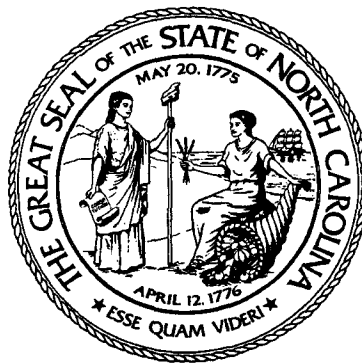


# Hospital, Medical, and Dental Service Corporation Charter Conversion Study Commission



REPORT TO THE  
1998 SESSION OF THE  
1997 GENERAL ASSEMBLY  
OF NORTH CAROLINA

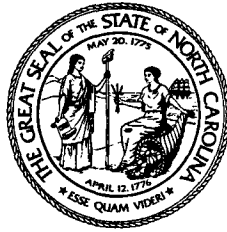
A LIMITED NUMBER OF COPIES OF THIS REPORT  
IS AVAILABLE FOR DISTRIBUTION THROUGH  
THE LEGISLATIVE LIBRARY.

ROOMS 2126, 2226  
STATE LEGISLATIVE BUILDING  
RALEIGH, NORTH CAROLINA 27611  
TELEPHONE: (919) 733-7778

OR

ROOM 500  
LEGISLATIVE OFFICE BUILDING  
RALEIGH, NORTH CAROLINA 27603-5925  
TELEPHONE: (919) 733-9390

**HOSPITAL, MEDICAL, AND DENTAL SERVICE  
CORPORATION CHARTER CONVERSION STUDY  
COMMISSION**



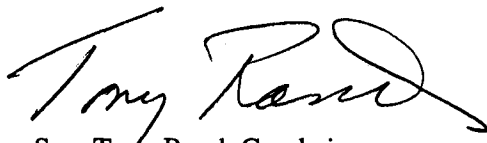
**May 1, 1998**


The Honorable Dennis Wicker, Lieutenant Governor  
The Honorable Marc Basnight, Senate President Pro Tempore  
The Honorable Harold Brubaker, Speaker of the House

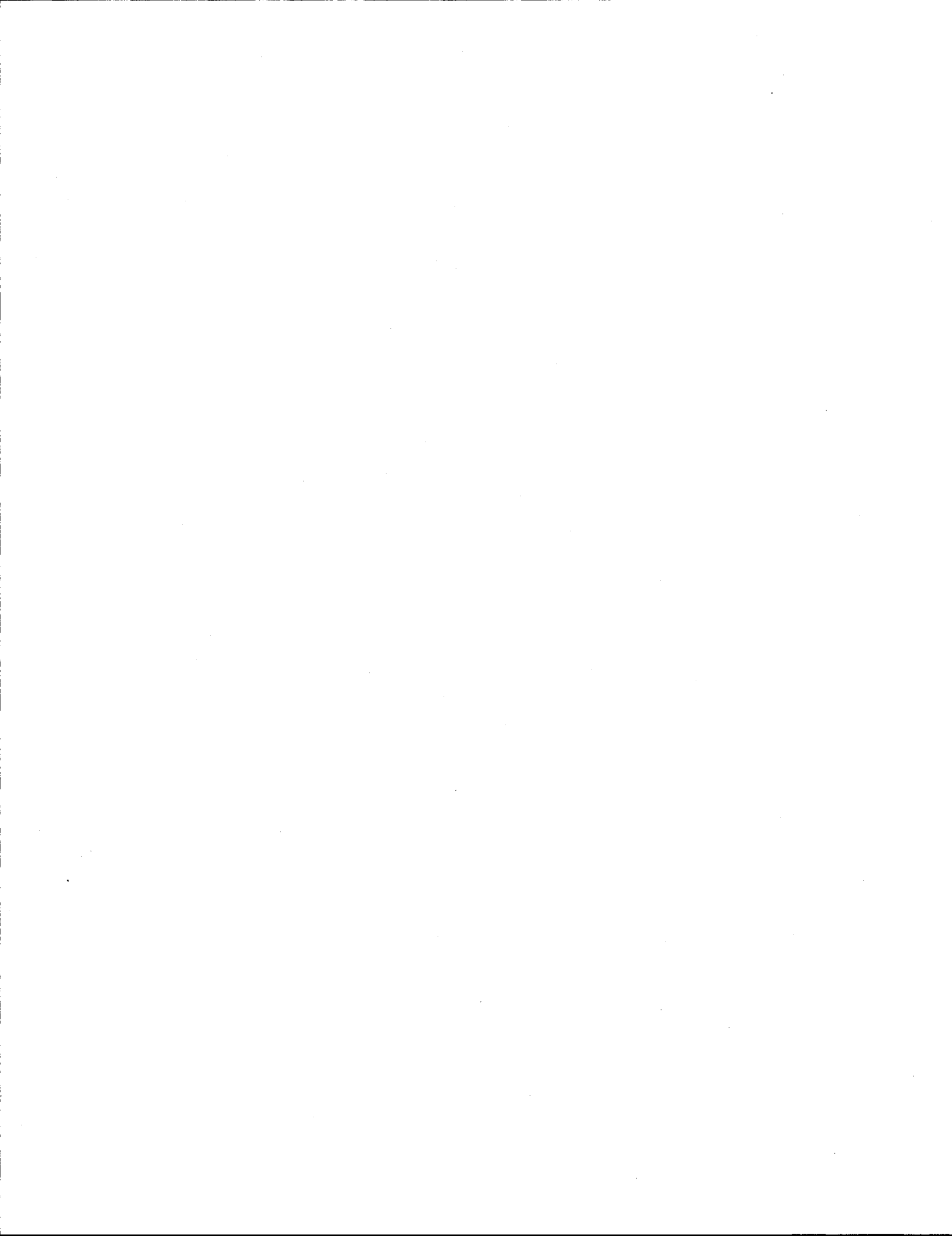
Dear Gentlemen:

On behalf of the Hospital, Medical and Dental Service Corporation Charter Conversion Study Commission, we are pleased to submit to you the report of the Commission.

Respectfully submitted,

  
Sen. Tony Rand, Co-chair

  
Rep. Leo Daughtry, Co-chair



## TABLE OF CONTENTS

LETTER OF TRANSMITTAL

STUDY COMMISSION MEMBERSHIP

PREFACE AND EXECUTIVE SUMMARY.....	1
COMMISSION PROCEEDINGS.....	3
RECOMMENDED LEGISLATION .....	31
EXPLANATION OF THE RECOMMENDED LEGISLATION .....	32
APPENDICES.....	39

### Authorizing Legislation

Memorandum from Linwood Jones

- \* Tax Information on Blue Cross Blue Shield
- \* Blue Cross Balance Sheet and Reserves
- \* Comments by Linwood Jones at January 5, 1998 meeting
- \* Comments by Peter Kolbe at January 5, 1998 meeting
- \* Legal Opinions re Blue Cross conversion

Comments of Rhone Sasser, Chairman of Board of Trustees of BCBSNC

Comments of Ken Otis, President and CEO of BCBSNC

Comments of Martin Eakes, Co-chair of Coalition for the Public Trust

Comments of Judith Bell, Director of West Coast Regional Office  
of Consumers Union

Comments of Richard Daugherty, Chairman, Rex HealthCare Board of Trustees

Comments of E. Ray Cope, Exec. Director, Kate B. Reynolds Charitable Trust

Comments of Gary Mendoza, Former Commissioner of California  
Department of Corporations

Comments of Robin L. Hinson, Robinson, Bradshaw and Hinson, P.A.

### Public Hearing Testimony

Richard Hatch (AARP)

Adam Searing (Health Access Coalition)

Abdul Sm Rasheed (NC Community Development Initiative)

Jane Kendall (NC Center for Nonprofits)

Watts Hill, Jr.

Discussion List for April 7, 1998 Meeting

Comments of Mr. Rhone Sasser, Chairman of Board of Trustees of BCBSNC (5/1/98)

Comments of Mr. Ken Otis, President and CEO of BCBSNS (5/1/98)

Comments of Mr. Adam Searing, NC Health Access Coalition

**HOSPITAL, MEDICAL, AND DENTAL SERVICE CORPORATION  
CHARTER CONVERSION STUDY COMMISSION  
1997-1999**

**Pro Tem's Appointments**

Sen. Anthony E. "Tony" Rand, Cochair  
2008 Litho Place  
Fayetteville, NC 28304

Sen. Betsy L. Cochrane  
122 Azalea Circle  
Advance, NC 27006

Mr. Thomas Lambeth  
Executive Director  
Z. Smith Reynolds  
101 Reynolda Village  
Winston-Salem, NC 27401

Sen. Howard N. Lee  
109 Glenview Place  
Chapel Hill, NC 27514

Sen. Beverly M. Perdue  
PO Box 991  
New Bern, NC 28563

Dr. Charles Sanders  
100 Europa Drive, Suite 170  
Chapel Hill, NC 27514

**Ex Officio and Non-Voting Members**

Mr. Peter Kolbe  
General Counsel  
Department of Insurance

Mr. Alan Hirsch  
Senior Deputy Attorney General  
Director of the Division of Consumer Services  
Office of the Attorney General

**Staff:**

Linwood Jones  
Linda Attarian  
Research Division

**Speaker's Appointments**

Rep. N. Leo Daughtry, Cochair  
PO Drawer 1960  
Smithfield, NC 27577-1960

Rep. Jerry C. Dockham  
PO Box 265  
Denton, NC 27239

Dr. Carolyn R. Ferree  
672 Hertford Road  
Winston-Salem, NC 27104

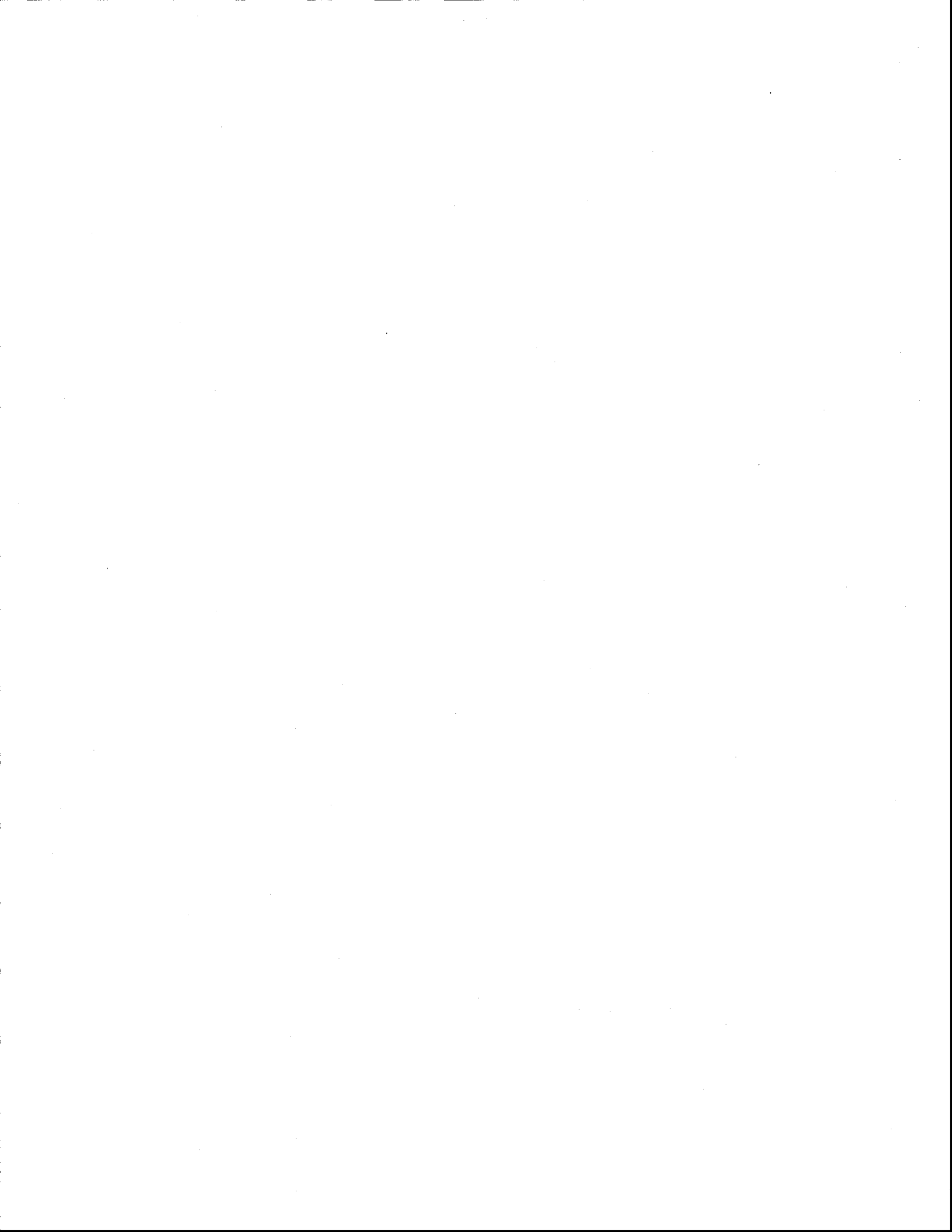
Rep. Lyons Gray  
420-C West 4<sup>th</sup> Street  
Winston-Salem, NC 27116

Rep. John W. Hurley  
PO Box 714  
Fayetteville, NC 28302

Mr. William S. Patterson  
Hunton-Williams Law Firm  
1 Hanover Square, Suite 1400  
1 Fayetteville Square  
Raleigh, NC 27601

**Clerk:**

Evelyn Costello





## **PREFACE AND EXECUTIVE SUMMARY**

The Hospital, Medical, and Dental Service Corporation Charter Conversion Study Commission was created by the General Assembly in 1997 to study the laws governing a possible conversion by Blue Cross Blue Shield of North Carolina to a for-profit entity. The creation of the Study Commission followed discussions and debate during the 1997 session on Senate Bill 993, a bill that would have set out in detail in the statutes the procedure a service corporation would follow to convert from a not-for-profit entity to a for-profit entity. A moratorium was placed on conversions by hospital, medical, and dental service corporations until August 1, 1998, giving the General Assembly time to enact conversion legislation during the 1998 short session before any possible conversion could take place.

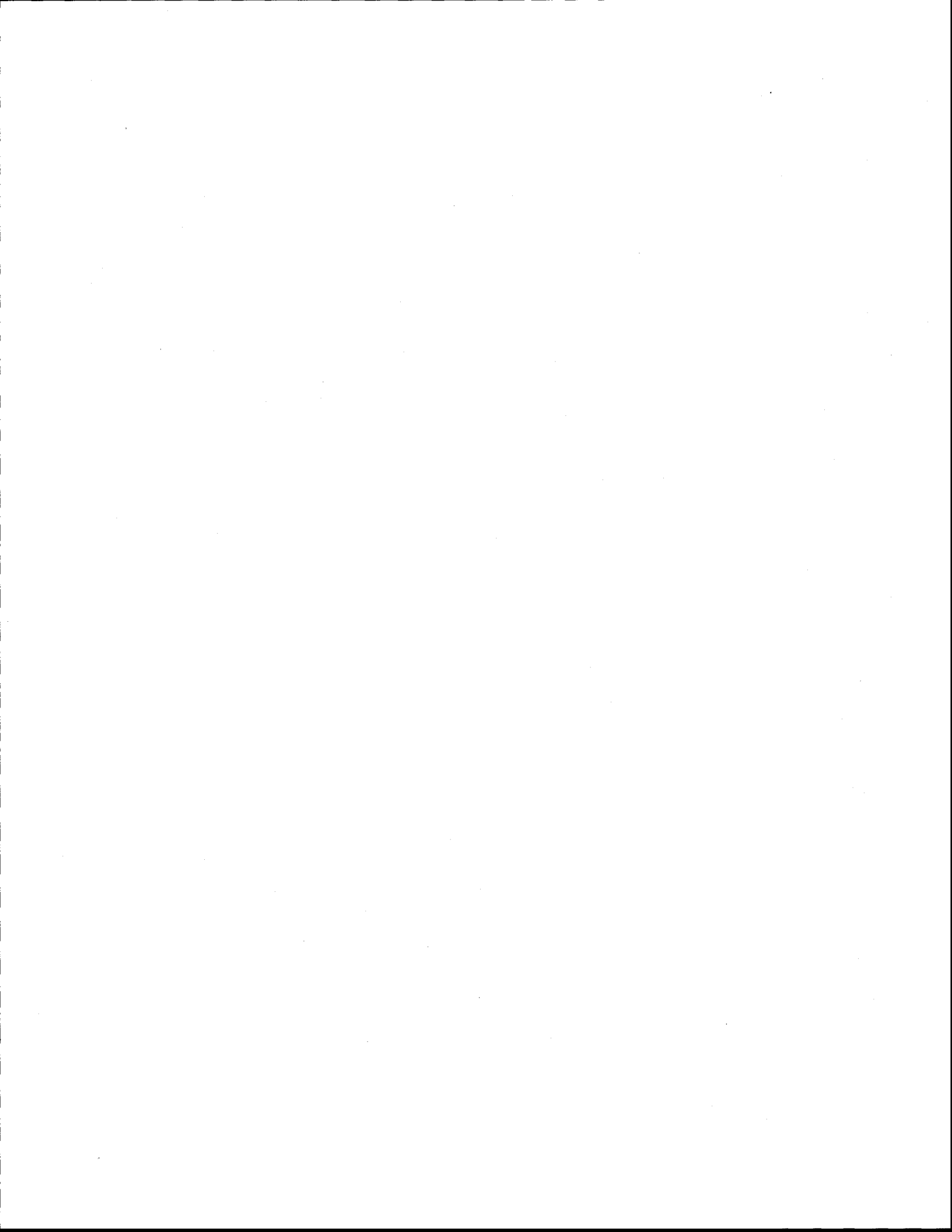
The Commission met five times during 1998 and heard from numerous speakers on the conversion issue. In working towards a legislative proposal, the Commission agreed to the following principles:

- That 100% of the fair market value of a medical, hospital, or dental service corporation should be set aside in a charitable foundation for the benefit of the citizens of North Carolina when the corporation converts to a for-profit entity
- That the foundation should be independent of the new for-profit company
- That the mission of the foundation should be to promote the health of the citizens of North Carolina
- That the reserves and other assets of the service corporation should remain intact when it converts so that the company can remain competitive and serve the needs of its subscribers

- That the officers, directors, and employees of the service corporation should not receive financial inducements or rewards as part of the conversion.
- That the Commissioner of Insurance and the Attorney General should both be involved in reviewing a proposed conversion, with the Commissioner focusing primarily on the insurance components of a proposed conversion and the Attorney General focusing on the foundation and its relationship with the for-profit company.

The Commission's proposed legislation carries out these principles. (See the section "Explanation of Recommended Legislation" for more details). The Commission recommends this legislation as a conference report to Senate Bill 993, which is pending in the Senate for concurrence.

# COMMISSION PROCEEDINGS



**January 5, 1998**

The Commission held its initial meeting on January 5, 1998. Mr. Linwood Jones, Commission Counsel, presented an overview of the history of Senate Bill 993 and how other states had handled Blue Cross conversions. Mr. Jones pointed out that the current "conversion" law briefly states that a proposed conversion must be equitable to the Blue Cross policyholders. There is nothing in this law that addresses the rights, if any, of the public to Blue Cross assets upon conversion. Under both common law and the North Carolina Nonprofit Corporation Act, when a charitable entity converts to a for-profit company, the assets are "impressed" for the benefit of the public -- i.e., they must continue to be used for charitable purposes. However, Blue Cross appeared to be exempt from the Nonprofit Corporation Act, and even if not exempt, would likely take the position that it was not a charitable organization.

Mr. Jones briefed the Commission on the legislative history of Senate Bill 993. The version that passed the Senate (3rd edition) authorized the Commissioner of Insurance to adopt rules governing conversion. These rules were to be adopted after consultation with the Joint Legislative Commission on Governmental Operations. This language was very similar to the existing conversion law in Article 65 of the Insurance Code. The bill was extensively revised in the House Rules Committee to provide more detail about the conversion process. The new bill required Blue Cross to file information with the Commissioner of Insurance, including, for example, a business plan for the new corporation, information on how the plan would protect policyholders, and an analysis of premium rates of the new company's proposed products. The bill also called for a public hearing by the Commissioner before deciding whether to grant an application for conversion.

The bill underwent additional amendments on the House floor. These amendments were targeted primarily at three concerns: (1) ensuring that officers and directors of Blue Cross would not profit from a conversion (the "anti-inurement" provision); (2) ensuring that any type of corporate restructuring that "looked" like a conversion would in fact be treated as a conversion; and (3) preserving any charitable trust rights that might exist.

