefit theory of determining charitable settlement, wouldn't the company want to offset that by the cost it has incurred, and the other side of the bargain, for example because it is a carrier of last resort?

Mr. Gerzog: Sure. One can make the argument that the company has already given the tax benefit back by charging lower premiums. The company paid for the tax benefits by accepting people of higher risk and thereby not charging higher premiums for that group. But, there are consumer groups who do not accept these arguments.

Mr. Dobson: As Jay said, the issue of appraisal has become very important, particularly if any of you are from Ohio or have seen any of the press in Ohio recently. An appraisal that M&R did has come under fire, if you will. First, I want to talk about some of the issues in an actuarial appraisal. Obviously, the first thing you start with is the adjusted net worth. Normally we would use the statutory surplus as of some point in time, and add in some estimate of the real value of nonadmitted assets. Within that present value of future profits is a value of current business and new business, though when we do valuations or appraisals that are primarily group, we deal with that through a net group rate, instead of having to deal with lapses and sales. That last piece is where a lot of the value can come from. If you are trying to minimize the amounts that you have to pay into some foundation or something, that can be a real issue.

Typically we work with a buyer or a seller. If we do an appraisal for the buyer, we need to know whether it wants us to substitute in what the buyer's own assumed expenses would be and its own deals with providers. It is more difficult to do that when you are dealing with a conversion situation, where there may or may not be any changes. In particular, the value to the owner that you have to give this value to could really be on a continuing basis; I would call it continuity of management. That is clearly one of the issues the person doing the appraisal has to deal with. If

there is a proposed transaction in place, are we going with the gist of the proposed transaction, or are you going to take into account other alternate transactions? In other words, reflect the best deal the buyer might be able to make.

As Jay said, one of the real issues is who gets that current value? It is real important to recognize the cost of capital. That obviously keeps the values realistic, and it is a true cost of doing business. We would put in the cost of capital either based on NAIC risk-based capital or the capital benchmark, but it does affect the value. Of course, you have to take into account the tax effects. Here the issue is whether you have to deal with the current tax status or the tax status after some transaction. Do you really know what that tax status after the transaction would be?

An investment banker tends to look at the adjusted book value and the present value of future profits. Investment bankers have four different approaches I have seen. I will describe them all. The first is discounted cash flow. This is sort of like actuarial present values, but the way I have seen it used, it is really not. I have seen investment bankers use much higher discount rates and also be more based on cash available out of the business. It tends to be for a shorter period I think than we would project. They also like to look at price to earnings and price per member of comparable public companies.

There is a publication called *Pulse*, which is put out by Sherlock and Company that gives information on for-profit HMOs. It gives information on price per member. The average as of May 31, 1996 was \$1,201 per member, but the variation was from \$145 to \$2,962. That is quite a variation even for actuaries. That is what they get into, price to earnings or price per member, and they do try to look at comparable public companies, and they take into account things like liquidity, i.e., is this going to be something that is openly traded or something that is privately held.

The other category would be looking at comparable initial public offerings when they first come out. There are a lot of differences between investment banker appraisals and actuarial appraisals. I think companies should have both. In fact, the cases that I have been involved in usually have one or the other. The ultimate goal from the investment banker side of the table is to give some sort of comfort and fairness either to the board or to regulators. As actuaries, we try to avoid getting into fairness issues. We say this is what we have, these are the assumptions we made, and this is the result.

That issue has been a critical issue in Ohio as I said. This is from *The Akron Beacon Journal*, Thursday, June 20, 1996. The authors let some accountants look at the M&R appraisal, and they have six points that they criticized it on. My favorite is this: "It was written by actuaries, statisticians who calculate insurance risks and

premiums. On most business evaluations of this size, appraisers must pass a rigorous certification process by American Society of Appraisers.” With that, I will turn it over to Andrew, and he will tell you something about the real world and what is happening in California.

Mr. Andrew B. Wang: Now you have heard from two distinguished speakers, one talking legalistically, and the other talking hypothetically. It is time for a reality check, so we can determine if what they have talked about is something even close to real.

What I plan to do is to focus my discussion primarily on what happened to the Health Net’s conversion. I will also touch on briefly the conversions of other California HMOs. What I will do is to point out how conversions were done prior to Health Net’s conversion leading to the way Health Net’s conversion took place. I will then point out what had happened to Well Point’s conversion, which happened after Health Net’s conversion.