Most of the amendments on the House floor focused on the charitable trust issue. One amendment provided that the plan, in addition to meeting the criteria already in the bill, must be "in the public interest" and that the presumption of "fairness" to the public and policyholders to which Blue Cross was entitled as a result of meeting those criteria was (1) rebuttable and (2) did not apply to any charitable trust claim made by the Attorney General. A second amendment required the Commissioner of Insurance, with the advice of the Attorney General, to determine what portion of Blue Cross' surplus would be subject to a charitable trust. The amendment went on to say that the Commissioner must then place this amount in a charitable health care trust. However, this latter language was removed by a perfecting amendment. The resulting amendment did not mandate that any particular portion of Blue Cross assets would be subject to a charitable trust. A separate amendment that would have directed any charitable trust amounts into either a high-risk health insurance pool for the uninsured or to a nonprofit health care foundation was defeated. An amendment designed to address concerns about a 2-step conversion process (Blue Cross converts to a mutual, then to a stock company) was also defeated.

Senate Bill 993 was returned to the Senate (5th edition), where it was discussed in the Rules Committee. The Senate failed to concur in the House changes to the bill, and both sides appointed conference committees to discuss the bill. Although there were some discussions, no additional action was taken on the bill. It was agreed that the issue would be studied during the interim by a

special committee. The Hospital, Medical, and Dental Service Corporation Charter Conversion Study Commission was created in the Study Bill (Senate Bill 32) to try to resolve the issue. In addition to creating the study commission, Senate Bill 32 also imposed a one-year moratorium on any conversion by Blue Cross. This would give the General Assembly time to take action during the short session on conversion legislation before any conversion could take place.

Mr. Jones highlighted a few of the states that had been involved with the Blue Cross conversion issue: Virginia, California, and Georgia. These three states had each taken different approaches to this issue. In California, 100% of the fair market value of Blue Cross (excluding a portion that had already been transferred prior to the transfer being treated as a conversion) was set aside in two charitable foundations. The total value of the set-aside, which consisted of both stock and cash, was approximately \$3.3 billion. The Georgia Legislature allowed Blue Cross to convert to a for-profit insurance company in 1995 without setting any funds aside for a charitable trust. Since that time, a lawsuit has been initiated to recover what are alleged to be assets belonging to the public. The plaintiffs argue that the Georgia legislature cannot constitutionally divest the public of vested rights in assets that are alleged to be belong to the public. The estimated value of the assets retained by Blue Cross was approximately \$400 million.

In Virginia, Trigon (Blue Cross Blue Shield of Virginia) was a mutual benefit corporation until 1991, at which time it converted to a "mutual" corporation. In 1995, it proposed to convert to a for-profit company by merging Trigon with a proposed new stock corporation. The proposal would have provided for the distribution of stock and/or cash to its policyholders at a value estimated at \$1 to \$1.5 billion. (This estimate was based on a multiple of Trigon's annual earnings). Trigon's initial application to the State for conversion did not contain a set-aside for a charitable trust. The Virginia Attorney General intervened and argued that a charitable trust should be created. In attempting

to settle the issue of the ownership of the assets, the Attorney General and Trigon looked at various events and dates in Trigon's corporate history to find the date at which it would be appropriate to draw the line between assets belonging to the public and assets belonging to Trigon's policyholders. The two parties eventually agreed that the controlling date should be January 1, 1988 - the date on which the State of Virginia made Trigon begin paying premium taxes. They agreed that Trigon's surplus on December 31, 1987 -- \$159 million - should be set aside in a charitable trust for the benefit of medical research. The agreement was presented to the legislature. The legislature agreed with the proposition that December 31, 1987 was the appropriate dividing line, but made two changes: (1) it required an additional \$10 million to be set-aside by Trigon, bringing the total charitable set-aside to \$175 million, and (2) it required the money to be placed into the State Treasury instead of a charitable foundation.

Mr. Jones also noted that there were judicial decisions requiring charitable set-asides in some states, some were in litigation over the issue of charitable set-asides, and others had existing laws allowing for conversion without any specific mention of charitable set-asides.

Mr. Peter Kolbe, General Counsel for the North Carolina Dept. of Insurance, spoke on behalf of the Department of Insurance. Mr. Kolbe noted that the Commissioner of Insurance was not at the meeting and would not be directly involved in the Commission's work because of his potential involvement as a hearing officer in the future if Blue Cross were to convert to a for-profit company.

Mr. Kolbe stated that the Department's position is that a charitable trust cannot occur at the expense of policyholder rights. There are three types of policyholder rights:

1. The policyholder right in reserves or surplus of the corporation dedicated to the payment of claims. No claims dedicated reserves can be disgorged from the corporation at any point.



2. The policyholder right in having a healthy and viable post-conversion entity. Blue Cross/Blue Shield is the state's largest health insurer, and a post-conversion insurer must be as strong after the conversion as it was going into it.

3. The ownership rights that may accrue to policy holders as the result of mutualization of the corporation. Under current law, the Department of Insurance feels that in the event of a mutualization, policyholders would own the incremental increase in the value of the corporation between the date of its conversion to mutual status until the date of its stock conversion.

Mr. Kolbe stated that mutualization would afford Blue Cross/Blue Shield tremendous business flexibility, but it creates legal problems for the imposition of a charitable trust. It creates two classes of potential owners: the public and the policyholders. The policyholders would own that incremental increase in value of the corporation from mutualization to stock conversion. The second problem with allowing the corporation to mutualize is that either no or only a very limited amount of money could be set aside (in a charitable trust) upon mutualization of the corporation. Unlike stock conversion, where money comes in from the sale of stock, there is no additional money coming into the corporation as a result of a mutualization, making it virtually impossible to disgorge assets of the corporation without impairing its ability to go forward and pay claims. Third, the difficulty in mutualization is that it presents the possibility for a mutual holding company to come into existence. North Carolina does not have provisions in the law for mutual holding companies. However, some other states do. This is the mechanism whereby a mutual company forms a holding company, puts the ownership rights and mutual policyholders in that, and the mutual company becomes a stock subsidiary. This would occur by any mutual company in this State merging with a mutual in another state which does have the law. This would impact on the mutualization issue in SB 993. In addition, Mr. Kolbe noted that mutualization prior to stock conversion presented valuation problems. How do you then figure out what the fair market value of the

corporation is? Do you do it upon mutualization? That may not be an appropriate time to take money or stock out of the corporation.

At the present time, Blue Cross/Blue Shield has approximately \$850 million in assets. They have a surplus of \$507 million, but at least \$200 million of that surplus is still dedicated to claims payments. Mr. Kolbe noted that the numbers can be misleading and that the Commission should be guarded in assessing what amounts of money it seeks to place in a trust and what amounts of money are truly dedicated to policyholder rights and policyholder claims payments.

Mr. Kolbe stated that SB 993, even with all of its changes, provides a good format for discussion. He stated that there are some flaws with it, there are some things that need to be deleted and some things added, but that it still provides a comprehensive format for addressing the issue. Mr. Kolbe encouraged the commission to use that as a springboard for addressing the conversion issue.

Mr. Alan Hirsch spoke to the Commission about the Attorney General's responsibility in the Blue Cross conversion issue. There are several legal responsibilities. With respect to non-profit organizations under Chapter 55(a) of the General Statutes, the Attorney General is charged with ensuring that non-profit assets continue to be used for the purposes for which they were originally designated. Mr. Hirsch noted that the Blue Cross situation is specifically excluded from the Non-profit Act. Mr. Hirsch added that there are also specific responsibilities with respect to charitable trusts. When money is given or dedicated for charitable purposes and the reasons behind them can no longer be met -- for example, when the beneficiaries are no longer in existence, or for some reason there is a change in ownership -- the Attorney General's Office is responsible for ensuring that those charitable assets are used for the purposes for which they were originally dedicated.

In both cases, this process works by the Latin doctrine known as "cy pres". The cy pres doctrine essentially means that when a particular purpose for which a charity or non-profit was created can no longer be met, the entity's assets must be turned over to one or more organizations engaged in activities that most closely match the original activities. That doctrine has been in place in the English common law for hundreds of years. In addition, the Attorney General is also responsible for being the parent of the state's people (parens patriae). Hence, the Attorney General is charged with acting in the public's interest and protecting those resources.

Mr. Hirsch noted that the issue of conversion of non-profit assets is tremendously important. It not only applies to Blue Cross, but to hospitals and other non-profit entities that convert also. He pointed out that in the last few years, there have been more conversions of non-profit and charitable assets to for-profit circumstances than in the entire history of the United States.

Mr. Hirsch emphasized that the Attorney General does not become involved in ensuring that the insurance company itself operates properly or that it has sufficient reserves and appropriate accounting procedures. That is solely a regulatory matter for the Department of Insurance.

Mr. Hirsch discussed pending legislation involving Blue Cross. In June, 1997, a lawsuit was filed by a member of the public against Blue Cross. Mr. Hirsch could not elaborate on the details of this pending litigation. The basic allegation in the lawsuit is that Blue Cross, through alleged accounting irregularities, built up a larger surplus than it should otherwise have. This particular plaintiff, in a class action suit, sought the return of that money to subscribers and, as part of that process, also claimed that the public has no rights in Blue Cross. The Attorney General disagreed and intervened in the lawsuit. The Attorney General contends in the lawsuit that: "All North Carolina

citizens have beneficial rights and interests in the assets of Blue Cross and Blue Shield of North Carolina by consequence of its status as a non-profit entity organized and existing for the public welfare." Motions to dismiss were filed in the case, alleging, among other things, that the individual is not a proper plaintiff because he is not a subscriber of Blue Cross. (The case is still pending as of April, 1998, although there has been no movement on it).

Mr. Hirsch gave the Commission brief reasons for the Attorney General's position. It is the Attorney General's position that all of the assets of Blue Cross are impressed with a public trust. The Attorney General's position is based primarily on the cy pres doctrine. Generally, when a non-profit converts, both federal and virtually all state laws require the dedication or transfer of the full value of the assets to a similar charitable purpose.

Mr. Hirsch gave some background on Blue Cross/Blue Shield. In the 1930's and early 1940's, there was concern that regular working people did not have access to hospital and medical care in an emergency. During the Depression the availability of cash beyond daily expenses was very small. Experiments began in England to establish medical insurance -- something that hadn't been seen before -- so that working people could pay \$1.00 per week, for example. By virtue of that, banding together with a community rating, nobody would have to pay higher rates if they were sick. Everyone could, by virtue of that small payment, begin to get medical care. In North Carolina, with a group of physicians, and with the help of the organization of the N.C. Medical Society, Duke Endowment and hospitals around North Carolina, a method was devised to help regular people pay for their medical costs and help hospitals survive in a difficult time of the Depression. The Blue Cross predecessors were established with a charitable purpose, specifically set out in the statutes. They had tax breaks -- local, state and federal. Even now Blue Cross organizations around America are organized (for federal tax purposes) as 501(c)(4) "public benefit" corporations. They are still the insurer of last resort. Blue Cross is open to all.

Mr. Hirsch felt that while much has changed over the decades, Blue Cross is still a good company that performs important public benefits to North Carolina. Fundamentally, Blue Cross has always been a non-profit company, and the Attorney General believes that all its assets were accumulated as a result of this non-profit status. The Attorney General's conclusion is that if Blue Cross changes its structure and is no longer a non-profit, the assets that were accumulated over time under the current laws should be used for similar charitable health care related purposes. That has been done in California and New York.

**February 3, 1998**

Rep. Daughtry recognized Mr. Rhone Sasser, chairman of the board of directors of Blue Cross Blue Shield of North Carolina. Mr. Sasser spoke of Blue Cross' commitment to and service in North Carolina. He stated that Blue Cross currently has no plans to convert to a for-profit company but that changing conditions in the marketplace could someday change that. Mr. Sasser pointed out the need for Blue Cross to continue to have the business flexibility to remain competitive. See the Appendices for Mr. Sasser's remarks.

Mr. Sasser introduced Mr. Ken Otis, President and Chief Executive Officer of Blue Cross Blue Shield of North Carolina, to share more specifics on Blue Cross' thoughts about conversion. Mr. Otis indicated that since the General Assembly's adjournment in August, 1997, Blue Cross had re-evaluated the conversion issue. He indicated that the legislation filed in 1997 (SB 993) was not an attempt by Blue Cross to initiate the conversion process but instead to put clear rules in place if a conversion ever occurred, especially in light of proposals being circulated by others that would, in the opinion of Blue Cross, have hurt the company's ability to operate competitively as a for-profit company. Mr. Otis said

that Blue Cross had developed the following four principles to govern the conversion issue:

- The assets of Blue Cross must be protected so that customers' medical claims will be paid and the company will remain financially sound
- Anyone associated with Blue Cross must not profit from the conversion
- Blue Cross must have the business flexibility to meet the needs of its customers and remain competitive in the marketplace
- Blue Cross would support the creation of one or more foundations, funded by stock, for the charitable purpose of serving the health care needs of North Carolina citizens.

Mr. Otis stated that Blue Cross had determined, after further review, that no one had a clear claim to the assets of Blue Cross (if it converts) but that by process of elimination and the application of broad equitable principles, the public has an interest in Blue Cross upon conversion. Mr. Otis recommended that the Commission consider a conceptual approach similar to that used in California -- where two foundations were set up to receive the proceeds of the California Blue Cross upon conversion.

In response to questions about "business flexibility," Mr. Otis responded that the proposals Blue Cross had seen in 1997 would have tied Blue Cross's hands in terms of it being able to do the day-to-day work of running its business. It would have required Blue Cross to submit to extra levels of reports and information, to seek approval to make regular business decisions (such as beginning work on a new computer system or buying buildings to house employees). Mr. Otis noted that Blue Cross needed a level playing field to be able to do what other insurers do in this state in the day-to-day running of their business to remain competitive.

Mr. Otis noted in response to a question about how Blue Cross would operate if it became a for-profit company that, given the Blue Cross board and its history, its management, and their history and commitment, the simple fact of moving to a publicly-traded company, should it ever become necessary, would not in and of itself change Blue Cross' attitude or sense of responsibility to the people. See the Appendices for Mr. Otis' written remarks.

Mr. Martin Eakes, Co-chair of the Coalition for Public Trust's Steering Committee and Executive Director of the Center for Community Self-Help, spoke to the Commission about the "win-win" solution to the Blue Cross conversion issue that can be achieved by having Blue Cross, at conversion, issue 100% of its stock initially to a charitable foundation. Mr. Eakes stated that there were two critical principles guiding the Coalition on this issue:

- 100% of the cash and assets of Blue Cross must be retained by Blue Cross to pay the claims of its policyholders
- 100% of the fair market value of Blue Cross at the time of conversion must be retained in a charitable foundation in the form of stock

Mr. Eakes briefly discussed the tax issues concerning charitable foundations. He also noted that the directors of a foundation set up as a result of any Blue Cross conversion should be independent of any control by Blue Cross and that the purpose of the foundation should be to promote the health of North Carolina citizens. Mr. Eakes noted that, in his opinion, if mutualization is allowed, the "win-win" situation will not work. When a company becomes a mutual, the value at the time of conversion is still held inside the company, but there is no stock passed to the private foundation.

In response to a question about employees and officers of a for-profit Blue Cross being highly compensated, Mr. Eakes felt that the foundation's interest and the interests of a for-profit Blue Cross are aligned in trying to maximize the

value of the stock. Stock options in converted Blues in other states created strong incentives for the management of the Blue Cross. Mr. Eakes was not concerned about these types of incentives as long as the stock options were aimed at increasing the overall value of Blue Cross. Mr. Eakes noted that in Ohio, there were stock options granted that were below the sales price of the stock -- which meant that they were receiving a windfall gain from the moment they took the stock options. Ultimately that was not permitted in Ohio. See the Appendices for Mr. Eakes' written remarks.

### **March 3, 1998**

The Commission held its third meeting on March 3, 1998. The following spoke to the Commission: former Governor Jim Holshouser of the Sanford and Holshouser Law Firm; Ms. Judith Bell, Director of the West Coast Regional Office of the Consumers Union; Mr. Richard Daugherty, former head of IBM's Research Triangle operation, former president of the NCCBI, former Blue Cross director, and currently chairman of the Board of Directors of Rex Hospital; Mr. Ray Cope, Executive Director of the Kate B. Reynolds Charitable Trust in Winston-Salem; Mr. Gary Mendoza, former Commissioner of the California Department of Corporations and currently a member of the law firm of Riordan & McKinzie in Los Angeles, California, and a consultant to Blue Cross Blue Shield of North Carolina; and Mr. Robin Hinson, a senior partner in the Charlotte law firm of Robinson, Bradshaw, and Hinson, and special counsel for Blue Cross Blue Shield of North Carolina.

Governor Holshouser spoke of the importance of establishing the right rules for conversion. He felt that the first duty is to ensure that the company survives and thrives in a competitive market place and that its 1.6 million policyholders continue to have coverage. Governor Holshouser also noted that there appears to be a consensus that a trust or a foundation should be



established to serve health care needs across North Carolina, capitalized through stock, if Blue Cross converts. Governor Holshouser felt that this was a sound idea but noted that the details are very important. Two of the details he felt needed to be addressed are (1) How the board of such a foundation would be selected and (2) what its mission would be. On the board issue, Governor Holshouser stated that we need people who know about running a large business and who also understand how to effectively meet the problems in health care delivery. He also felt that the foundation should not become a matter of political patronage for the Governor or the Legislature. He recommended a system of nominations from the professional community, followed by appointments by the Governor and legislative leadership as one possible selection method. On the mission statement, he urged that the Commission confine the mission to "health care" because that is what Blue Cross was established for.

Ms. Bell spoke about the California Blue Cross conversion. Ms. Bell discussed the history of the California Blue Cross conversion. In 1993, Blue Cross of California proposed to transfer 90% of its assets to a for-profit subsidiary – Wellpoint. Eighty percent of the Wellpoint stock was transferred to its non-profit parent, with 20% being sold to the public. The California Department of Corporation accepted that this was not a conversion, but later reversed itself. Blue Cross agreed to contribute \$5 million per year for 20 years to health care charities, but the public and the Department argued that the public had a right to all of the fair market value. The result was that two foundations – a 501(c)(3) and a 501(c)(4) – were organized with a combined endowment of \$3.3 billion. The two foundations were the California Health Care Foundation and the California Endowment. The first – the California Health Care Foundation -- was endowed with \$2 billion in Wellpoint stock, with most of this being monetized and passed to the second foundation. The California Health Care Foundation was a 501(c)(4) and its board was comprised of a majority of the old Blue Cross board members. The second foundation was initially endowed with

\$800 million in cash and was controlled by a majority of new directors independent of Blue Cross. See the Appendices for Ms. Bell's written remarks.

Ms. Bell felt that the following were the key issues the Commission needed to look at:

- Conversion transactions should be subject to full public disclosure and discussion
- Public hearings should be held before a decision is made
- An independent valuation should be conducted for the regulator responsible for reviewing the transaction
- 100% of the fair market value should be set aside in a charitable trust if the entity converts
- The foundation's board should be independent of the board of the new for-profit entity
- Voting agreements and demand registration rights should protect the foundation.

Mr. Daugherty spoke of the need to ensure that Blue Cross remains a competitor if it goes into the for-profit marketplace. The legislation adopted by the Commission should recognize the need for Blue Cross to maintain its business flexibility. Mr. Daugherty addressed some of the issues that had been discussed concerning a possible conversion by Blue Cross. Mr. Daugherty felt that the State should not dictate what Blue Cross does as far as compensation or other incentives to employees or directors once it becomes a for-profit company and repays whatever debts it owes to the public. He also noted that Blue Cross' assets should remain with Blue Cross if it converts so that the company remains financially strong for its customers. Mr. Daugherty felt that Blue Cross was as strong as it was today not because of tax breaks but because it was the first in the marketplace 65 years ago, it offered a good product at an affordable price, and it has met the needs of its customers. On the issue of

governance, Mr. Daugherty noted that it was important for the proposed foundation to be independent of Blue Cross and for Blue Cross to be independent of the foundation. Blue Cross would need to select its own directors with health insurance business market experience.

The Commission discussed with Mr. Daugherty the issue of stock dilution – i.e., whether an initial public offering of stock by a for-profit Blue Cross dilutes the value of the previous stock given to the charitable foundation. Mr. Daugherty felt that this problem would be avoided either by an increase over time in the value of the company or the retention by Blue Cross of some of the stock so that it can use it as capital. The second option would involve moving less than 100% of the fair market value of Blue Cross to a foundation. See the Appendices for Mr. Daugherty's written remarks.

Mr. Cope discussed the history, operation, and mission of the Kate B. Reynolds Charitable Trust. Mr. Cope's comments were aimed at providing the Commission with information on structuring a charitable foundation for Blue Cross Blue Shield stock or stock proceeds should Blue Cross ever convert. The Kate B. Reynolds Charitable Trust is one of more than 850 private foundations in North Carolina and is funded through the will of the late Mrs. Kate B. Reynolds. The Trust has a Health Care Division advisory board that meets twice a year to consider grant proposals. The Division's advisory board has 11 members, 5 of whom serve ex officio and 6 of whom are chosen at-large from around the State. They serve 3-year terms. The Trust has funded such health-related programs as the Good Health Program to enhance preventative health care services for low-income residents in certain communities and the hospice program. Mr. Cope noted that Wachovia manages the investment of funds for the Kate B. Reynolds Trust. See the Appendices for Mr. Cope's written remarks.