Over the last ten years, a number of California HMOs have converted from not-for-profit to for-profit. My understanding is that Maxicare was the first one that went through a conversion that took place in 1980. Following that were a number of conversions including Family Health Plan (FHP), Foundation Health, PacifiCare, and Inland Health Care, right around 1984–85. In 1987, Heals, later bought by QualMed and now merged as part of Health Net, was converted. Health Net had to go through two steps of conversions, first moving from being a department of insurance (DOI) regulated organization to a department of corporations (DOC) regulated organization, followed by the conversion from not-for-profit to for-profit. Blue Cross/Well Point had gone through similar but not exactly the same process.

Included in the for-profit conversion, as Jay pointed out, is the requirement of donating a properly determined value to charity. In essence, this represents a compensation to the public’s loss of the public-policy benefits what a not-for-profit organization brings. Prior to Health Net’s conversion, total amounts contributed to charities ranged from less than \$1 million to less than \$100 million. PacifiCare and Inland Health paid less than \$1 million each; FHP paid \$38.5 million; and, Foundation paid \$78.0 million. Heals paid \$2.1 million, and after that, it went into financial trouble and was bought out by QualMed.

Let’s now talk about Health Net prior to the conversion: Health Net was first formed in 1979, as a subsidiary of Blue Cross of California. Since Blue Cross was a department of insurance regulated organization, Health Net was also formed under the same umbrella. So Health Net had to go through two steps of the conversions:

First move from being a department of insurance regulated organization to a department of corporations regulated organization under the Knox-Keene Act.

Prior to the conversion, Health Net had approximately 750,000 members, one of the largest California HMOs (in fact the largest other than Kaiser). The rapid growth since the formation in 1979 came with inherent financial problems, particularly in 1987 and 1988. Health Net suffered continued underwriting and net losses. Health Net would become technically insolvent if the losses continued for one more year. Fortunately, Health Net began to show profitable growth since 1989.

It was also the time that increased competition appeared in the HMO marketplace. Although HMOs continued to increase their penetration into the employer groups, premium rate setting also became subject to more rigorous scrutiny by employer groups. That was also the time new innovative hybrid products like point-of-service (POS) started showing up in the marketplace. Health Net also has to begin developing products other than just the vanilla HMO product.

In essence, Health Net was operated in only one state, California, and Health Net is the largest plan to convert, which brought a lot of attention to the public. At the same time, HMOs were beginning to be adopted and used by mainstream corporate America, in light of their future growth expectations.

Let's talk about stakeholders. Often questions arise as who the stakeholders are during the conversion process, i.e., who are involved? There at least four types of stakeholders: management, employees, investment bankers, and regulators or the state.

Of course, management needs to first investigate the pros and cons of converting. Once converted, the management needs also to redefine the corporate strategy and its long-term goals and plans. Here, management also includes the board. One of the least appreciated implications was the change in corporate culture and the effect it had to have in operating norms. The temptation to move to a quarterly view of the world, due to earnings release expectation and results, is very hard to resist.

Employees will determine, once the conversion is completed, whether it is more compatible to their goal of continuing to work for the company. With the for-profit environment, how will that affect employees' job securities, for example. On the other hand, with the for-profit environment, would it provide better financial potential.

Regarding investment bankers or Wall Street, normally the process would involve the use of investment bankers for the structuring of the conversion, valuing the company, as well as stock offerings, if such an offering is initiated.

The state has the responsibility to the public overseeing the conversion process taking place properly.

While these are the four specific groups of stakeholders, there are numerous other parties affected by the conversion:

1. Charities: For the charitable organization, there are many important issues to consider, for example, the charter/purpose of the charitable organization. In the case of Health Net, it is the California Wellness Foundation for the purpose to further promote the wellness program, which has been Health Net's long-standing commitment to improve health. In order to carry out that charter/purpose, the foundation also needs to know the funding, including amount as well as timing of the funding.
2. Consumer Watch Dogs: Consumer groups representing consumers would watch out for the consumer's interest. In the case of Health Net's conversion, there were some groups with a political ax to grind (Pete Stark, Democrats versus Republicans).
3. Competitors: With the conversion, competitors may be in a better or worse competitive position. In the case of Health Net, several competitors would rather grab this opportunity to buy Health Net. Such firms as Pacific Mutual, Humana, Maxicare, and others all tried to buy Health Net or succeed in raising the bid price so as to weaken a competitor with debt payments.
4. Suppliers: With the conversion, how would physician medical groups, hospitals, and vendors deal with the new firm? Most of all, how would this affect our relationship with our members and employer groups? This put an enormous burden on management to address and communicate the "why" of the conversion.

At the time of conversion, Health Net considered pros and cons. The pros include:

1. Access to Capital Market: In today's health care business, capital requirements become a necessity to finance expansion and growth. These include, for example, new product development and a system upgrade. In fact, at the time of the Health Net conversion, competitors were able to access the capital market through the issuance of stock offerings.

2. Mergers and Acquisitions: A conversion provides the vehicle to participate in merger and acquisition activities when opportunities suggest advantages to do so.
3. Equity ownership and employee incentives: Conversion provides the ability to offer the incentives of ownership to employees through the stock offerings and/or options.
4. Attract and retain management talent: The stock option can be part of the compensation program to attract top quality management talent at a lower cash salary level.

I would like to quote what Commissioner of Corporations Thomas Sayles said about Health Net conversion: "This conversion is a 'win, win, win' transaction. The state wins because California has another taxpaying company to contribute to our tax base. Health Net wins because, as a for-profit organization, it now has access to capital markets to raise the funds it believes are necessary to accomplish its corporate objectives. Most importantly, the people of this state win because millions of dollars will be available to support programs providing preventive care."

There are a number of negatives that may or will result from the conversion. These include:

1. Taxes: Indeed, as a for-profit organization, we have to pay taxes. These include federal, state, and city taxes, plus property taxes. For Health Net, city tax alone was about \$5 million, which never had to be paid before.
2. Increased regulation: Conversion causes increased disclosure rules, Securities and Exchange Commission (SEC) regulations, and reporting requirements (10Ks, 10Qs, and others).
3. Increased Operating expenses: Conversion includes loss of certain benefits such as not-for-profit mailing benefits. There also is the introduction of investor relations/public relations departments, printing costs, and annual meetings.
4. Increased accountability: This occurs with specific results and timetables to the board, shareholders, and employees. This is another culture change from not-for-profit to for-profit.

Given the pros and cons, Health Net moved forward to the conversion. What is the rationale of the conversion? The rationale behind Health Net's conversion is best

put by Roger Greaves in the 1991 Annual Statement, which is also the three objectives set forth by the Board of Directors in 1990:

- To endow the California Wellness Foundation to carry on our long-standing commitment to wellness.
- To offer ownership incentives to the Associates of Health Net.
- To place Health Net on a level playing field with its competitors that have access to bank credit and capital markets.

From an environmental context standpoint, Health Net was facing many issues that affected the final terms of the conversion. The conversions of other HMOs have set the precedent for the conversion process, even though, at that time there were no specific regulations governing the conversion process.

Maxicare challenged DOCs approval of FHP's conversions via bidding a higher price to purchase FHP. DOC rejected Maxicare's bid on the grounds that it was not in the public interest to stop others from converting. DOC maintains that FHP was not obligated to sell to the highest bidder, or use the open bidding as the means to dictate the conversion price. In fact, the attorney general also filed a suit to block the conversion, alleging the conversion price understated FHP's actual value and the court upheld DOC's position. The court determined that the attorney general has no jurisdiction over the FHP's conversion process.

There has been increasing pressure from consumer groups to voice concern that the public got shortchanged from prior conversions. After about six or seven conversions, the public started realizing that the public may be shortchanged. For example, shortly after FHP's conversion at \$38.5 million, the value escalated to over \$100 million. As a result, Health Net's conversion has gone through much more rigorous scrutiny.

As a result of these changes in external environment, instead of a simple conversion for Health Net, it took over a year of public open meetings and press interviews before the conversion was approved by DOC. These include multiple justifications of methodology used for valuation, independent party fairness opinion, and so on.