Mr. Mendoza spoke about the conversion of the California Blue Cross Blue Shield. Mr. Mendoza discussed the history of the California Blue Cross

conversion. Mr. Mendoza noted that Blue Cross of California had already sold some stock to the public for a for-profit subsidiary – Wellpoint – before the restructuring transaction was characterized as a conversion. As Commissioner of the California Department of Corporations, Mr. Mendoza felt it was critical that the following principles guide the Department in resolving the Blue Cross of California situation:

- 100% of the fair market value of Blue Cross should be made available to one or more health care foundations as part of the conversion
- The foundations should be managed by independent boards of directors
- The corporate structure chosen for the foundations should be flexible enough to enhance the benefits made available to the public through the foundations' activities
- The foundations should be dedicated to serving broadly-stated health care needs of the people of the State
- The process of the conversion review and resolution should not adversely impact Blue Cross/Wellpoint's ability to successfully manage its operations and provide health care coverage to Californians

Mr. Mendoza stated that, in his opinion, any conversion that involves the transfer of 100% of the stock of Blue Cross to the foundation(s) constitutes a transfer of 100% of the fair market value. Mr. Mendoza made additional points on each of these issues, as outlined in his statement of remarks in the appendices. He noted that the ideal structure for a foundation would be a 501(c)(4) organization with the important 501(c)(3) protections that apply to private foundations built in. He felt that two foundations in California had been a source of some confusion and that it had increased the administrative costs of the charitable mission by having two sets of staffs, attorneys, accountants, etc. carrying out that mission.

Mr. Mendoza also spoke about the national Blue Cross/Blue Shield Association and its control over the trademark and logo for Blue Cross. As a prerequisite for continuing to use the trademark, the national association required that (1) at least a majority of the foundation board be former Blue Cross/Blue Shield of California board members for 5 years; and (2) other than the foundation, no one could hold more than 5% of the company. Mr. Mendoza noted that there were a series of voting agreements that were entered into between the foundation and the for-profit company. The voting agreements required the foundation to vote its stock in a manner that was consistent with the nominations of portions of the for-profit company's board. Thus, the foundations' board had to follow the Blue Cross board's direction in respect to who they voted for. On other voting issues, there were also provisions that required the foundation to vote certain shares of stock in a manner consistent with the vote of the other public shareholders. The foundation could vote to remove a Blue Cross board member in case of gross misconduct. The foundation also retained the right to vote some of its shares independently of the voting trust. See the Appendices for Mr. Mendoza's written remarks.

Mr. Hinson spoke briefly on his views about the conversion process, the proposed foundation, and the governing boards. Mr. Hinson stated that while it was not clear where ownership of Blue Cross would be vested if it converted, the public has the best claim to the ownership of the value of the company upon conversion. Mr. Hinson concluded that the Blue Cross subscribers have no claim to the ownership of the company upon conversion; their only rights are "contract" rights that are designed to ensure that their claims are paid. Mr. Hinson questioned how the assets of Blue Cross would even be apportioned among past and present Blue Cross subscribers if it were decided that the subscribers owned all or part of Blue Cross. Mr. Hinson also noted that Blue Cross is not a charitable corporation and that the public was not entitled to a transfer of actual assets to repay for tax breaks Blue Cross has received. Mr.

Hinson noted that other types of nonprofit organizations have also received favorable tax treatment.

Mr. Hinson stated the following as fundamental principles for any conversion legislation:

- The assets and reserves of Blue Cross must be maintained for the benefit of subscribers and the financial soundness of Blue Cross
- Blue Cross must have the business flexibility to manage its business and compete in the health care marketplace
- The directors, officers, and employees of Blue Cross must not profit from or receive any distribution in connection with the conversion
- Blue Cross should fulfill its obligation to the public upon converting by issuing 100% of the new stock to the foundation
- The timing of any initial public offering of Blue Cross common stock must be in the discretion of the directors of the board of directors of Blue Cross
- The conversion transaction must be a nontaxable event under both state and federal law

Mr. Hinson also pointed out what he felt were essential elements of an acceptable conversion statute and presented a diagram of how the conversion transaction could work. See the Appendices for Mr. Hinson's written remarks.

At the conclusion of these presentations, the Commission held a public hearing to allow members of the public to comment on the Blue Cross conversion issue. The following individuals spoke: Mr. Richard Hatch, AARP; Mr. Adam Searing, The North Carolina Health Access Coalition; Ms. Myrna Miller, National Association of Social Workers - NC Chapter; Ms. Jane Kendall, Center for Non-Profits; and Mr. Watts Hill, Jr. Mr. Abdul Sm Rasheed of the NC Community Development Initiative, Inc. and the North Carolina State Grange

provided written comments to the Commission. See the Appendices for these comments.

#### **APRIL 7, 1998**

The Commission held its fourth meeting on April 7, 1998. The co-chairmen presented a list of discussion issues to the Commission for their consideration. See the Appendices for the Discussion List. The list contained a series of issues about the conversion process, the structure and purpose of the foundation, and related issues. The Commission went through the list issue-by-issue to determine what should be included in a final bill draft. The Commission's thoughts were as follows:

(1) Dental service corporations should be treated the same as Blue Cross under the bill. Currently, dental service corporations fall under the same regulatory law as Blue Cross, a hospital and medical service corporation. Blue Cross and Delta Dental are the only service corporations in existence under this law, although there could be others in the future. The Commission felt that the conversion law should apply to all service corporations, not just Blue Cross.

(2) Approval of the subscribers and certificateholders should not be required to amend the charter of Blue Cross to allow conversion. Current law requires 2/3 of the certificateholders of Blue Cross to approve an amendment to the Blue Cross charter for the purpose of converting to a for-profit entity. The Commission members felt that the public is entitled to 100% of the fair market value of Blue Cross if it converts. Because of this public ownership interest, most of the Commission felt that a vote by the certificateholders was unnecessary and would likely be counter-productive. It was felt that the right of the certificateholders in Blue Cross is a contractual right to ensure that proper reserves are maintained in the company to pay their claims and that this right

could be safeguarded by allowing the certificateholders, if Blue Cross proposes to convert, to submit evidence before the Commissioner of Insurance on the impact of the conversion on future claims payments and more generally on the affordability and continued accessibility of Blue Cross insurance. Mr. Kolbe, speaking on behalf of the Commissioner, felt that the statutory right of certificateholders to approve a proposed conversion should not be taken away. Mr. Kolbe stated that if the Commission did take that right away, the Commissioner would at least want the authority to review the proposed conversion's effect on insurance affordability and accessibility so that current certificateholders would be ensured that the cost and availability of Blue Cross products throughout the State would not be adversely impacted.

(3) The Commissioner of Insurance should be allowed to look at the accessibility and affordability of health care in evaluating whether to approve a conversion plan. This language was included at the recommendation of Mr. Kolbe (see #2 above).

(4) The Commissioner should have authority to review the plan of conversion and to look at such issues as the following:

- Ensuring that the transfer of stock or other assets to the Foundation represents the appropriate percentage of Blue Cross' fair market value that is required to be transferred.
- Ensuring that the new company has adequate capital and reserves and can pay the claims of policyholders
- Ensuring that officers and employees of the not-for-profit Blue Cross do not receive financial inducements for effecting a conversion
- Ensuring that the public interest is protected.



(5) The Attorney general should have approval authority over the Articles of Incorporation and by-laws of the foundation and the voting agreement between the foundation and the new Blue Cross. This is in recognition of the Attorney General's jurisdiction over charitable trusts generally and its role as representative of the public. The Attorney General would also have authority over abuses in the foundation's grant-making process, although he would not interfere with the foundation's judgment in making grants.

(7) The mission of the foundation should be to "promote the health of the people of North Carolina." This mission recognizes the original mission of Blue Cross.

(8) The foundation should be organized under the federal tax laws as a 501(c)(4) entity, subject to 501(c)(3) restrictions on political activity and lobbying. The 501(c)(3) payout requirement would not be included, but language requiring a payout of "substantially all of its (the foundation's) income, less operating expenses" would be included. Organization as a 501(c)(4) entity has tax advantages over a 501(c)(3) entity.

(9) The foundation board should initially be 11 members appointed by the Attorney General. These 11 members would be chosen from a list of at least 22 North Carolinians identified by a search firm. The Attorney General could appoint an advisory committee to help him with the selection, but the legislation would not require the advisory committee. There would be no categories or slots for the appointments. The initial members would be staggered between 2 and 4 year terms, with members thereafter serving 4-year terms. A member could serve up to 10 consecutive years. After the initial board is established, it becomes self-perpetuating and can decrease in size to as few as 9 members or increase in size to 15 members.

(10) A list of the compensation of the board members should be reported annually to the Joint Legislative Commission on Governmental Operations. The

Commission on Governmental Operations does not have authority to approve or modify compensation. The purpose of the review is to serve as a check against abusive compensation practices.

(11) The charter of the foundation will be subject to amendment by the legislature.

(12) The issue of what constitutes a conversion will continue to be worked on, and language on this issue would be presented at the final meeting.

(13) The Commission approved the following items as required elements of a plan of conversion:

- Purpose of the conversion
- Proposed articles of incorporation and bylaws
- A description of changes in how the new company will operate
- How policyholders' rights will be protected
- Business plan of the new corporation (including analysis of recent premium charges and projected charges)
- Foundation's articles of incorporation and bylaws
- Agreements between the Foundation and the new Blue Cross

(14) There should be broad public input into a proposed conversion. It was recommended that there be at least 3 public hearings.

(15) If Blue Cross converts, 100% of the fair market value should be transferred to a charitable foundation.

**APRIL 28, 1998**

Mr. Jones briefed the Commission on the draft bill. The Commission members approved the following changes to the draft:

- After the 10 year "no competition" period expires (i.e., the foundation cannot set up an insurance company or similar entity to compete with Blue Cross during that period), it was felt that the prohibition on members of the foundation serving on the board of Blue Cross or one of its affiliates and the prohibition on Blue Cross members serving on the foundation board should be relaxed. The change will remove the prohibition after 10 years and the divestment by the foundation board of 95% of the Blue Cross stock obtained in the conversion.
- Mr. Jones pointed out that the national Blue Cross Association in Chicago, which owns the license and trademark under which Blue Cross of North Carolina operates, was concerned about one individual – the Attorney General – wielding too much appointment power over the foundation's board. (The national association's concerns stem from the fact that the foundation will initially own 100% of the stock of Blue Cross). To address concerns about the appointment process, the Commission agreed to establish an ex officio advisory committee, consisting of representatives of the business community, hospitals, physicians, medical schools, and private foundations.
- The Coalition for Public Trust proposed a change to the pay-out provision. The original proposal would have required the foundation to pay out substantially all of its income. The Coalition recommended using the standard applicable to 501(c)(3) foundations under the federal tax code: essentially a payout of 5% of net assets. Because this could potentially require the foundation to invade the corpus of its trust to meet the payout requirement, the Commission recommended language requiring a payout of

the lesser of (1) 5% of net assets or (2) substantially all of the income, and in no event does corpus have to be invaded.

- The foundation reporting requirement, which would have required the foundation to report its tax returns and grant-making activities to the Commissioner of Insurance and the Attorney General, was amended to require an additional report on directors compensation to the Joint Legislative Commission on Governmental Operations. (This was further amended at the final meeting of the Commission).

The Commission spent most of its time focusing on the one remaining central issue: what constitutes a conversion. Mr. Kolbe recommended that the following thresholds should apply in determining whether Blue Cross has in fact converted:

- If Blue Cross transfers more than 10% of its assets to a for-profit company
- If Blue Cross transfers any assets at all to an outside investor
- If 25% of the assets of Blue Cross are used by for-profit subsidiaries
- If 25% of the revenue of Blue Cross and its subsidiaries are generated by for-profit operations
- In no event should Blue Cross be allowed to be in a business other than health insurance or insure non-North Carolinians
- The Commissioner should be allowed to aggregate transactions to determine if a conversion has occurred.

Mr. Kolbe felt that this provided Blue Cross sufficient flexibility.

Mr. Hinson presented a proposal from Blue Cross on this issue. Under the Blue Cross proposal, a conversion would occur if any of the following occurred:

- If Blue Cross transfers more than 10% of its assets to a for-profit company. However, the following 4 transfers or acquisitions would not count against the 10% figure:

- The value of health insurance policies purchased (to the extent the policies are on North Carolinians)
  - The common stock of a for-profit company (to the extent that the value of the stock represents health insurance policies on North Carolinians)
  - Security interests
  - Investment portfolio transactions in the ordinary course of business
- If Blue Cross transfers any assets at all to an outside investor
  - If 50% of the assets of Blue Cross are used by for-profit subsidiaries
  - If 50% of the revenue of Blue Cross and its subsidiaries are generated by for-profit operations
  - The Commissioner would be allowed to aggregate transactions to determine if a conversion has occurred.

Mr. Eakes presented a proposal on behalf of the Coalition. The major differences between the Coalition's proposal and Blue Cross' proposal was as follows:

- The Coalition felt that the value of common stock purchases of for-profit companies attributable to health insurance policies on North Carolinians should not be excluded from the 10% limitation
- The Coalition felt that no more than 40% of revenues should come from for-profit subsidiaries and no more than 40% of the assets should be used by for-profit subsidiaries.

The Commission also discussed the length of time that might elapse between (i) Blue Cross undertaking a transaction or series of transactions that the Commissioner determines to be a conversion and (ii) a final appellate decision on the Commissioner's determination. The Blue Cross proposal would have provided Blue Cross 24 months after an appellate decision in the Commissioner's favor to file a plan of conversion. The Commission agreed to

reduce this period to 12 months and asked Mr. Jones to develop language to expedite the appeals process.

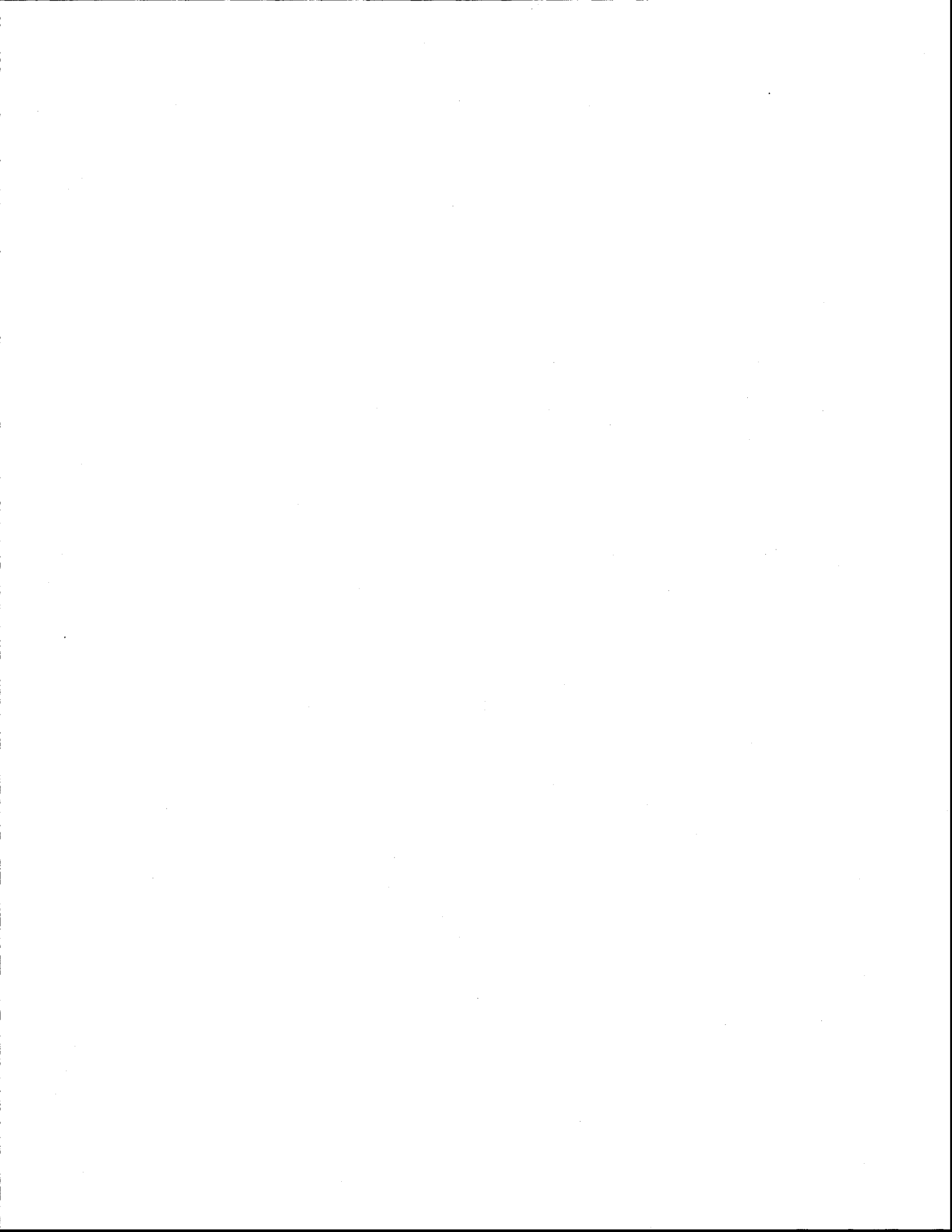
### **May 1, 1998**

The Commission held its final meeting on May 1, 1998. Mr. Jones reviewed with the Commission the substantive changes that had been made to the bill.

Senator Perdue moved that the advisory committee members selected by the NC Center for Nonprofits include representatives of foundations and other nonprofit organizations. Mr. Jones requested that the Commission revisit the issue of the foundation payout requirement. Mr. Jones noted that the provision, as written, could potentially allow the foundation to accumulate substantial amounts of money in good investment years without being required to pay them out. However, the provision could be left as written, entrusting the proper payout in those years to the foundation board. The Commission decided to leave the provision as they had amended it at the last meeting: i.e., the foundation must pay out either 5% of net assets or substantially all of its net income, whichever is less, and in no event is the foundation required to invade the trust corpus to meet the payout requirement in any given year.

Mr. Hinson and Mr. Eakes restated the respective proposals of Blue Cross and the Coalition. Mr. Otis and Mr. Sasser also addressed the Commission about the need for Blue Cross to have sufficient business flexibility. Their comments are included in the appendix. They stated that Blue Cross would agree to a reduction from 50% to 40% on the assets test and the revenue test. Mr. Eakes proposed that the Commission, in addition to the 40% changes, limit the purchase by Blue Cross of health insurance policies on North Carolinians and common stock of for-profit companies to an additional 10% (above the standard 10% allowed for asset purchases in both the Coalition's proposal and Blue Cross' proposal). Mr. Searing also addressed the Commission. His comments are included in the Appendix. A motion to adopt the Coalition's

proposal failed. A motion to adopt the Blue Cross proposal, with an amendment reducing the assets and revenue test thresholds from 50% to 40% passed. The Commission adopted the final report for recommendation to the General Assembly.





# PROPOSED LEGISLATION



GENERAL ASSEMBLY OF NORTH CAROLINA

SESSION 1997

S

D

SENATE BILL 993

Rules and Operations of the Senate Committee Substitute Adopted  
4/29/97

Third Edition Engrossed 4/30/97  
House Committee Substitute Favorable 5/27/97  
Fifth Edition Engrossed 6/9/97

PROPOSED CONFERENCE COMMITTEE SUBSTITUTE

S993-CRRNZ-006 (5.11)

THIS IS A DRAFT

10:20:41 11-MAY-98

Short Title: Medical Service Corp. Charters.

(Public)

---

Sponsors:

---

Referred to:

---

April 21, 1997

1 A BILL TO BE ENTITLED  
2 AN ACT TO ESTABLISH PROCEDURES FOR CONVERSIONS BY HOSPITAL,  
3 MEDICAL, AND DENTAL SERVICE CORPORATIONS.  
4 The General Assembly of North Carolina enacts:  
5 Section 1. G.S. 58-65-130(3) reads as rewritten:  
6 "(3) The charter of any corporation subject to the  
7 provisions of this Article and Article 66 of this  
8 Chapter may be amended to convert that corporation,  
9 so amending its charter, into ~~either a mutual~~  
10 ~~nonstock or~~ stock accident and health insurance  
11 company or stock life insurance company subject to  
12 the provisions of Articles 1 through 64 of this  
13 Chapter provided the contractual rights of the  
14 subscribers ~~or~~ and certificate holders ~~in the~~

~~reserves and capital of such of the corporation are adequately protected under rules and regulations adopted by the Commissioner of Insurance, protected. The proposed amendment shall be considered pursuant to G.S. 58-65-131, 58-65-132, and 58-65-133. Other provisions of this section and this Article relating to the procedure for amending the charter shall not apply."~~

Section 2. Article 65 of Chapter 58 of the General Statutes is amended by adding the following new sections to read:

"§ 58-65-131. Findings; definitions; conversion plan.

(a) Intent and findings.-- It is the intent of the General Assembly by the enactment of this section, G.S. 58-65-132, and G.S. 58-65-133 to create a procedure for a medical, hospital, or dental service corporation to convert to a stock accident and health insurance company or stock life insurance company that is subject to the applicable provisions of Articles 1 through 64 of this Chapter. Except as provided herein, it is not the intent of the General Assembly to supplant, modify, or repeal other provisions of this Article and Article 66 of this Chapter or the provisions of Chapter 55A of the General Statutes (the Nonprofit Corporation Act) that govern other transactions and the procedures relating to such transactions that apply to corporations governed by the provisions of this Article and Article 66 of this Chapter.

The General Assembly recognizes the substantial and recent changes in market and health care conditions that are affecting these corporations and the benefit of equal regulatory treatment and competitive equality for health care insurers. The General Assembly finds that a procedure for conversion is in the best interest of policyholders because it will provide greater financial stability for these corporations and a greater opportunity for the corporations to remain financially independent. The General Assembly also finds that if a medical, hospital or dental service corporation converts to a stock accident and health insurance company or stock life insurance company, the conversion plan must provide a benefit to the people of North Carolina equal to one hundred percent of the fair market value of the corporation.

(b) Definitions.-- As used in this section, G.S. 58-65-132, and G.S. 58-65-133:

(1) "Certificate holder" includes an enrollee, as defined in Article 67 of this Chapter, in a health maintenance plan provided by the corporation or a

- 1           subsidiary or by the new corporation or a  
2           subsidiary.
- 3           (2) "Code" means Title 26 of the United States Code,  
4           the United States Internal Revenue Code of 1986, as  
5           amended.
- 6           (3) "Conversion" means the conversion of a hospital,  
7           medical, or dental service corporation to a stock  
8           accident and health insurance company or stock life  
9           insurance company subject to the applicable  
10           provisions of Articles 1 through 64 of this  
11           Chapter.
- 12           (4) "Corporation" means a hospital, medical, or dental  
13           service corporation governed by this Article that  
14           files or is required to file a plan of conversion  
15           with the Commissioner under subsection (d) of this  
16           section to convert from a hospital, medical, or  
17           dental service corporation to a stock accident and  
18           health insurance company or stock life insurance  
19           company.
- 20           (5) "Foundation" means a newly formed tax-exempt  
21           charitable social welfare organization formed and  
22           operating under Section 501(c)(4) of the Code and  
23           Chapter 55A of the General Statutes.
- 24           (6) "New corporation" means a corporation originally  
25           governed by this Article that has had its plan of  
26           conversion approved by the Commissioner under G.S.  
27           58-65-132 and that has converted to a stock  
28           accident and health insurance company or stock life  
29           insurance company.
- 30 (c) Compliance required in certain events.-- A corporation  
31 governed by this Article shall comply with the provisions of this  
32 section, G.S. 58-65-132 and G.S. 58-65-133 before it may do any  
33 of the following:
- 34           (1) Sell, lease, convey, exchange, transfer, or make  
35           other disposition, either directly or indirectly in  
36           a single transaction or related series of  
37           transactions, of ten percent (10%) of the  
38           corporation's assets, as determined by statutory  
39           accounting principles, to, or merge or consolidate  
40           or liquidate with or into, any business corporation  
41           or other business entity, except a business  
42           corporation or other business entity that is a  
43           wholly-owned subsidiary of the corporation. The

1           ten percent asset limitation in this subdivision  
2           does not apply to:

3           a. the purchase, acquisition by assignment or  
4           otherwise by the corporation of individual  
5           accident and health policies or contracts  
6           insuring North Carolina residents, or with  
7           respect to accident and health group master  
8           policies or contracts, only the percentage  
9           portion of those policies or contracts  
10           covering North Carolina resident certificate  
11           holders, and that are issued by a company  
12           domiciled or licensed to do business in North  
13           Carolina, if the purchase is first approved by  
14           the Commissioner after notice to the Attorney  
15           General, no profit will inure to the benefit  
16           of any officer, director or employee of the  
17           corporation or its subsidiaries, the purchase  
18           is transacted at arm's length and for fair  
19           value, and the purchase will further the  
20           corporation's ability to fulfill its purposes;

21           b. in the case of a purchase by the corporation  
22           of all the common stock of a company domiciled  
23           or licensed to do business in North Carolina,  
24           that portion of the value of the company which  
25           is determined by the Commissioner to be  
26           attributable to individual accident and health  
27           policies or contracts insuring North Carolina  
28           residents or, in the case of accident and  
29           health group master policies or contracts, the  
30           percentage portion of those policies or  
31           contracts covering North Carolina resident  
32           certificate holders, if the purchase is first  
33           approved by the Commissioner after notice to  
34           the Attorney General, no profit will inure to  
35           the benefit of any officer, director, or  
36           employee of the corporation or its  
37           subsidiaries, the purchase is transacted at  
38           arm's length and for fair value, and the  
39           purchase will further the corporation's  
40           ability to fulfill its purposes;

41           c. granting encumbrances such as security  
42           interests or deeds of trust with respect to  
43           assets owned by the corporation or any wholly  
44           owned subsidiary to secure indebtedness for

- 1                   borrowed money, the proceeds of which are paid  
2                   solely to the corporation or its wholly owned  
3                   subsidiaries and remain subject to the  
4                   provisions of this section G.S. 58-65-131; and  
5           d.       sales or other transfers in the ordinary  
6                   course of business for fair value of any  
7                   interest in real property or stocks, bonds, or  
8                   other securities within the investment  
9                   portfolio owned by the corporation or any  
10                  wholly owned subsidiary, the proceeds of which  
11                  are paid solely to the corporation or any  
12                  wholly owned subsidiary and remain subject to  
13                  the provisions of this section G.S. 58-65-131.
- 14           (2)     Directly or indirectly issue, sell, convey,  
15                  exchange, transfer, or make other disposition to  
16                  any party of any equity or ownership interest in  
17                  the corporation or in any business entity that is  
18                  owned by or is a subsidiary of the corporation,  
19                  including stock, securities, or bonds, debentures,  
20                  notes or any other debt or similar obligation that  
21                  is convertible into any equity or ownership  
22                  interest, stock or securities. This subdivision  
23                  shall not be construed to prohibit the corporation  
24                  or a wholly owned subsidiary, with the approval of  
25                  the Commissioner after notice to the Attorney  
26                  General, from investing in joint ventures or  
27                  partnerships with unrelated third parties, if no  
28                  profit will inure to the benefit of any officer,  
29                  director, or employee of the corporation or its  
30                  subsidiaries, the transaction is conducted at arm's  
31                  length and for fair value, and the transaction  
32                  furtheres the corporation's ability to fulfill its  
33                  purposes.
- 34           (3)     Permit its aggregate annual revenues, determined in  
35                  accordance with statutory accounting principles,  
36                  from all for-profit activities or operations,  
37                  including but not limited to those of the  
38                  corporation, any wholly owned subsidiaries, and any  
39                  joint ventures or partnerships, to exceed forty  
40                  percent (40%) of the aggregate annual revenues,  
41                  excluding investment income, of the corporation and  
42                  its subsidiaries and determined in accordance with  
43                  statutory accounting principles; or

1           (4) Permit its aggregate assets for four consecutive  
2           quarters, determined in accordance with statutory  
3           accounting principles, employed in all for-profit  
4           activities or operations, including but not limited  
5           to those assets owned or controlled by any for-  
6           profit wholly owned subsidiaries, to exceed forty  
7           percent (40%) of the aggregate admitted assets of  
8           the corporation and its subsidiaries for four  
9           consecutive quarters, determined in accordance with  
10           statutory accounting principles.

11       In determining whether the corporation must comply with the  
12       provisions of this section, G.S. 58-65-132, and G.S. 58-65-133,  
13       the Commissioner may review and consolidate actions of the  
14       corporation, its subsidiaries, and other legal entities in which  
15       the corporation directly or indirectly owns an interest, and  
16       treat the consolidated actions as requiring a conversion. An  
17       appeal of the Commissioner's order that consolidated actions  
18       require a conversion shall lie directly to the North Carolina  
19       Court of Appeals, provided that any party may petition the North  
20       Carolina Supreme Court, pursuant to G.S. 7A-31(b), to certify the  
21       case for discretionary review by the Supreme Court prior to  
22       determination by the Court of Appeals. Appeals under this  
23       subsection must be filed within thirty days of the Commissioner's  
24       order and shall be considered in the most expeditious manner  
25       practical. The corporation must file a plan of conversion within  
26       12 months of the later of the issuance of the Commissioner's  
27       order or a final decision on appeal.

28       (d) Charter amendment for conversion.-- A corporation may  
29       propose to amend its charter pursuant to this Article to convert  
30       the corporation to a stock accident and health insurance company  
31       or stock life insurance company subject to the applicable  
32       provisions of Articles 1 through 64 of this Chapter. The  
33       proposed amended charter and a plan for conversion as described  
34       in subsection (e) of this section shall be filed with the  
35       Commissioner for approval.

36       (e) Filing conversion plan; costs of review.-- A corporation  
37       shall file a plan for conversion with the Commissioner and submit  
38       a copy to the Attorney General at least 120 days before the  
39       proposed date of conversion. The corporation or the new  
40       corporation shall reimburse the Department of Insurance and the  
41       office of the Attorney General for the actual costs of reviewing,  
42       analyzing, and processing the plan. The Commissioner and the  
43       Attorney General may contract with experts, consultants, or other  
44       professional advisors to assist in reviewing the plan. These



1 contracts are personal professional service contracts exempt from  
2 Articles 3 and 3C of Chapter 143 of the General Statutes.  
3 Contract costs for these personal professional services shall not  
4 exceed an amount that is reasonable and appropriate for the  
5 review of the plan.

6 (f) Plan requirements.-- A plan of conversion submitted to the  
7 Commissioner shall state with specificity the following terms and  
8 conditions of the proposed conversion:

- 9           (1) The purposes of the conversion.  
10           (2) The proposed articles of incorporation of the new  
11           corporation.  
12           (3) The proposed bylaws of the new corporation.  
13           (4) A description of any changes in the new  
14           corporation's mode of operations after conversion.  
15           (5) A statement describing the manner in which the plan  
16           provides for the protection of all existing  
17           contractual rights of the corporation's subscribers  
18           and certificateholders to medical or hospital  
19           services or the payment of claims for reimbursement  
20           for those services. The corporation's subscribers  
21           and certificate holders shall have no right to  
22           receive any assets, surplus, capital, payment or  
23           distribution or to receive any stock or other  
24           ownership interest in the new corporation in  
25           connection with the conversion.  
26           (6) A statement that the legal existence of the  
27           corporation does not terminate and that the new  
28           corporation is subject to all liabilities,  
29           obligations and relations of whatever kind of the  
30           corporation and succeeds to all property, assets,  
31           rights, interests and relations of the corporation.  
32           (7) Documentation showing that the corporation, acting  
33           by its board of directors, trustees or other  
34           governing authority, has approved the plan. It  
35           shall not be necessary for the subscribers or  
36           certificate holders of the corporation to vote on  
37           or approve the plan of conversion, any amendments  
38           to the corporation's articles of incorporation or  
39           bylaws, or the articles of incorporation or the  
40           bylaws of the new corporation, notwithstanding any  
41           provision to the contrary in this Article or  
42           Article 66 of this Chapter or in the articles of  
43           incorporation or bylaws of the corporation.

- 1           (8) The business plan of the new corporation,  
2           including, but not limited to, a comparative  
3           premium rate analysis of the new corporation's  
4           major plans and product offerings, that, among  
5           other things, compares actual premium rates for the  
6           three-year period before the filing of the plan for  
7           conversion and forecasted premium rates for a  
8           three-year period following the proposed  
9           conversion. This rate analysis shall address the  
10           forecasted effect, if any, of the proposed  
11           conversion on the cost to policyholders or  
12           certificateholders of the new corporation and on  
13           the new corporation's underwriting profit,  
14           investment income, and loss and claim reserves,  
15           including the effect, if any, of adverse market or  
16           risk selection upon these reserves. Information  
17           provided under this subsection is confidential  
18           pursuant to G.S. 58-19-40.
- 19           (9) Any conditions, other than approval of the plan of  
20           conversion by the Commissioner, to be fulfilled by  
21           a proposed date upon which the conversion would  
22           become effective.
- 23           (10) The proposed articles of incorporation and bylaws  
24           of the Foundation, containing the provisions  
25           required by G.S. 58-65-133(h).
- 26           (11) Any proposed agreement between the Foundation and  
27           the new corporation, including but not limited to  
28           any agreement relating to the voting or  
29           registration for sale of any capital stock to be  
30           issued by the new corporation to the Foundation.
- 31           (g) Public Comment.-- Within 20 days of receiving a plan to  
32           convert, the Commissioner shall publish a notice in one or more  
33           newspapers of general circulation in the corporation's service  
34           area describing the name of the corporation, the nature of the  
35           plan filed under G.S. 58-65-131(d), and the date of receipt of  
36           the plan. The notice shall indicate that the Commissioner will  
37           solicit public comments and hold three public hearings on the  
38           plan. The public hearings must be completed within 60 days of  
39           the filing of the conversion plan. The written public comment  
40           period will be held open until 10 days after the last public  
41           hearing. For good cause the Commissioner may extend these  
42           deadlines once for a maximum of 30 days. The Commissioner shall  
43           provide copies of all written public comments to the Attorney  
44           General.

1 (h) Public access to records.-- All applications, reports,  
2 plans, or other documents under this section, G.S. 58-65-132, and  
3 G.S. 58-65-133 are public records unless otherwise provided in  
4 this Chapter. The Commissioner shall provide the public with  
5 prompt and reasonable access to public records relating to the  
6 proposed conversion of the corporation. Access to public records  
7 covered by this section shall be made available for at least 30  
8 days before the end of the public comment period.

9 "§ 58-65-132. Review and approval of conversion plan; new  
10 corporation.

11 (a) Approval of plan of conversion.-- The Commissioner shall  
12 approve the plan of conversion and issue a certificate of  
13 authority to the new corporation to transact business in this  
14 State only if the Commissioner finds all of the following:

15 (1) The plan of conversion meets the requirements of  
16 G.S. 58-65-131, this section, and G.S. 58-65-133.

17 (2) Upon conversion, the new corporation will meet the  
18 applicable standards and conditions under this  
19 Chapter, including applicable minimum capital and  
20 surplus requirements.

21 (3) The plan of conversion adequately protects the  
22 existing contractual rights of the corporation's  
23 subscribers and certificate holders to medical or  
24 hospital services and payment of claims for  
25 reimbursement for those services.

26 (4) No director, officer, or employee of the  
27 corporation will receive:

28 a. Any fee, commission, compensation or  
29 other valuable consideration for aiding,  
30 promoting, or assisting in the conversion  
31 of the corporation other than  
32 compensation paid to any director,  
33 officer, or employee of the corporation  
34 in the ordinary course of business; or

35 b. Any distribution of the assets, surplus,  
36 capital, or capital stock of the new  
37 corporation as part of a conversion.

38 (5) The corporation has complied with all material  
39 requirements of this Chapter, and disciplinary  
40 action is not pending against the corporation.

41 (6) The plan of conversion is fair and equitable and  
42 not prejudicial to the contractual rights of the  
43 the policyholders and certificateholders of the new  
44 corporation.

1           (7) The plan of conversion is in the public interest.  
2           The Commissioner shall find that the plan is in the  
3           public interest only if it provides a benefit for  
4           the people of North Carolina equal to the value of  
5           the corporation at the time of conversion, in  
6           accordance with the criteria set out in this  
7           subdivision. In determining whether the plan of  
8           conversion is in the public interest, the  
9           Commissioner may also consider other factors,  
10           including but not limited to those relating to the  
11           accessibility and affordability of health care.  
12           The Commissioner must determine that the plan of  
13           conversion meets all of the following criteria:

14           a. Consideration, determined by the  
15           Commissioner to be equal to one hundred  
16           percent of the fair market value of the  
17           corporation, will be conveyed or issued  
18           by the corporation to the Foundation at  
19           the time the new corporation files its  
20           articles of incorporation. If the  
21           consideration to be conveyed is all of  
22           the common stock of the new corporation  
23           that is then issued and outstanding at  
24           the time of conversion, and there is no  
25           other capital stock of any type or nature  
26           then outstanding, it is conclusively  
27           presumed that the Foundation will acquire  
28           the fair market value of the corporation.

29           b. At any time after the conversion, the new  
30           corporation may issue, in a public  
31           offering or a private placement,  
32           additional shares of common stock of the  
33           same class and having the same voting,  
34           dividend, and other rights as that  
35           transferred to the Foundation, subject to  
36           the applicable provisions of Chapter 55  
37           of the General Statutes and any voting  
38           and registration agreements.

39           (8) The plan of conversion contains a proposed voting  
40           agreement and registration agreement between the  
41           Foundation and the proposed new corporation that  
42           meets the requirements of G.S. 58-65-133.

43           (9) The Attorney General has given approval pursuant to  
44           G.S. 58-65-133(h).

1 (b) New corporation.-- After issuance of the certificate of  
2 authority as provided in subsection (a) of this section, the new  
3 corporation shall no longer be subject to this Article and  
4 Article 66 of this Chapter but shall be subject to and comply  
5 with all applicable laws and regulations applicable to domestic  
6 insurers and Chapter 55 of the General Statutes, except that  
7 Articles 9 and 9A of Chapter 55 shall not apply to the new  
8 corporation. The new corporation shall file its articles of  
9 incorporation, as amended and certified by the Commissioner, with  
10 the North Carolina Secretary of State. The legal existence of  
11 the corporation does not terminate, and the new corporation is a  
12 continuation of the corporation. The conversion shall only be a  
13 change in identity and form of organization. Except as provided  
14 in subdivision (a)(7) of this subsection, all property, assets,  
15 rights, liabilities, obligations, interests, and relations of  
16 whatever kind of the corporation shall continue and remain in the  
17 new corporation. All actions and legal proceedings to which the  
18 corporation was a party prior to conversion shall be unaffected  
19 by the conversion.

20 (c) Final decision and order; procedures.-- The Commissioner's  
21 final decision and order regarding the plan of conversion shall  
22 include findings of fact and conclusions of law. Findings of  
23 fact shall be based upon and supported by substantial evidence,  
24 including evidence submitted with the plan by the corporation and  
25 evidence obtained at hearings held by the Commissioner. A  
26 person aggrieved by a final decision of the Commissioner  
27 approving or disapproving a conversion may petition the Superior  
28 Court of Wake County within 30 days thereafter for judicial  
29 review. An appeal from a final decision and order of the  
30 Commissioner under this section shall be conducted pursuant to  
31 G.S. 58-2-75. Chapter 150B of the General Statutes does not  
32 apply to the procedures in this section, G.S. 58-65-132, and G.S.  
33 58-65-133. This subsection does not apply to appeal of an order  
34 of the Commissioner issued pursuant to G.S. 58-65-131(c).

35 (d) Attorney General's enforcement authority; legal action on  
36 validity of plan of conversion.--

37 (1) Nothing in this Chapter limits the power of the  
38 Attorney General to seek a declaratory judgment or  
39 to take other legal action to protect or enforce  
40 the rights of the public in the corporation.

41 (2) Any legal action with respect to the conversion  
42 must be filed in the Superior Court of Wake County.

43 "§ 58-65-133. Creation and operation of foundation.

1 (a) Creation.-- A Foundation shall be created to receive the  
2 fair market value of the corporation as provided in G.S. 58-65-  
3 132(a)(7) when the corporation converts.

4 (b) Purpose.-- The charitable purpose of the Foundation shall  
5 be to promote the health of the people of North Carolina. For a  
6 period of ten years from the effective date of the conversion,  
7 the Foundation may not, without the consent of the Attorney  
8 General, establish or operate any entity licensed pursuant to  
9 Chapter 58 of the General Statutes that would compete with the  
10 new corporation or any of its subsidiaries.

11 (c) Board of directors.-- The initial board of directors of the  
12 foundation shall consist of eleven members appointed by the  
13 Attorney General from a list of nominees recommended pursuant to  
14 subsection (d) of this section. The Attorney General shall  
15 stagger the terms of the initial appointees so that six members  
16 serve two-year terms and five members serve 4-year terms. The  
17 board shall fill a vacancy in an initial term. Their successors  
18 shall be chosen by the board of directors of the Foundation in  
19 accordance with the bylaws of the Foundation and shall serve 4-  
20 year terms. No member may serve more than two consecutive full  
21 terms nor more than 10 consecutive years. The Foundation may  
22 increase or decrease the size of the board in accordance with its  
23 by-laws, provided that the board shall have no fewer than nine  
24 directors and no more than 15 directors and that a decrease in  
25 size does not eliminate the then current term of any director.

26 (d) Advisory committee.-- An advisory committee shall be formed  
27 to (i) develop, subject to the approval of the Attorney General,  
28 the criteria for selection of the Foundation's initial board of  
29 directors and (ii) nominate candidates for the initial board of  
30 directors. The advisory committee shall be comprised of the  
31 following eleven members: three representatives of the business  
32 community selected by North Carolina Citizens for Business and  
33 Industry, three representatives of the public and private medical  
34 school community selected by the University of North Carolina  
35 Board of Governors, three representatives of private foundations  
36 and other nonprofit organizations selected by the North Carolina  
37 Center for Nonprofits, a representative of the North Carolina  
38 Association of Hospitals and Health Care Networks, and a  
39 representative of the North Carolina Medical Society. After  
40 receiving a copy of the proposed plan of conversion, the Attorney  
41 General shall immediately notify these organizations, and the  
42 advisory committee shall be constituted within 45 days thereafter.