There are a number of valuation methods that can be applied to determine a fair value. Health Net initially engaged Ernst and Young (E&Y) (instead of actuarial!) to perform such a valuation. Subsequently, D&T, along with a number of investment bankers, were also involved. Let me first describe a few of the valuation methods commonly discussed.

Discounted future cash flow is to determine the value based on the discounted projected cash flow from the company over a number of years, say a five-year period. It involves a financial forecast based on historical financial results and the best estimate of future membership growth and potential earnings.

Capitalization of historical earnings is to determine the company's historical earnings level to project future earnings potential. A capitalization rate will then apply to the earnings level to estimate the value. For Health Net, over the ten years prior to conversion, there were profitable and not so profitable years.

Fair market value is usually defined to mean the cash or cash-equivalent price at which property would change hands between a willing buyer and willing seller, supposing both are adequately informed of the relevant facts and neither feel compelled to buy or to sell.

Adjusted net assets is to determine the value based on the current book value, adjusted to reflect the fair market value of fixed assets in excess of book value, the estimated losses in the refinancing of any tax-exempt debt, and the fair market value of intangible assets.

Several of these methods were used, and they all seem to arrive at values within reasonable range, i.e., somewhat over \$100 million. Prior to Health Net's conversion, these valuations would have been accepted by DOC as a fair value conversion price.

As it turned out, none of the valuation results were used as the final conversion price. The actual conversion price is \$300 million cash plus 80% of the stock paid to a nonprofit organization. Just the cash portion exceeded (in fact, more than doubled) the valuation results completed by E&Y. The way it was structured is that Health Net paid \$75 million initially along with carrying a \$225 million debt, all to the charitable organization, California Wellness Foundation. The foundation has the option to sell its stock ownership over the next five years. It is nonvoting stock before it is sold by the foundation. As you can see, there are a lot of details in the working of the financial structure of these conversions.

Is Health Net the largest conversion ever? Yes, it was until 1996. The latest one is Blue Cross of California and Well Point conversion. You may have seen the newspaper articles talking about \$3.0 billion donated for this conversion. In reality, it really is only a \$1.0 billion cash donation. Not only that, the way it is structured, the \$1 billion comes after Well Point declares a \$10 per share dividend. So the actual cash donation is much less than \$1 billion from Blue Cross, the not-for-profit entity. So there are a lot of ways to structure it and for it to be approved by DOC.

As for the stock ownership, 80% of the stock goes to two different charitable foundations, and it is an 80/20 split. There is a lot of intricacy in the details, I am not privy to that, but you can read about those already made to the public.

Where do we go from here? One of the big issues in everybody's mind is how people pursue conversion and who owns the equity prior to the conversion. As mentioned by Jay and Bob earlier, that is the biggest issue. Also, what is the best, for both the public interest and the company interest. For example, you do not want to make a conversion price so high that after the conversion, the company goes bankrupt. You want to make sure that the company can continue operating. Using California's current approach of the foundation owning 80% of the stock, it provides a vehicle that the bulk of the actual value is donated for public cause, and it provides equity incentives to the management people so that they would do everything possible to make this company be a viable company. I do not have the answer to how you balance that. One thing you can see is that the conversion is not going to be as easy as in the past.

One last thing I want to mention is that California finally does have a conversion code now. It is called Section 1399 that lays out at least certain rules on the restructuring of conversion. Will this set the trend as the regulation model for the future? I do not know.

Mr. Sutton: The NAIC, as mentioned, has a committee trying to provide information to commissioners so they can look at value and other things they want to look at. At least one state has said it wants the money just to reduce the state budget deficit, whereas most of them have set up trusts.

Mr. Jerry W. Fickes: First, I have to give a disclaimer, since I am on that NAIC committee with Blue Cross and have been on it since the beginning. I'm not speaking for them, although I've worked as their advisory staff. I'm not speaking for New Mexico. I was interested in the comments made, during a special day-and-a-half seminar for NAIC and Blue Cross staffs. It was not enough. We had presentations by the American Academy of Actuaries. They were excellent. We also had them by Donaldson, Lufkin and Jennrette, which was a very good investment banking presentation.

As I was listening to Jay make his presentation, I made some notes on the IRS interest, and there was a comment about valuation. I would say that their secondary interest normally becomes more primary if they think that this is a form of a dividend that's being moved out into new owner's hands. That's something to be concerned about.