43 The advisory committee's criteria shall ensure an open  
44 recruitment process for the directors. The advisory committee

1 shall nominate 22 residents of North Carolina for the 11  
2 positions to be filled by the Attorney General. The Attorney  
3 General shall retain an independent executive recruiting firm or  
4 firms to assist the advisory committee in its work.

5 (e) Foundation and new corporation independent.-- The  
6 Foundation and its directors, officers, and employees shall be  
7 and remain independent of the new corporation and its affiliates.  
8 No director, officer, or employee of the Foundation shall serve  
9 as a director, officer, or employee of the new corporation or any  
10 of its affiliates. No director, officer or employee of the new  
11 corporation or any of its affiliates shall serve as a director,  
12 officer, or employee of the Foundation. This subsection shall no  
13 longer apply after (i) ten years following the effective date of  
14 the conversion or (ii) the divestment by the Foundation of at  
15 least ninety-five percent (95%) of the stock of the new  
16 corporation received pursuant to G.S. 58-65-132(a)(7)a. and  
17 subsection (a) of this section, whichever occurs later.

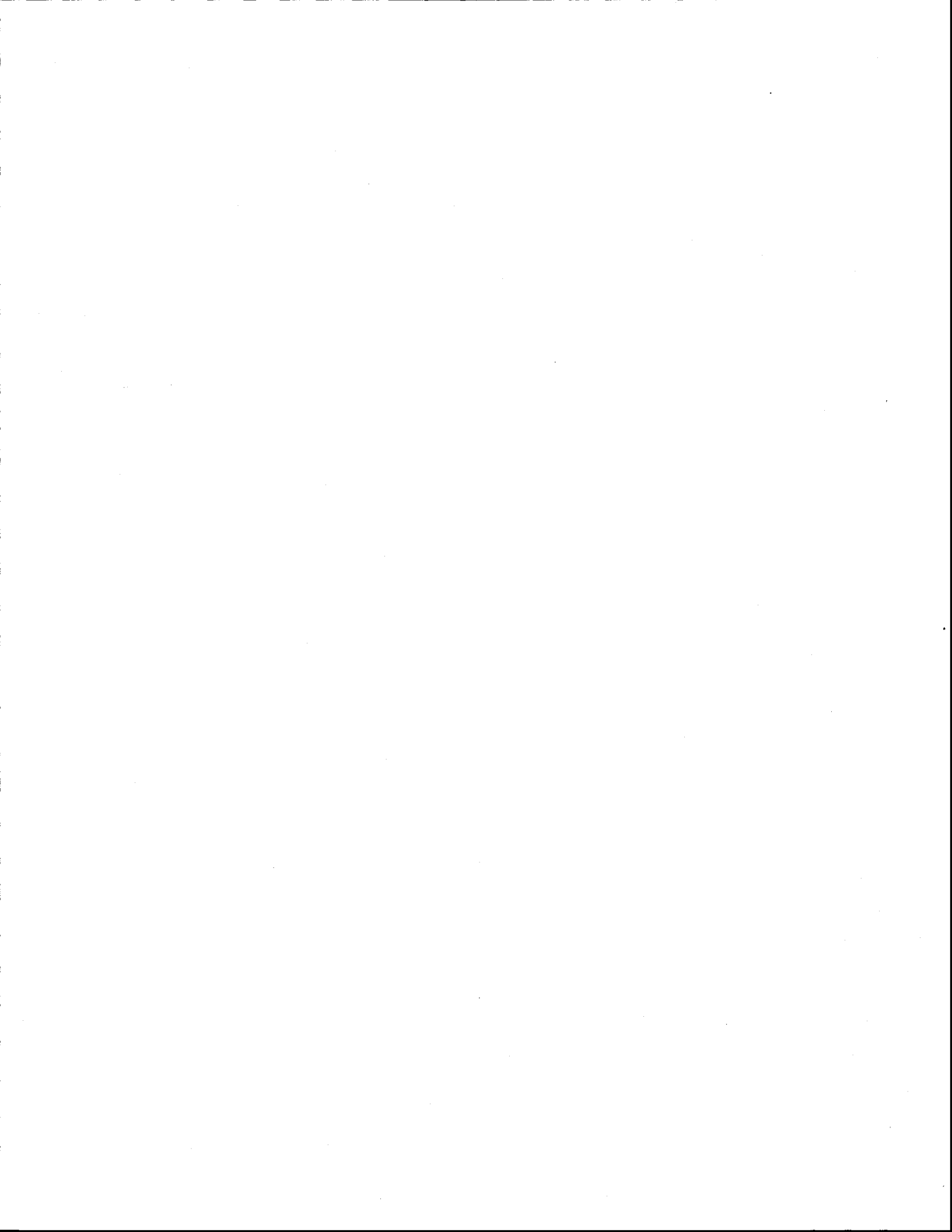
18 (f) Voting and stock registration agreement.-- The Foundation  
19 and the new corporation shall operate under a voting agreement  
20 and a stock registration agreement, approved by the Commissioner  
21 and the Attorney General, that provides at a minimum for the  
22 following:

- 23 (1) The Foundation will vote the common stock in the  
24 new corporation for directors of the new  
25 corporation nominated by the board of directors of  
26 the new corporation to the extent provided by the  
27 terms of the voting agreement.
- 28 (2) The voting restrictions will not apply to common  
29 stock of the new corporation sold by the  
30 Foundation.
- 31 (3) The board of directors of the new corporation will  
32 determine the timing of any initial public offering  
33 of the new corporation's common stock, either by  
34 the new corporation or by the Foundation, and the  
35 Foundation shall have demand registration rights  
36 and optional "piggy-back" or "incidental"  
37 registration rights in connection with any  
38 offerings of the new corporation's common stock by  
39 the new corporation, on the terms and conditions  
40 set forth in a stock registration agreement and  
41 agreed upon by the new corporation and the  
42 Foundation and approved by the Commissioner and the  
43 Attorney General.

- 1           (4) The voting agreement may contain additional terms,  
2           including (i) voting and ownership restrictions  
3           with regard to the common stock of the new  
4           corporation and (ii) provisions for the voting or  
5           registration for sale of any common stock to be  
6           issued to the Foundation by the new corporation.
- 7           (g) Costs.-- The corporation shall pay the reasonable expenses  
8           of the advisory committee and executive search firm and the costs  
9           of any consultants, experts, or other professional advisors  
10           retained by the Attorney General incident to review under this  
11           section.
- 12           (h) Attorney General's approval.-- Before the Commissioner  
13           approves a plan of conversion pursuant to G.S. 58-65-132, the  
14           Attorney General, on behalf of the public and charitable  
15           interests in this State, must approve the determination relating  
16           to the fair market value of the corporation under G.S. 58-65-  
17           132(a)(7), the articles of incorporation and bylaws of the  
18           foundation, and all proposed agreements between the new  
19           corporation and the Foundation, including stock voting or  
20           registration agreements. The Attorney General may seek advice on  
21           these matters from consultants, investment bankers, and other  
22           professional advisors engaged by the Commissioner or Attorney  
23           General incident to review of the plan. The proposed articles of  
24           incorporation of the Foundation shall provide for all of the  
25           following:
- 26           (1) State that the Foundation is organized and operated  
27           exclusively for charitable purposes and for the  
28           promotion of social welfare.
- 29           (2) State that no part of the net earnings of the  
30           Foundation shall inure to the benefit of any  
31           private shareholder or individual.
- 32           (3) State that the Foundation shall not engage in any  
33           political campaign activity or the making of  
34           political contributions.
- 35           (4) Prohibit the Foundation from paying or incurring  
36           any amount that, if paid by an organization  
37           classified as a 'private foundation' under Section  
38           509(a) of the Code, would constitute a 'taxable  
39           expenditure' as defined by Sections 4945(d)(1) and  
40           (2) of the Code.
- 41           (5) Prohibit the Foundation from engaging in any self-  
42           dealing for the benefit of its directors, officers,  
43           or employees.



- 1           (6) Provide for an ongoing community advisory committee  
2           to offer broad public input to the Foundation  
3           concerning its operations and activities.
- 4           (7) Provide that the Foundation, after its first three  
5           years of operation, will payout the lesser of (i)  
6           "qualifying distributions" of "distributable  
7           amounts," as defined in section 4942 of the Code,  
8           as if the Foundation were classified as a private  
9           Foundation subject to the distribution  
10           requirements, but not the taxes imposed, under that  
11           section or (ii) substantially all of its income,  
12           less qualifying expenses. In no event shall the  
13           Foundation be required to invade its corpus to meet  
14           the distribution requirements under this  
15           subdivision.
- 16           (8) State that provisions in the articles of  
17           incorporation that are either required by this  
18           subdivision or designated by the Attorney General  
19           cannot be amended without the prior written  
20           approval of the Attorney General.
- 21           Within 120 days of the end of its fiscal year, the Foundation  
22           shall provide the Attorney General, the Commissioner, the Speaker  
23           of the House of Representatives and the President Pro Tempore of  
24           the Senate its state and federal tax returns for the preceding  
25           fiscal year. The tax returns shall be made available for public  
26           inspection."
- 27           Section 3. G.S. §58-65-160 is repealed.
- 28           Section 4. This act is effective when it becomes law.
- 29
- 30
- 31
- 32 -----
- 33
- 34
- 35



## **EXPLANATION OF THE RECOMMENDED LEGISLATION**

The proposed bill spells out in detail the proposed conversion procedure and defines the converting service corporation's obligation to the public. The bill applies not only to Blue Cross but also to Delta Dental and any other medical, hospital, or dental service corporation that might come into existence. However, for purposes of simplicity, the remainder of this explanation refers to "Blue Cross."

**Amending the charter:** Current law requires 2/3 of Blue Cross certificateholders to approve a conversion. The bill would eliminate this requirement, making it consistent with the Study Commission's position that the certificateholders do not own the company. However, the Commissioner, in his evaluation of the plan, must still determine that the contractual rights of the certificateholders to have their claims paid will not be impaired by the conversion. In addition, the Commissioner can also examine the impact of the proposed conversion on health care accessibility and affordability.

In addition, the bill changes the current law with respect to the vote required by the board of directors for conversion. The board would only need a majority vote (rather than a 2/3 vote) to move forward on a conversion.

**No mutualization:** Current law allows Blue Cross to convert to either a stock company or a mutual. The bill would eliminate the ability of Blue Cross to become a mutual because of concerns about the impact of mutualization on the public's ownership rights and the valuation of those rights at the time of an eventual conversion to a stock company.

**What constitutes a conversion:** To determine whether Blue Cross has converted, the following tests apply. Blue Cross is considered to have converted if any of the following occur:

- It merges with a for-profit company
- It sells or transfers any stock to an outside investor (i.e., the for-profit subsidiaries of Blue Cross must be wholly-owned by Blue Cross to avoid conversion).
- It sells or transfers 10% or more of its assets in one transaction or a series of related transactions to a for-profit business. However, the following do not count in determining this 10% limit:
  - The purchase of health insurance policies from a for-profit company, to the extent those policies insure North Carolina residents. The value of any policies insuring non-North Carolinians is counted in determining the 10% (if approved by the Commissioner).
  - The purchase of the common stock of a for-profit company to the extent that the stock value reflects health insurance policies covering North Carolina residents (if approved by the Commissioner).
  - The granting of security interests for money borrowed
  - The transfer in the ordinary course of business real estate, stocks, and other securities within the investment portfolio
- Its annual revenues from for-profit activities exceed 40% of total revenues
- Its assets used in for-profit activities exceed 40% of total assets

In addition, the Commissioner can review and consolidate transactions of Blue Cross in determining whether a conversion has occurred. If the Commissioner, after consolidating transactions of Blue Cross, does determine that a transaction has occurred, Blue Cross has 12 months in which to file a plan of conversion with the Commissioner. This 12-month period is suspended while any appeal of the Commissioner's order is pending. The bill provides for an expedited appeals process. The appeal of the Commissioner's order will bypass the superior court and go directly to the Court of Appeals. Any party can petition the Supreme Court to hear the appeal without it being first heard by the Court of Appeals.

**Filing the Conversion Plan:** If Blue Cross decides to convert to a for-profit company, it must seek the approval of the Commissioner of Insurance. In seeking the Commissioner's approval, Blue Cross is required to file a "plan of conversion" with the Commissioner of Insurance and submit a copy of the plan to the Attorney General at least 120 days before the proposed conversion would take effect. The plan of conversion must show the following:

- The purposes of the conversion
- The articles of incorporation of the new for-profit Blue Cross that will be formed
- The bylaws of the new Blue Cross
- How the mode of operations will change, if it all
- How existing policyholders' claims and rights to reimbursement will be safeguarded in the conversion
- A statement recognizing that the new Blue Cross is subject to all of the rights, liabilities, obligations, etc. of the old Blue Cross
- Proof that the board of directors of Blue Cross has approved the conversion
- A business plan for the new Blue Cross, including a comparison of recent premium charges by the old Blue Cross and projected premium charges by the new Blue Cross
- Any conditions that Blue Cross must fulfill by the proposed effective date of the conversion in order for the conversion to take effect
- The proposed articles of incorporation and bylaws of the charitable foundation that will be created to receive the fair market value of the converted Blue Cross

**Reviewing the Plan of Conversion:** The Commissioner will review the plan. In addition, the public may present written comments to the Commissioner during the comment period. There will also be three public hearings to solicit additional

input from the public. With the exception of the business plan required to be filed by Blue Cross, the remaining parts of the proposed conversion plan are public records. The Attorney General will review the portions of the plan relating to the charitable foundation.

**Commissioner's approval of the plan:** The Commissioner will approve the plan if all of the following conditions are met:

- The conversion plan meets the requirements of the bill
- The new Blue Cross will meet the applicable capital and surplus requirements for a health insurance company and all other standards and conditions that apply to health insurance companies
- The plan of conversion adequately protects the claims and reimbursement rights of existing policyholders.
- No director, officer, or employee of Blue Cross will receive a fee or other valuable consideration (other than ordinary compensation) for assisting in the conversion nor will they receive any stock or other assets in the new corporation as part of the conversion.
- Blue Cross has complied with all material requirements of the Insurance Code (Chapter 58), and there are no pending disciplinary actions against it.
- The plan of conversion is fair with respect to the contract rights of both the existing and prospective policyholders
- The plan of conversion is in the "**public interest**".
- The plan contains a voting and registration agreement
- The Attorney General approves of the finding that 100% of the fair market value will be transferred, the foundation's articles of incorporation and bylaws, and the voting and registration agreements the foundation and Blue Cross would propose to enter into

**When is the Plan in the public interest?:** To protect the public interest, the conversion plan must provide that 100% of the fair market value of Blue Cross will be transferred to a 501(c)(4) foundation. The bill provides that it will be conclusively presumed that 100% of the fair market value is transferred if all of the Blue Cross stock issued at the time of conversion goes to the foundation. In evaluating whether the plan is in the public interest, the Commissioner may also look at the effect of the proposed conversion on the accessibility and affordability of health care.

**Creation of the foundation:** The foundation will be created to receive the fair market value of Blue Cross upon conversion. The purpose of the foundation will be to "promote the health of the people of North Carolina." The foundation's articles of incorporation, by-laws, and any agreements between the foundation and the new Blue Cross are also subject to the approval of the Attorney General. The foundation is prohibited, for a period of ten years after the conversion, from setting up an insurance company or similar entity that would compete against the new for-profit Blue Cross. The foundation cannot engage in political activity. It would also have its own advisory committee (not the same as the advisory committee that may be involved in nominating the initial board of directors) to offer public input on its activities. The foundation would be required to pay out substantially all of its income, less operating expenses, or 5% of its net assets, whichever is less, in furtherance of its charitable mission. In no event is the foundation required to invade the corpus of the trust.

**Governance of the foundation:** The foundation will be governed by a board of directors, completely independent of any control by the new for-profit Blue Cross. The initial board of directors will consist of 11 members. These 11 members will be appointed by the Attorney General from a list of 22 nominees selected by an independent advisory committee. The advisory committee would be comprised of the following:

- 3 business representatives selected by NCCBI
- 3 public and private medical school representatives selected by the UNC Board of Governors
- 3 foundation or nonprofit representatives selected by the NC Center for Nonprofits
- 1 representative of the Hospital Association
- 1 representative of the Medical Society

Together, these 11 individuals will determine what kind of qualifications the initial members of the board of directors of the foundation should have and will nominate 22 persons for those 11 positions. There is no intent that each representative will nominate someone from his or her industry. Instead, the committee will act as a group in selecting nominees. With the approval of the Attorney General, the committee will establish the qualifications for the nominees. All nominees must be North Carolinians. A search firm will assist the committee in selecting qualified nominees.

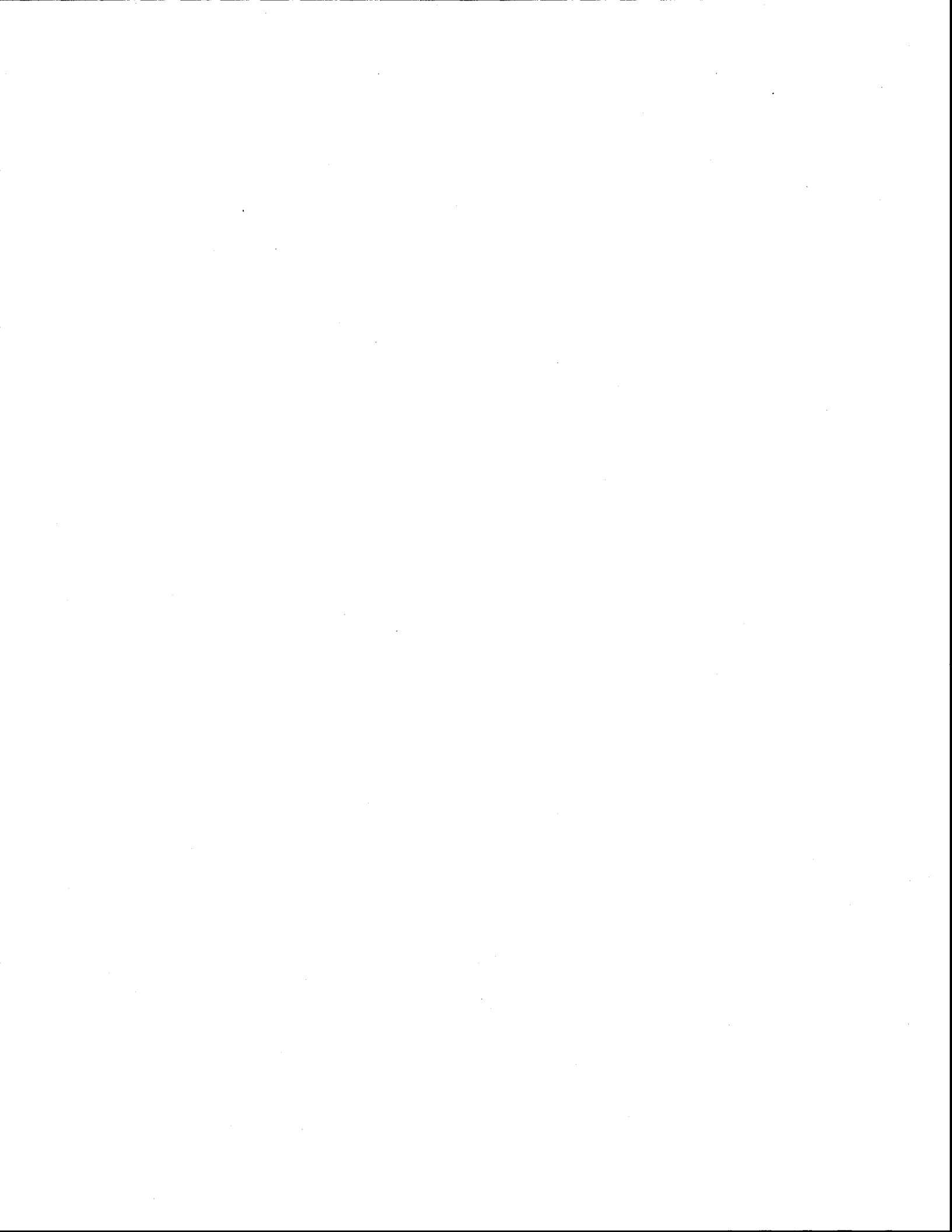
The initial terms will be staggered so that some serve 2-year terms and some serve 4-year terms. Afterwards, all terms are for 4 years. A member can serve two full consecutive terms or 10 consecutive years. Thereafter, the board becomes self-perpetuating, with its members serving 4-year terms and chosen in accordance with the foundation's by-laws. The foundation can increase in size to 15 members or decrease in size to 9 members, although no member would be thrown out in the middle of a term solely because of a decision to reduce the board's size. The foundation must file its tax returns with the Attorney General, Commissioner of Insurance, the Speaker of the House, and the President Pro Tempore of the Senate.

**Relationship between foundation and the new Blue Cross:** The foundation will initially own 100% of the stock of the new Blue Cross. The foundation and the new Blue Cross will enter into a voting agreement that ensures that the foundation will vote its stock in favor of the directors nominated by the new Blue Cross. The new Blue Cross will have some control over the timing of the



additional shares to the public. Until 10 years have elapsed from the conversion and the foundation has divested itself of 95% of the Blue Cross stock it received, no foundation members can serve on the Blue Cross board and no Blue Cross board members can serve on the foundation board.

**Challenges to a conversion plan:** The Attorney General retains full power to take any legal action necessary to enforce the rights of the public in the event of a conversion or proposed conversion. Any person aggrieved by an order of the Commissioner approving or disapproving a conversion has 30 days after the issuance of the order to appeal to the Superior Court of Wake County for judicial review of the order.



## APPENDICES

### Memorandum from Linwood Jones

- \* Tax Information on Blue Cross Blue Shield
- \* Blue Cross Balance Sheet and Reserves
- \* Comments by Linwood Jones at January 5, 1998 meeting
- \* Comments by Peter Kolbe at January 5, 1998 meeting
- \* House Floor Amendments to Senate Bill 993
- \* Legal Opinion of Peter Kolbe re Blue Cross conversion
- \* Legal Opinion of Attorney General re Blue Cross conversion

Comments of Rhone Sasser, Chairman of Board of Trustees of BCBSNC (2/3/98)

Comments of Ken Otis, President and CEO of BCBSNC (2/3/98)

Comments of Martin Eakes, Co-chair of Coalition for the Public Trust (2/3/98)

Comments of Judith Bell, Director of West Coast Regional Office  
of Consumers Union (3/3/98)

Comments of Richard Daugherty, Chairman of Board of Trustees of  
Rex HealthCare (3/3/98)

Comments of E. Ray Cope, Executive Director, Kate B. Reynolds  
Charitable Trust (3/3/98)

Comments of Gary Mendoza, Former Commissioner of California  
Department of Corporations (3/3/98)

Comments of Robin L. Hinson, Senior Partner,  
Robinson, Bradshaw and Hinson, P.A. (3/3/98)

### Public Hearing Testimony

Richard Hatch (AARP)

Adam Searing (Health Access Coalition)

Abdul Sm Rasheed (NC Community Development Initiative)

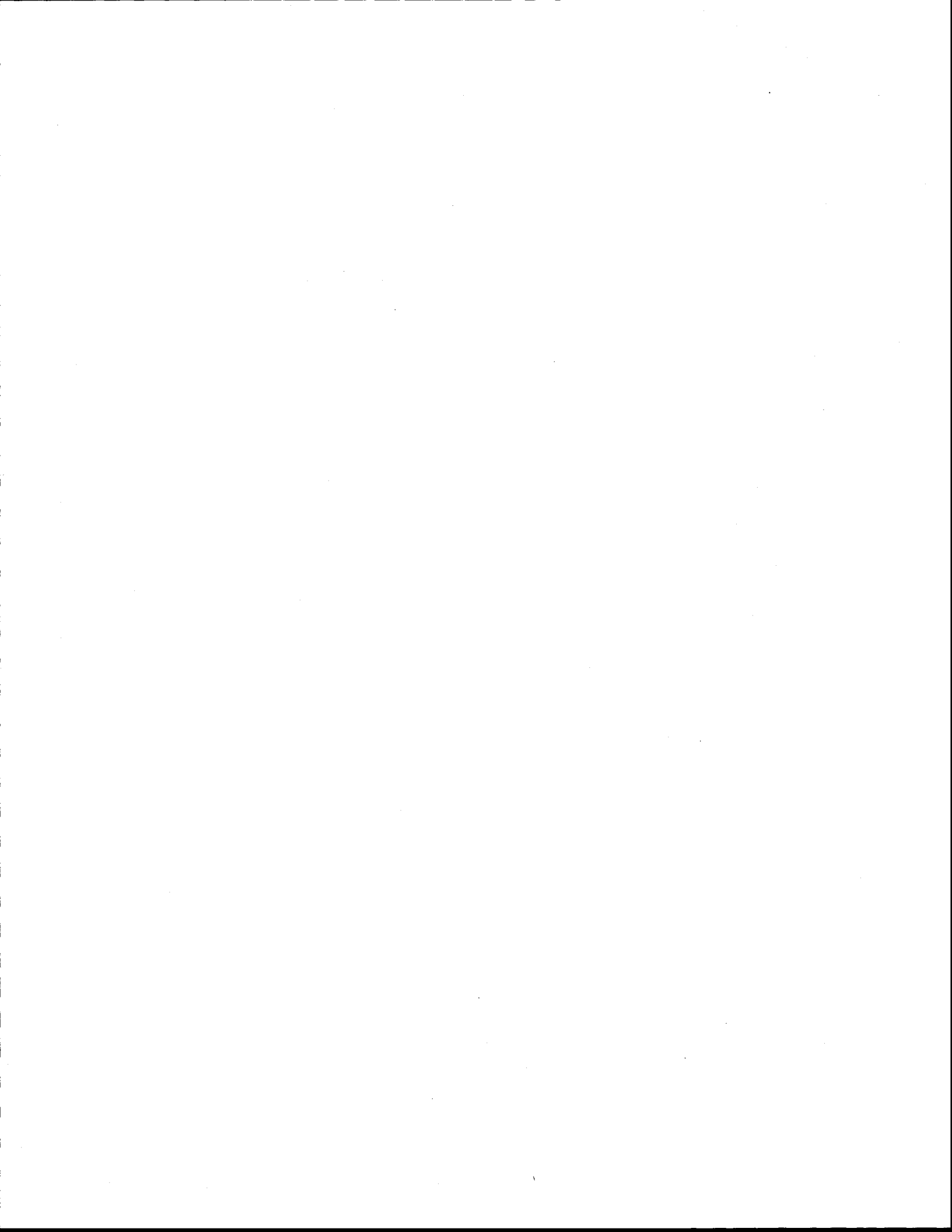
Jane Kendall (NC Center for Nonprofits)

Watts Hill, Jr.

Comments of Mr. Rhone Sasser, Chairman of Board of Trustees of BCBSNC (5/1/98)

Comments of Mr. Ken Otis, President and CEO of BCBSNS (5/1/98)

Comments of Mr. Adam Searing, NC Health Access Coalition (5/1/98)





**North Carolina General Assembly  
Legislative Services Office**

George R. Hall, Legislative Services Officer  
(919) 733-7044

Elaine W. Robinson, Director  
Administrative Division  
Room 5, Legislative Building  
16 W. Jones Street  
Raleigh, NC 27603-5925  
(919) 733-7500

Gerry F. Cohen, Director  
Bill Drafting Division  
Suite 401, LOB  
300 N. Salisbury St.  
Raleigh, NC 27603-5925  
(919) 733-6660

Thomas L. Covington, Director  
Fiscal Research Division  
Suite 619, LOB  
300 N. Salisbury St.  
Raleigh, NC 27603-5925  
(919) 733-4910


Donald W. Fulford, Director  
Information Systems Division  
Suite 400, LOB  
300 N. Salisbury St.  
Raleigh, NC 27603-5925  
(919) 733-6834

Terrence D. Sullivan, Director  
Research Division  
Suite 545, LOB  
300 N. Salisbury St.  
Raleigh, NC 27603-5925  
(919) 733-2578

**January 24, 1998**

**MEMORANDUM**

**TO:** Members of the "Blue Cross Blue Shield" Study Commission  
and Other Interested Parties

**FROM:** Linwood Jones, Commission Counsel 

**RE:** Material and Information Requested on Blue Cross

This packet contains information and material that was requested at the January meeting of the Blue Cross Blue Shield Study Commission. This memo outlines the material. There are several attachments.

**A. Tax Information:**

Information was requested on the value of the tax exemptions and tax preferences received by Blue Cross on local property taxes, state premium taxes, and federal taxes.

**Local property taxes:** Blue Cross was exempt from local property taxes prior to 1974. However, we have been unable to determine the value of those exemptions. In addition, Blue Cross may have voluntarily made payments in lieu of taxes during some of the years prior to 1974 in recognition of basic municipal services, such as water and sewer, that it received from local governments.

**Federal income taxes:** Blue Cross was exempt from federal income taxes until 1987. The Department of Insurance is currently trying to determine the value of those exemptions.

**State premium taxes:** Blue Cross is and has been taxed at a substantially lower rate on its premium taxes than commercial insurance companies. The current value of

the amount saved by Blue Cross since 1941 as a result of this tax preference on State premium taxes is estimated at approximately \$380 to \$420 million. This is based on premium tax payment information provided by Blue Cross and present-value calculations performed by the legislature's chief economist. I am still reviewing information from the Department of Insurance that indicates that the savings may be as much as 5 to 7% higher. See Attachment A.

**Sales Tax Refunds:** I am in the process of trying to obtain information on sales tax refunds, if any, claimed by Blue Cross. I would expect the amount of these refunds, if any, to be small compared to the State premium tax savings.

**\*\*Caution/Use of Tax Information:** The amount saved by Blue Cross as a result of preferential tax policies is important and has been one of the more widely-requested pieces of information on the conversion issue. It is certainly a big factor in evaluating whether Blue Cross is indebted to the public if it converts. However, any approach that would have Blue Cross turn over this amount in cash to a charitable foundation upon conversion could create problems for the for-profit Blue Cross company that would emerge from the conversion. As pointed out in Mr. Kolbe's remarks concerning Blue Cross' balance sheet, the for-profit company must have sufficient reserves to pay claims and capital for growth. This approach raises an additional issue that would also need to be examined: to what extent did the tax savings result in lower premiums for Blue Cross' policyholders?

## **B. Blue Cross Balance Sheet and Reserves**

The balance sheet for Blue Cross as of September 30, 1997, is attached. (See Attachment B). As of that date, Blue Cross had assets of almost \$900 million. Also attached is a letter from Peter Kolbe explaining the balance sheet. Mr. Kolbe cautions against using the balance sheet to arrive at an amount of actual dollars that could be taken from Blue Cross' surplus and given to a charitable trust. Most of those assets would be needed for claims payments and growth in the event the company converted to a for-profit company. Mr. Kolbe notes that other methods, such as the issuance of stock by Blue Cross to a nonprofit foundation, may be one approach to consider in ensuring that a for-profit Blue Cross retains adequate capital and reserves. This approach may be further explored at the February and/or March meetings of the Commission.

## **C. Comments by January Speakers**

The written comments of Mr. Kolbe and myself at the January meeting are attached. I expect to have Mr. Hirsch's comments soon. (See Attachment C.)

## D. House Floor Amendments

The amendments offered to Senate Bill 99<sup>3</sup> on the House floor during the 1997 session were requested. Here is what those amendments would have done, who offered them, and how they fared on the House floor vote. See Attachment D for the text of the amendments:

*Amendment 1 (Hackney):* This amendment added language requiring that a plan of conversion must be "in the public interest" and also made clear that the presumption that arises in favor of a conversion plan when it meets all of the criteria in the bill does not apply to "any legal action" brought by the Attorney General. In essence, if the Attorney General filed suit to establish the public's right to assets of Blue Cross, he would not be faced with overcoming the presumption that the plan is fair. The amendment passed.

*Amendment 2 (Howard):* This amendment would have required the Commission of Insurance to take the portion of Blue Cross' surplus that belongs to the public, if any, and place it in either a high-risk pool (if in existence at the time) for the uninsured or otherwise in a nonprofit health care foundation. (North Carolina does not have a high-risk pool). The amendment failed.

*Amendment 3 (Baddour):* This amendment added additional language about a plan of conversion protecting the public's interest and provided that if Blue Cross first converted to a mutual, then to a stock company, the anti-inurement restrictions would apply to both the first conversion (the mutualization) and the second conversion (the demutualization). The amendment passed.

*Amendment 4 (Hurley):* This amendment made clear that any type of significant corporate restructuring that "looks" like a conversion will in fact be treated as a conversion. For example, a transfer by Blue Cross of 70% of its stock into a for-profit subsidiary would most likely be considered a conversion under this amendment. The amendment also required the Commissioner of Insurance to determine, if Blue Cross proposes to convert, what portion of its surplus belongs to the public and to place this amount in a new or existing nonprofit charitable foundation for the improvement of health care of all North Carolinians. During the House floor debate, some members became concerned about giving the Commissioner of Insurance this much discretionary authority over the disposition of this surplus. A perfecting amendment, Amendment #5 (Hackney), removed this particular language about the Commissioner disposing of the surplus. This amendment, as perfected by Amendment #5, passed.

*Amendment #5 (Hackney):* See the discussion on Amendment #4. This amendment passed.

*Amendment #6 (Gamble):* This amendment extended the effect of Rep. Baddour's amendment (Amendment #3) with respect to the two-step conversion process (Blue Cross first becomes a mutual, then becomes a stock company). Rep. Baddour's

amendment provided that the anti-inurement restrictions (restrictions against officers and directors of Blue Cross enriching themselves as a result of a conversion) applied to the eventual conversion to a stock company. Rep. Gamble's amendment would have made the entire bill applicable to the eventual conversion to a stock company. This amendment failed.

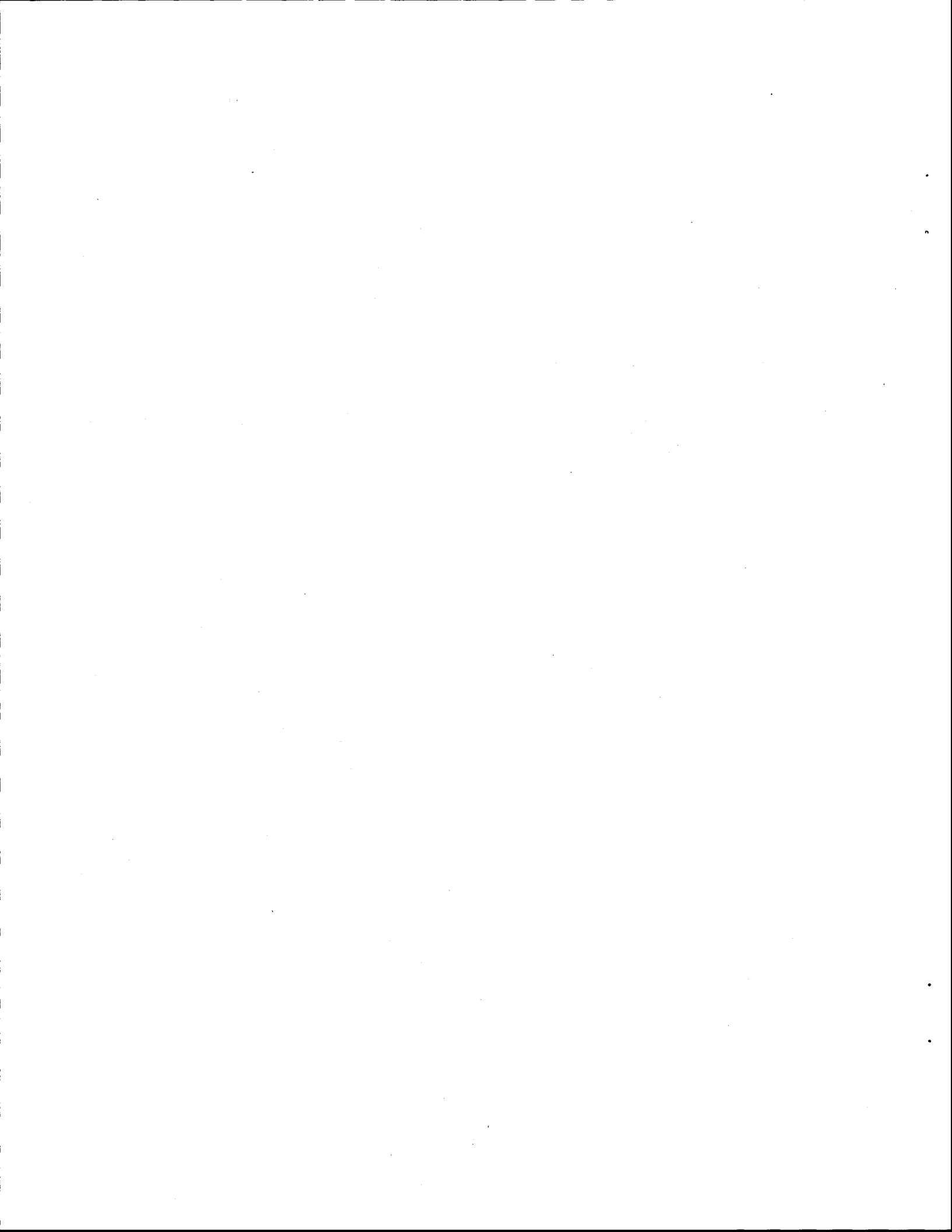
All of the successful amendments are incorporated into the 5th edition of Senate Bill 993.

## **E. Legal Opinions**

Previous legal opinions issued by the Attorney General's office and the Department of Insurance on the charitable trust obligations of Blue Cross are attached. Both opinions were written during the debate on Senate Bill 993 in the 1997 session. See Attachment E.



## **A. Tax Information**



Year	Premium Tax Paid Since 1941*	Commercial Rate	Difference	Property Tax Paid 1974 - 1996	Federal Income Tax Paid 1987 - 1996
1941	2,535.86	7,684.43	5,148.57		
1942	2,961.07	8,972.95	6,011.88		
1943	3,240.80	9,820.60	6,579.80		
1944	6,061.31	18,367.62	12,306.31		
1945	7,580.22	22,970.35	15,390.13		
1946	10,178.99	30,845.43	20,666.44		
1947	13,920.29	42,182.69	28,262.40		
1948	16,935.07	51,318.38	34,383.31		
1949	20,586.10	62,382.11	41,796.01		
1950	25,122.94	76,130.11	51,007.17		
1951	28,317.47	85,810.50	57,493.03		
1952	33,336.70	101,020.30	67,683.60		
1953	41,250.34	125,001.04	83,750.70		
1954	45,631.03	138,275.84	92,644.81		
1955	50,199.03	152,118.27	101,919.24		
1956	55,248.64	167,420.13	112,171.49		
1957	61,456.58	186,232.07	124,775.49		
1958	67,920.46	205,819.57	137,899.11		

\*BCBSNC premium tax paid amounts for years 1941 - 1967 are estimated based on premiums written multiplied by the applicable tax rate of 1/3 of 1%. The amounts for the years 1941 - 1967 are estimated due to the unavailability of statutory financial statements for such years.

Year	Premium Tax Paid Since 1941*	Commercial Rate	Difference	Property Tax Paid 1974 - 1996	Federal Income Tax Paid 1987 - 1996
1959	77,275.91	234,169.41	156,893.50		
1960	86,580.17	262,364.14	175,783.97		
1961	99,605.44	301,834.67	202,229.23		
1962	112,674.73	341,438.58	228,763.85		
1963	126,278.79	382,662.99	256,384.20		
1964	147,121.12	445,821.57	298,700.45		
1965	167,821.39	508,549.66	340,728.27		
1966	180,572.55	547,189.56	366,617.01		
1967	205,026.78	621,293.28	416,266.50		
1968	237,432.58	713,010.76	475,578.18		
1969	271,933.46	816,616.99	544,683.53		
1970	338,833.92	1,017,519.28	678,685.36		
1971	421,547.21	1,265,907.55	844,360.34		
1972	539,359.56	1,619,698.38	1,080,338.82		
1973	579,703.77	1,740,852.16	1,161,148.39		
1974	670,392.55	2,013,190.85	1,342,798.30		
1975	808,923.56	2,429,199.88	1,620,276.32	222,328.17	
1976	986,201.30	2,961,565.47	1,975,364.17	260,400.03	

\*BCBSNC premium tax paid amounts for years 1941 - 1967 are estimated based on premiums written multiplied by the applicable tax rate of 1/3 of 1%. The amounts for the years 1941 - 1967 are estimated due to the unavailability of statutory financial statements for such years.

Year	Premium Tax Paid Since 1941*	Commercial Rate	Difference	Property Tax Paid 1974 - 1996	Federal Income Tax Paid 1987 - 1996
1977	1,142,386.41	3,430,529.76	2,288,143.35	262,633.37	
1978	1,290,836.40	3,876,385.60	2,585,549.20	255,929.36	
1979	1,540,761.69	4,626,911.97	3,086,150.28	256,946.46	
1980	1,743,536.52	5,235,845.40	3,492,308.88	392,110.64	
1981	1,969,523.57	5,914,485.19	3,944,961.62	283,694.76	
1982	2,014,189.84	6,048,618.14	4,034,428.30	318,623.68	
1983	1,730,668.29	5,197,202.08	3,466,533.79	289,333.07	
1984	1,788,052.15	5,369,525.97	3,581,473.82	313,808.01	
1985	1,994,963.00	3,989,926.00	1,994,963.00	303,189.53	
1986	2,078,196.00	4,156,392.00	2,078,196.00	335,595.06	
1987	2,342,689.00	4,685,378.00	2,342,689.00	448,994.02	
1988	3,486,215.00 <sup>1</sup>	6,972,430.00	3,486,215.00	535,807.32	
1989	4,307,788.00	8,615,576.00	4,307,788.00	524,973.72	306,748.00
1990	4,441,301.00	8,882,602.00	4,441,301.00	671,684.39	1,436,801.00

\*BCBSNC premium tax paid amounts for years 1941 - 1967 are estimated based on premiums written multiplied by the applicable tax rate of 1/3 of 1%. The amounts for the years 1941 - 1967 are estimated due to the unavailability of statutory financial statements for such years.