We have seen the "drop-down." In New Mexico, we're more concerned about Blue Cross. We have six HMOs, all for-profit. The "drop-down" we have seen already in Blue Cross is because it tried to spread into other venues. This has caused a problem in many states because of the Insurance Holding Company Act, due to material transactions whenever they try to take anything public, taking away part of the parent's resources. Now, the "drop-down" probably makes the most sense if you can sell some of the stock to determine a true value.

We have problems, at least personally, with the conflict of interest of the directors. I think since you have mentioned that, I know the Blue Cross Association has special rules that require that it continue to have the voice and directorship of that upper foundation, which then brings the question as to whether that is still carrying out the purposes that it should. As to the other 20% of stock, as some of the regulators have asked, how should we determine a valuation? Should we use the actuarial method or should we use the investment? We don't know which one is part of it.

In our state we go beyond the attorney general. It's also under the Department of Insurance because this is under our jurisdiction and the nonprofit ball has been moved. We start out by saying, "need for capital, who decided?" I mean who are these directors who decided that they needed capital. Our real question is why everyone requires this \$100 million of capital today. We have other companies operating with less, why the capital? We think the real reason is mergers and acquisitions to get a national network. That is really what's needed in HMOs and Blue Cross organizations. I'd appreciate your comments on that.

The foundation with the "drop-down" does have a problem, I believe, with the 501(c)4 of Blue Cross. I think that's required unless you want to divest stock or have a value at 5% a year.

Mr. Gerzog: Right.

Mr. Fickes: The second conversion method, the "side parallel," is one that I don't think, as a regulator, I would accept. I think it's obvious why. You're giving away value that really belongs to another entity, and I think we've had a tough time in this with people understanding that there is a wall around their company, and you just don't move value from one company to the other one whenever you want to. Again the Blue Cross has restrictions on ownership of the stock when you spin it off. The rule is not more than 20%, I think, with 5% voting for anybody, or something like that. You can't have more than five or six owners. You might want to comment on that. Outside of that, the only other comment I have is, I think that part of

the reason you see this big variation in valuation of members per month is because there is a big difference in the value for managed care.

Many of these firms in preparation have tried to push what was a PPO-type organization or an old indemnity into a managed care HMO environment, before they go public for that major increase in value, which runs three to five times greater than valuations of the traditional indemnity carrier. As a result there's a question as to what value is being left in the other company. Is that the good business or the bad business? You might want to consider that.

Mr. Gerzog: I want to address Jerry's comment about the 5% distribution requirement. What's at issue here is that the nonprofit parent, which now holds all of the stock of the for-profit subsidiary operating entity, may have become classified as a private foundation, rather than as a public charity, for federal tax purposes. They are both exempt from taxes under Section 501(c)(3), but the rules are much more stringent for private foundations. Although you would want to seek to avoid the private foundation status classification, it is not always possible.

One of the rules applicable to private foundations is that each year a foundation has to make distributions in furtherance of its exempt purposes of a minimum amount equal to 5% of the value of its charitable assets. If the only asset that it owns is the stock of the for-profit organization, it would not have the cash to satisfy this distribution obligation unless dividends were paid on such stock, which is often not the case. If dividends are not being paid on the stock, the foundation would need to liquidate some of the shares, and that becomes a big concern.

Aside from the 5% distribution requirement, the foundation will not be permitted to hold more than a certain percentage, generally 20% or 35%, of the for-profit entity's stock for more than a limited period of time. This is known as the excess business holdings limitation. There are ways to try to structure around this issue, one is to use a 501(c)(4) organization. It still is tax exempt, but it is not subject to classification as a private foundation. This is what was done in California where they set up tandem organizations, a 501(c)(3) charity, which I believe received the cash component of the settlement, and a 501(c)(4) organization, which received the stock component. As it sells off that stock and receives cash, it transfers the cash over to the 501(c)(3) charity, but it does not have to sell the stock each year if it may not be economically or otherwise advisable to do so.

Typically, you would want to try to avoid private foundation status if you can. One way to do this is, if you can raise a sufficient amount of funds from the public in the form of contributions, you now become a publicly supported public charity and, consequently, avoid private foundation status.