<sup>1</sup> BCBSNC Rate for 1/88 - 6/88 is 1/3 of 1%, and the BCBSNC Rate for 7/88 - 12/88 and for subsequent years is 1/2 of 1%.

Year	Premium Tax Paid Since 1941*	Commercial Rate	Difference	Property Tax Paid 1974 - 1996	Federal Income Tax Paid 1987 - 1996
1991	4,168,542.00	14,589,897.00 <sup>2</sup>	10,421,355.00	686,493.88	1,409,096.00
1992	4,321,655.00	16,206,206.00 <sup>3</sup>	11,884,551.00	692,187.40	10,951,228.00
1993	4,520,479.00	17,177,820.00 <sup>4</sup>	12,657,341.00	809,645.56	22,885,528.00
1994	4,451,948.00	16,917,402.00	12,465,454.00	874,114.94	10,571,757.00
1995	4,291,103.00	16,306,191.00	12,015,088.00	966,928.40	10,871,682.00
1996	4,822,960.00	18,334,382.00	13,511,422.00	1,198,636.91	2,500,439.00
<b>TOTALS</b>	<b>\$64,997,561.56</b>	<b>\$196,248,963.68</b>	<b>\$131,251,402.12</b>	<b>\$10,904,058.68</b>	<b>\$60,933,279.00</b>

---

<sup>2</sup> Commercial Rate changed from 1% to 1.75%.

<sup>3</sup> Commercial Rate changed from 1.75% to 1.88%.

<sup>4</sup> Commercial Rate changed from 1.88% to 1.90%

**Linwood Jones (Research)**

---

**From:** David Crotts (Fiscal Research)  
**Sent:** Monday, January 19, 1998 9:10 PM  
**To:** Linwood Jones (Research)  
**Subject:** Blue Cross/Blue Shield

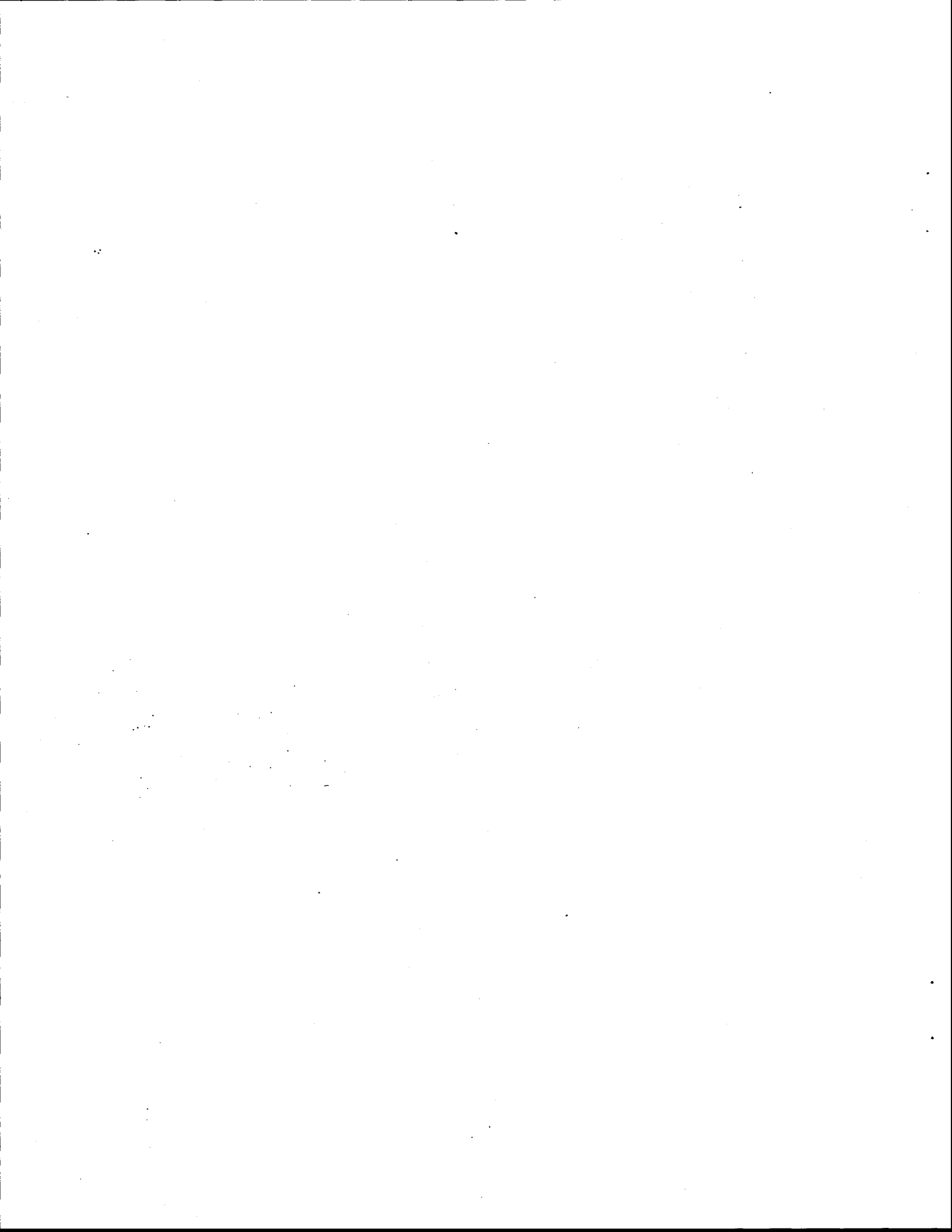
Linwood:

In my earlier analysis the net present value of the BC/BS premium tax savings for the 1968-96 period was \$336.0 million using the State Treasurer's Short-Term Investment Returns for the period (except that the 3-month treasury bill rate was used prior to the mid-80's due to lack of Treasurer data) and \$376 million using Long-Term Investment Returns.

I did the same analysis for the 1941-67 period using the data you had furnished. I had the use the 3-month treasury bill rate as the investment return option. The analysis added \$43.3 million to the present value data.

The reason that the increment is small is that interest rates were much lower during the 1941-67 period (below 1% in many years) and the fact that the tax revenue base from which the tax savings were calculated was very small.

Please call if I can be of further assistance.





June 3, 1997

**MEMORANDUM**

**TO: INTERESTED PARTIES**

**FROM: DAVE CROTTS**  
**SENIOR FISCAL ANALYST**  
**FISCAL RESEARCH DIVISION**  
**N.C. GENERAL ASSEMBLY**

**SUBJECT: BLUE CROSS/BLUE SHIELD TAX CALCULATION**

You had asked for the results of an analysis that estimates the current dollar value of the savings that have accrued to Blue Cross/Blue Shield ("BCBS") since 1968 due to the preferential insurance premiums tax rate assessed BCBS relative to commercial health insurers. The calculation was made from the point of view of what the value would have been if the State had invested the funds.

My analysis used the investment return earned by the State Treasurer to adjust each year's tax savings to 1997. The analysis indicates that the 1997 value of the tax savings ranges between \$336.0 million and \$376.0 million. The lower figure is based on the Treasurer's short-term rate of return on the investment of the State's cash balance (annual average return is 8.0%). The higher number is based on the long-term investment return of the Treasurer on state and local pension funds (annual average of 8.3%). The estimates are conservative due to the fact that the State's investment return is calculated on a July 1-June 30 fiscal year basis. To match the data with BCBS calendar year premiums, I applied the investment return for the fiscal year beginning after the end of the calendar year for which the BCBS premiums tax is calculated. This means that the calculation leaves out one year of investment returns.

Actual rate of return data was available from the annual report of the State Treasurer for the 1976-77 fiscal year through April 30, 1997. For the prior years I used the annual average return on 3-month treasury bills to calculate both the short-term and long-term investment yields.

The tax rates, computed as a percent of premiums, are shown below:

<u>Tax Year</u>	<u>Commercial Insurer Tax Rate*</u>	<u>BCBS Tax Rate</u>
1968-85	1.000%	.33%
1986-87	1.750%	.33%
1988-90	1.750%	.50%
1991	1.875%	.50%
1992	1.900%	.50%

\* In addition, commercial insurers began paying a regulatory surcharge in 1991 to reimburse the State General Fund for the State's regulatory expenses. The 1991 rate of 6.5% was increased to 7.25% for 1992 and future years. The surcharge was included in the calculation.



DEPARTMENT OF INSURANCE  
State of North Carolina

P. O. Box 26387  
RALEIGH, N. C. 27611-6387

JIM LONG  
COMMISSIONER OF INSURANCE

GENERAL COUNSEL  
(919) 715-0011

MEMORANDUM

TO: Linwood Jones, Esquire  
Counsel to the NCBCBS Study Commission

FROM: Peter A. Kolbe *PAK*  
General Counsel

DATE: January 21, 1998

RE: Premium Tax Figures

Attached please find our calculations of the premium tax savings that BCBS has enjoyed since 1968. These figures are not in present day dollars, but I am sure that your financial experts at the legislature can easily translate them in the same. You will note that the tax savings from the premium tax alone was some \$144,000,000.

As mentioned yesterday, we are having difficulty making similar calculations for the federal tax, and the good folks at the Revenue Department probably will not have this done prior to the time by which you need to mail the packet of information to the members of the study commission. However, I should have further word on this by this afternoon, and I will report to you then. Please call me should you have any questions or comments.

**Attachments**

cc: chron file  
BCBS file  
Dash Propes (with attachment)  
Wake Hamrick

BLUE CROSS AND BLUE SHIELD OF NORTH CAROLINA

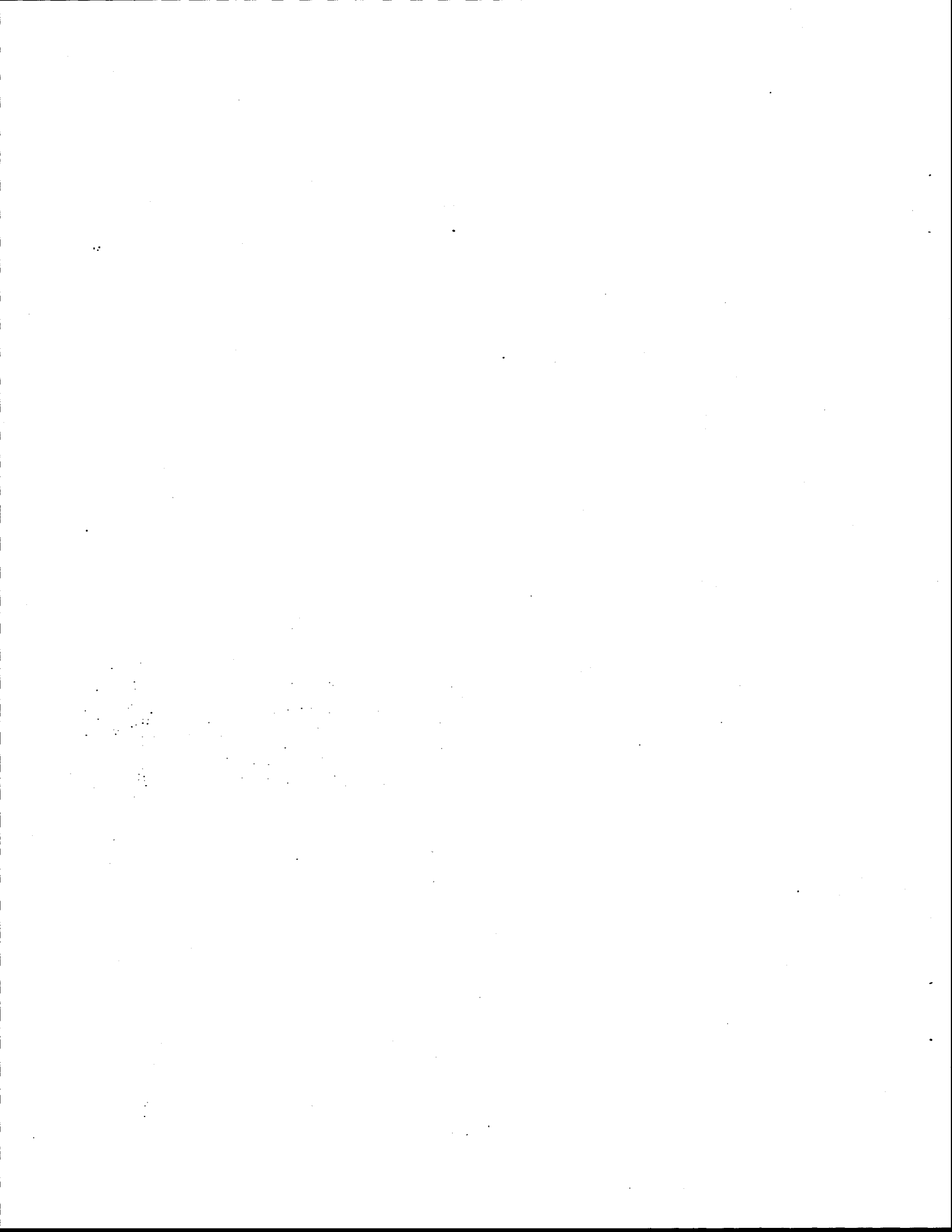
Year	Net Written Premiums	Direct Written Premiums	Total	Premiums Summary		Difference A-B	Estimated Commercial Premium Tax C	Difference A-C
				Estimated Premium Tax A	Premium Taxes Paid B			
1968	\$ 71,301,077		\$ 71,301,077	\$ 237,870.28	\$ 237,432.58	\$ 237.68	\$ 713,010.77	\$ (475,340.51)
1969	81,881,700		81,881,700	272,205.67	271,933.46	272.21	818,617.00	(544,411.33)
1970	101,751,929		101,751,929	339,173.10	338,833.92	339.18	1,017,519.29	(678,346.19)
1971	126,590,755		126,590,755	421,969.18	421,547.21	421.97	1,265,907.55	(843,938.37)
1972	161,989,839		161,989,839	539,899.46	539,359.56	539.90	1,619,698.39	(1,079,798.93)
1973	174,085,217		174,085,217	580,284.08	579,703.77	580.29	1,740,852.17	(1,160,568.11)
1974	201,319,085		201,319,085	671,063.62	670,392.55	671.07	2,013,190.85	(1,342,127.23)
1975	242,919,988		242,919,988	809,733.29	808,923.58	809.73	2,429,199.88	(1,619,466.59)
1976	296,156,547		296,156,547	987,188.49	986,201.30	987.19	2,961,565.47	(1,974,378.98)
1977	343,011,834		343,011,834	1,143,372.11	1,142,386.41	985.70	3,430,116.34	(2,286,744.23)
1978	387,633,073		387,633,073	1,292,110.24	1,290,836.40	1,273.84	3,876,330.73	(2,584,220.49)
1979	462,691,197		462,691,197	1,542,303.99	1,540,761.69	1,542.30	4,626,911.97	(3,084,607.98)
1980	523,584,540 **		523,584,540	1,745,281.80	1,743,536.52	1,745.28	5,235,845.40	(3,490,563.60)
1981	591,448,519		591,448,519	1,971,495.06	1,969,523.57	1,971.49	5,914,485.19	(3,942,990.13)
1982	604,861,814		604,861,814	2,016,206.05	2,014,189.84	2,016.21	6,048,618.14	(4,032,412.09)
1983	519,720,208		519,720,208	1,732,400.69	1,730,668.29	1,732.40	5,197,202.08	(3,464,801.39)
1984	536,952,597		536,952,597	1,789,841.99	1,788,052.15	1,789.84	5,369,525.97	(3,579,683.98)
1985	555,294,379		555,294,379	1,850,981.28	1,994,963.00	(143,981.74)	5,552,943.79	(3,701,962.53)
1986	623,458,826		623,458,826	2,078,196.09	2,078,196.00	0.09	6,234,588.26	(4,156,392.17)
1987		\$ 702,806,941	702,806,941	2,342,689.80	2,342,689.00	0.80	7,028,069.41	(4,885,379.61)
1988		833,850,329	833,850,329	3,474,376.00	3,486,215.00	(11,839.00)	8,338,503.29	(4,864,127.29)
1989		861,557,661	861,557,661	4,307,788.31	4,307,788.00	0.30	8,615,576.61	(4,307,788.31)
1990		888,260,353	888,260,353	4,441,301.77	4,441,301.00	0.76	8,882,603.53	(4,441,301.77)
1991		908,638,431	908,638,431	4,543,192.16	4,168,542.00	374,650.16	15,901,172.54	(11,357,980.39)
1992		960,519,094	960,519,094	4,802,595.47	4,321,655.00	480,940.47	18,057,758.97	(13,255,163.50)
1993		1,008,783,581	1,008,783,581	5,043,917.91	4,520,479.00	523,438.91	19,166,888.04	(14,122,970.13)
1994		1,008,494,011	1,008,494,011	5,042,470.08	4,451,948.00	590,522.08	19,161,386.21	(14,118,916.15)
1995		981,071,237	981,071,237	4,905,356.19	4,291,103.00	614,253.19	18,640,353.50	(13,734,997.32)
1996		1,111,184,116	1,111,184,116	5,555,820.58	4,822,960.00	732,860.58	21,112,118.20	(15,556,297.62)
<b>Total</b>	<b>\$ 6,606,412,924</b>	<b>\$ 9,265,145,764</b>	<b>\$ 15,871,558,678</b>	<b>\$ 66,480,885</b>	<b>\$ 63,302,122</b>	<b>\$ 3,178,763</b>	<b>\$ 210,969,580</b>	<b>\$ (144,487,676)</b>

\* The number represents Earned Premiums for the year 1980 as indicated in the year 1981 annual statement. It is used in lieu of Net Written Premiums due to the unavailability of the 1980 annual statement

† Used 50% of premiums at 1/3 of 1% and 50% at 1/2 of 1% due to the change in the premium tax rate during 1986

Differences reported between Columns A and B for the years 1991 - 1996 appear to be due to the premiums received by BCBSNC for the Federal Employees Health Benefit Program. These premiums are included in the numbers in the Department's direct premiums written column

## **B. Blue Cross Balance Sheet and Reserves**





DEPARTMENT OF INSURANCE  
State of North Carolina

P. O. Box 26387  
RALEIGH, N. C. 27611-6387

JIM LONG  
COMMISSIONER OF INSURANCE

GENERAL COUNSEL  
(919) 715-0011

MEMORANDUM

TO: Linwood Jones, Esquire  
Counsel to the NCBCBS Study Committee

FROM: Peter A. Kolbe *PAK*  
General Counsel - NCDOI

DATE: January 12, 1998

RE: NC Blue Cross / Blue Shield

Per your recent request, I have compiled certain financial information relating to BCBS and its "for profit" HMO. More specifically, you had asked about the assets and surplus of BCBS and also what percentage of BCBS' assets are represented by its "for profit" HMO. The questions appear simple, but the answers are somewhat confusing. In responding to your request I have employed a grossly simplified financial overview which makes my financial folks here shudder. The sole purpose in my doing so is that I, not being an accountant, do not know how else to phrase the answers other than in layman's terms. All figures given are current to September 30, 1997.

The Assets and Surplus of BCBS

As of September 30, 1997, BCBS had net admitted assets of \$ 898,681,236. Assets of BCBS equal its liabilities plus its surplus. BCBS' liabilities are \$ 390,885,119. The vast amount of these liabilities are claims related. In other words, most of these liabilities represent claims obligations to BCBS's subscribers. The surplus of BCBS is \$ 507,796,117. This surplus is a combination of a statutory "special contingent surplus or reserve", of \$ 174,527,275 ( mandated by NCGS § 58-65-95 for policyholder protection ) and "unassigned funds" representing accumulated losses and profits from inception to September 30, 1997 of \$ 333,268,842.

The above figures do not include specific provision for the liabilities, reserves, or surplus of BCBS's active, "for profit", wholly owned subsidiary HMO, known as The Personal Care Plan of NC, Inc. ( hereinafter "PCP" ). The net assets of PCP would,

however, be reflected in the overall assets of BCBS. Importantly, it should be noted that BCBS has for some time sold HMO coverages itself and independent of PCP. This "quasi" HMO coverage is referred to as the "HMO line of business", and figures for this business are included in the above numbers.

It should also be noted that the above figures *generally* do not include liabilities or reserves for BCBS' Administrative Services Only ( hereinafter "ASO" ) business. This is business whereby BCBS administers the health insurance plans of non affiliated self insured entities for a fee. With respect to the ASO business, the self insured entity alone is on the risk for the claims, and BCBS simply accepts an administrative fee which is reflected in the "unassigned funds" category. The one glitch is that, in certain cases where BCBS may have some concerns about a self insured entity's ability to promptly provide money to BCBS with which to pay claims, BCBS may require those entities to post a deposit for the payment of claims. These deposits total \$ 4,295,150 and *are* included in the above figures for BCBS' liabilities.

#### The Assets and Surplus of PCP

PCP is a wholly owned "for profit" subsidiary of BCBS. It has net assets of \$9,853,881, liabilities of \$ 1,192,065, and surplus of \$ 8,632,549. Of the surplus, \$1,671,287 is a "special contingent surplus or reserve" mandated by NCGS § 58-67-40 for policyholder protections.

As PCP is a "for profit" entity, I think that there are significant problems in attempting to apply the charitable trust doctrine to it. Further, it may be appropriate to "back out" from the assets figures of BCBS those amounts representing the assets of PCP.

#### Conclusion

Linwood, you and I both recognize the current interest in the "reserve" and "surplus" figures. These are categories to which hard numbers are assigned, and thus they naturally *seem* to provide a basis for evaluating what assets of BCBS may be placed in a charitable trust. However, I do not think that it is appropriate to talk about impressing the reserves and surplus of BCBS because doing so necessarily means pulling money out of the company which is necessary for the payment of claims and to ensure that the company has sufficient assets to go forward and grow. The solution to the impressment problem, is, to my mind, the transfer of the *fair market value* of the company to a charitable trust by way of 1) BCBS placing newly issued stock in a charitable trust or 2) BCBS making an initial public offering of stock ( "IPO" ) in the capital markets and then placing the cash proceeds from that IPO in the charitable trust. Under either scenario ( both of which are complex and not without concerns ) , no money would actually be ripped out of the company and its claims paying abilities and operations would not be endangered. Consequently, when we at the Department of insurance consider what is appropriate should the charitable trust doctrine be applied, we



believe that the *fair market value* of the company is the *key*, and that figure may be represented and transferred by either an IPO or a stock transfer without ever necessitating consideration of reserve or surplus numbers.

For your convenience, I have attached pertinent portions of the recent financial statements from BCBS and PCP. Please call me should you have any further questions or comments.

cc: chron file  
matter file



**LIABILITIES, RESERVES AND OTHER FUNDS**

	1	2
	Current Statement Date	December 31 Prior Year
1. Claims unpaid (Includes provision for retroactive cost adjustments \$ .....	166,154,277	177,670,748
2. Provision for deferred maternity benefits .....		
3. Unpaid claims adjustment expenses .....	9,525,830	9,983,829
4. Unearned premiums .....	104,760,862	99,553,665
5. Unearned investment income .....		
6. A. Taxes, licenses and fees due or accrued (excluding Federal income taxes)	713,310	541,221
B. Federal income taxes (excluding deferred taxes)	1,494,419	
C. Other expenses due or accrued .....	17,789,646	10,637,567
7. Premium deposits made by applicants rejected or not as yet accepted as members or subscribers		
8. Borrowed money \$ 120,924 and interest thereon \$ .....	120,924	295,442
9. Amounts withheld or retained for account of others .....	1,341,205	6,048,986
10. Liability for amounts held under uninsured accident and health plans .....	4,295,150	4,465,506
11. Funds held by corporation under reinsurance treaties .....		
12A. Unearned premiums on reinsurance in unauthorized companies .....	\$ .....	
12B. Reinsurance on paid losses \$ .....		
and on unpaid reported losses \$ .....		
and on incurred but not reported losses \$ .....		
recoverable from unauthorized companies .....	\$ .....	
12C. Paid and unpaid allocated loss adjustment expenses recoverable from unauthorized companies .....	\$ .....	
12D. Less funds held or retained by corporation for account of such unauthorized companies .....	\$ .....	
13. Provision for unauthorized reinsurance (Lines 12A + 12B + 12C - 12D)		
14. Aggregate write-ins for other liabilities .....	84,689,496	117,975,455
15. Total liabilities .....	390,885,119	427,172,419
<b>RESERVES AND OTHER FUNDS</b>		
16. Statutory reserve .....	174,527,275	165,531,522
17. Surplus notes .....		
18. Aggregate write-ins for reserves and other funds .....		
19. Unassigned funds .....	333,268,842	318,564,894
20. Total reserves and unassigned funds .....	507,796,117	484,096,416
21. TOTALS (Lines 15 plus 20) .....	898,681,236	911,268,835
<b>DETAILS OF WRITE-INS</b>		
1401. Negative Cash .....	28,382,571	36,762,064
1402. Stale Dated Checks .....	2,158,623	2,375,827
1403. Other Liabilities .....	32,551,037	33,326,674
1498. Summary of remaining write-ins for Line 14 from overflow page .....	21,597,265	45,510,890
1499. Totals (Lines 1401 thru 1403 plus 1498)(Line 14 above) .....	84,689,496	117,975,455
1801. ....		
1802. ....		
1803. ....		
1898. Summary of remaining write-ins for Line 18 from overflow page .....		
1899. Totals (Lines 1801 thru 1803 plus 1898)(Line 18 above) .....		

# ASSETS

	Current Statement Date				December 31 Prior Year
	1 Ledger Assets	2 Non-Ledger Including Excess of Market (or Amortized) Over Book Values	3 Assets Not Admitted Including Excess of Book Over Market (or Amortized) Values	4 Net Admitted Assets (Columns 1 + 2 - 3)	
1. Bonds .....	411,852,348		550,126	411,302,222	413,353,140
2. Stocks:					
2.1 Preferred stocks .....					
2.2 Common stocks .....	177,815,959	72,374,604	4,105,860	246,084,703	249,328,195
3. Mortgage loans on real estate:					
3.1 First liens .....					
3.2 Other than first liens .....					
4. Real estate:					
4.1 Properties occupied by the company (less \$..... encumbrances) .....	38,389,635			38,389,635	37,361,142
4.2 Other Properties (Less \$..... encumbrances) .....					
5. Collateral loans .....					
6. Cash (\$..... 4,180 ) and short-term investments (\$..... 111,043,262 ) .....	111,047,442			111,047,442	110,922,074
7. Other invested assets .....					
8. Aggregate write-ins for invested assets .....					
9. Subtotals, cash and invested assets (Lines 1 to 8) .....	739,105,384	72,374,604	4,655,986	(a) 806,824,002	810,954,551
10. Uncollected premiums .....	50,992,434		1,029,850	49,962,584	58,833,570
11. Amounts receivable relating to uninsured accident and health plans .....	1,541,955			1,541,955	1,286,503
12. Funds held by or deposited with reinsured companies .....					
13. Reinsurance recoverables on loss and loss adjustment expense payments .....					
14. Federal income tax recoverable .....	2,322,021			2,322,021	1,662
15. Electronic data processing equipment .....	23,723,157			23,723,157	26,822,984
16. Interest and other investment income due and accrued .....	5,840,852			5,840,852	5,954,113
17. Receivable from parent, subsidiaries and affiliates .....	625,641			625,641	1,049,418
18. Other assets nonadmitted .....	33,256,891		33,256,891		
19. Aggregate write-ins for other than invested assets .....	13,213,590		5,372,566	7,841,024	6,356,034
20. TOTALS (Lines 9 through 19) .....	870,621,925	72,374,604	44,315,293	898,681,236	911,268,835

## DETAILS OF WRITE-INS

0801. ....					
0802. ....					
0803. ....					
0898. Summary of remaining write-ins for Line B from overflow page .....					
0899. Totals (Lines 0801 thru 0803 plus 0898) (Line B above) .....					
1901. National Control and Inter Plan Service ...	7,329,219			7,329,219	6,046,998
1902. Miscellaneous Accounts Receivable .....	682,863			682,863	
1903. Employee Travel Advances .....	34,022			34,022	
1998. Summary of remaining write-ins for line 19 from overflow page .....	5,167,486		4,655,581	511,905	388,026
1999. Totals (Lines 1901 thru 1903 plus 1998) (Line 19 above) .....	13,213,590		5,372,566	7,841,024	6,356,034

(a) Includes \$.... 13,418,394 investments in subsidiaries, and affiliates.

**REPORT #1 - FORT M: ASSETS**

	Current Period			Prior Calendar Year (a)
	1 Assets	2 Assets Not Admitted	3 Net Admitted Assets	4 Net Admitted Assets
<b>CURRENT ASSETS:</b>				
1. Cash (\$..... 196,904 ) and short-term investments (\$..... 1,497,375 ) .....	1,694,279		1,694,279	1,974,387
2. Premiums Receivable .....	333,029	5,915	327,114	625,135
3. Investment Income Receivables .....	134,570		134,570	57,554
4. Health Care Receivables .....	4,239		4,239	5,560
5. Amounts Due from Affiliates .....				
6. Aggregate Write-ins for Current Assets .....	23,352	23,352		
7. TOTAL CURRENT ASSETS (Lines 1 to 6) .....	2,189,469	29,267	2,160,202	2,662,636
<b>OTHER ASSETS:</b>				
8. Restricted Cash and Other Assets .....	515,228		515,228	515,422
9. Bonds .....	7,149,184		7,149,184	6,539,855
10. Stocks:				
10.1 Preferred Stocks .....				
10.2 Common Stocks .....				
11. Other Long-term Invested Assets .....				
12. Amounts Due from Affiliates .....				
13. Aggregate Write-ins for Other Assets .....				
14. TOTAL OTHER ASSETS (Lines 8 to 13) .....	7,664,412		7,664,412	7,055,277
<b>PROPERTY AND EQUIPMENT:</b>				
15. Land, Building and Improvements .....				
16. Furniture and Equipment .....				
17. Leasehold Improvements .....				
18. Aggregate Write-ins for other property and equipment .....				
19. TOTAL PROPERTY AND EQUIPMENT (Lines 15 to 17) .....				
20. TOTAL ASSETS (Lines 7, 14, and 19) .....	9,853,881	29,267	9,824,614	9,717,913
<b>DETAILS OF WRITE-INS</b>				
0601. Capitation Paid In Advance .....	23,352	23,352		
0602. ....				
0603. ....				
0698. Summary of remaining write-ins for Line 6 from overflow page .....				
0699. Totals (Lines 0601 thru 0603 plus 0698)(Line 6 above) .....	23,352	23,352		
1301. ....				
1302. ....				
1303. ....				
1398. Summary of remaining write-ins for Line 13 from overflow page .....				
1399. Totals (Lines 1301 thru 1303 plus 1398)(Line 13 above) .....				
1801. ....				
1802. ....				
1803. ....				
1898. Summary of remaining write-ins for Line 18 from overflow page .....				
1899. Totals (Lines 1801 thru 1803 plus 1898)(Line 18 above) .....				

(a) Or other annual reporting period as permitted by regulatory authority.

# Report #1 - Part B: LIABILITIES AND NET WORTH

	Current Period			Prior Calendar Year (a)
	1 Covered	2 Uncovered	3 Total	4 Total
<b>CURRENT LIABILITIES:</b>				
1. Accounts Payable .....				
2. Claims Payable (Reported and Unreported) .....	391,972		391,972	1,244,975
3. Accrued Medical Incentive Pool .....				
4. Unearned Premiums .....	2,831		2,831	3,244
5. Loans and Notes Payable .....				
6. Amounts Due to Affiliates .....	784,182		784,182	230,621
7. Aggregate Write-ins for Current Liabilities .....	13,080		13,080	54,080
<b>B. TOTAL CURRENT LIABILITIES (Lines 1 to 7) .....</b>	<b>1,192,065</b>		<b>1,192,065</b>	<b>1,532,920</b>
<b>OTHER LIABILITIES:</b>				
9. Loans and Notes Payable .....				
10. Amounts Due to Affiliates .....				
11. Aggregate Write-ins for Other Liabilities .....				
<b>12. TOTAL OTHER LIABILITIES (Lines 9 to 11) .....</b>				
<b>13. TOTAL LIABILITIES (Lines 8 and 12) .....</b>	<b>1,192,065</b>		<b>1,192,065</b>	<b>1,532,920</b>
<b>NET WORTH:</b>				
14. Common Stock .....	X X X	X X X	100,000	100,000
15. Preferred Stock .....	X X X	X X X		
16. Paid in Surplus .....	X X X	X X X	13,900,000	13,900,000
17. Contributed Capital .....	X X X	X X X		
18. Surplus Notes .....	X X X	X X X		
19. Contingency Reserves .....	X X X	X X X	1,671,287	1,649,428
20. Retained Earnings/Fund Balance .....	X X X	X X X	(7,038,738)	(7,464,435)
21. Aggregate Write-ins for Other Net Worth Items .....	X X X	X X X		
<b>22. TOTAL NET WORTH (Lines 14 to 21) .....</b>	<b>X X X</b>	<b>X X X</b>	<b>8,632,549</b>	<b>8,184,993</b>
<b>23. TOTAL LIABILITIES AND NET WORTH (Lines 13 and 22) .....</b>	<b>1,192,065</b>		<b>9,824,614</b>	<b>9,717,913</b>
<b>DETAILS OF WRITE-INS</b>				
0701. Federal Income Tax Due Parent .....			80	80
0702. Unpaid Claims Processing Adjustment .....	13,000		13,000	54,000
0703. Contract Settlements CPM .....				
0798. Summary of remaining write-ins for Line 7 from overflow page .....				
<b>0799. Totals (Lines 0701 thru 0703 plus 0798)(Line 7 above) .....</b>	<b>13,080</b>		<b>13,080</b>	<b>54,080</b>
1101. ....				
1102. ....				
1103. ....				
1198. Summary of remaining write-ins for Line 11 from overflow page .....				
<b>1199. Totals (Lines 1101 thru 1103 plus 1198)(Line 11 above) .....</b>				
2101. Restricted Reserves .....	X X X	X X X		
2102. ....	X X X	X X X		
2103. ....	X X X	X X X		
2198. Summary of remaining write-ins for Line 21 from overflow page .....	X X X	X X X		
<b>2199. Totals (Lines 2101 thru 2103 plus 2198)(Line 21 above) .....</b>	<b>X X X</b>	<b>X X X</b>		

(a) Or other annual reporting period as permitted by regulatory authority.

## **C. Comments by January Speakers**



**North Carolina General Assembly  
Legislative Services Office**

George R. Hall, Legislative Services Officer  
(919) 733-7044

Elaine W. Robinson, Director  
Administrative Division  
Room 5, Legislative Building  
16 W. Jones Street  
Raleigh, NC 27603-5925  
(919) 733-7500

Gerry F. Cohen, Director  
Bill Drafting Division  
Suite 401, LOB  
300 N. Salisbury St.  
Raleigh, NC 27603-5925  
(919) 733-6660

Thomas L. Covington, Director  
Fiscal Research Division  
Suite 619, LOB  
300 N. Salisbury St.  
Raleigh, NC 27603-5925  
(919) 733-4910


Donald W. Fulford, Director  
Information Systems Division  
Suite 400, LOB  
300 N. Salisbury St.  
Raleigh, NC 27603-5925  
(919) 733-6834

Terrence D. Sullivan, Director  
Research Division  
Suite 545, LOB  
300 N. Salisbury St.  
Raleigh, NC 27603-5925  
(919) 733-2578

**January 5, 1998**

**MEMORANDUM**

**TO: Members of the Blue Cross Conversion Study Commission**

**FROM: Linwood Jones, Commission Counsel** 

**RE: Legislative Background (Senate Bill 993) and Conversion Activity in Other States**

**LEGISLATIVE BACKGROUND**

**Current Law:** Blue Cross Blue Shield is a hospital and medical service corporation organized under Article 65 of the Insurance Code. Blue Cross and Delta Dental are the only entities of which I am aware that are regulated under this law. Commercial health insurance companies are regulated under a different part of the Insurance Code (Articles 1 through 64) and HMOs under yet another part of the Code (Article 67).

Article 65 authorizes Blue Cross to convert to a for-profit stock company or a mutual company under rules adopted by the Commissioner of Insurance. There are no rules specifically governing such a conversion. The national Blue Cross organization, which owns and licenses the use of the Blue Cross Blue Shield name and logo, prohibited conversions to stock companies until a few years ago.

The current "conversion" law briefly states that a proposed conversion must be equitable to the Blue Cross policyholders. There is nothing in this law that addresses the rights, if any, of the public to Blue Cross assets upon conversion. Under both common law and the North Carolina Nonprofit Corporation Act, when a charitable entity converts to a for-profit company, the assets are "impressed" for the benefit of the public -- i.e., they must continue to be used for charitable purposes. Blue Cross is specifically exempt from the Nonprofit Corporation Act. The exemption most likely was in



recognition of the fact that Blue Cross was being regulated under the Insurance Code. I do not believe it was related to the charitable trust issue, particularly since the exemption came long before the national Blue Cross's recent authorization for state plans to become for-profit companies. In any event, if Blue Cross were subject to the Nonprofit Corporation Act, I assume it would take the same position that it has taken in the recent past on the common law claim of charitable trust -- i.e., that it is not a charity.

**Senate Bill 993:** Senate Bill 993 was introduced in April, 1997. The version that passed the Senate (3rd edition) authorized the Commissioner of Insurance to adopt rules governing conversion. These rules were to be adopted after consultation with the Joint Legislative Commission on Governmental Operations. This language was very similar to the existing conversion law in Article 65 of the Insurance Code.

The bill was extensively revised in the House Rules Committee to provide more detail about the conversion process. The new bill required Blue Cross to file information with the Commissioner of Insurance, including, for example, a business plan for the new corporation, information on how the plan would protect policyholders, and an analysis of premium rates of the new company's proposed products. The bill also called for a public hearing by the Commissioner before deciding whether to grant an application for conversion.

The bill underwent additional amendments on the House floor. These amendments were targeted primarily at three concerns: (1) ensuring that officers and directors of Blue Cross would not profit from a conversion (the "anti-inurement" provision); (2) ensuring that any type of corporate restructuring that "looked" like a conversion would in fact be treated as a conversion; and (3) preserving any charitable trust rights that might exist.

Most of these amendments on the House floor focused on the charitable trust issue. One amendment provided that the plan, in addition to meeting the criteria already in the bill, must be "in the public interest" and that the presumption of "fairness" to the public and policyholders to which Blue Cross was entitled as a result of meeting those criteria was (1) rebuttable and (2) did not apply to any charitable trust claim made by the Attorney General. A second amendment, more popularly known as the Hurley amendment, required the Commissioner of Insurance, with the advice of the Attorney General, to determine what portion of Blue Cross' surplus would be subject to a charitable trust. The amendment went on to say that the Commissioner must then place this amount in a charitable health care trust. However, this latter language was removed by a perfecting amendment. The resulting amendment does not mandate that any particular portion of Blue Cross assets are subject to a charitable trust. A separate amendment that would have directed any charitable trust amounts into either a high-risk health insurance pool for the uninsured or to a nonprofit health care foundation was defeated. An amendment designed to address concerns about a 2-step conversion process (Blue Cross converts to a mutual, then to a stock company) was also defeated. It is my understanding that current law already prohibits the second step -- conversion

from a mutual to a stock -- although legislation allowing such demutualizations is pending.

Senate Bill 993 was returned to the Senate (5th edition), where it was discussed in the Rules Committee. The Senate failed to concur in the House changes to the bill, and both sides appointed conference committees to discuss the bill. Although there were some discussions, no additional action was taken on the bill. It was agreed that the issue would be studied during the interim by a special committee.

**Senate Bill 32:** The special committee was established in Senate Bill 32, the omnibus study bill enacted at the end of the session. The committee consists of 14 members -- two of whom (Department of Insurance designee and the Attorney General's designee) are nonvoting members.

The Commission must complete its work and report back to the General Assembly by May 11th of this year. Once it makes its report, the Commission terminates. Because of the general practice of the leadership to have appropriations committees begin meeting two weeks before the short session and to have staff direct their attention to session activities, I recommend that the Commission target the end of April for completion of its work.

In addition to creating the study commission, the study bill also imposed a one-year moratorium on any conversion by Blue Cross. Although Blue Cross announced during the 1997 session that it had no immediate plans to convert, the moratorium ensures that the Study Commission will be able to complete its work and that the General Assembly can take action on the Commission's recommendations during the 1998 short session before a possible conversion.

## **CONVERSION ACTIVITY IN OTHER STATES**

### **California**

Blue Cross of California restructured in 1992 by transferring approximately 90% of its assets to a for-profit subsidiary, Wellpoint. Blue Cross remained as a nonprofit company with the remaining 10% of the assets and 80% of the stock of Wellpoint. The State of California did not require Blue Cross to set aside money in a charitable trust although Blue Cross indicated that it would spend \$5 million per year for 20 years on charity.

In 1993-94, the California Department of Insurance and Blue Cross argued back and forth over the adequacy of the \$5 million per year for charity that Blue Cross had

indicated it would provide. The Department alleged that Blue Cross should spend at least \$100 million on charitable purposes in 1994 and transfer 40% of its stock to a new charitable foundation. Public interest groups began demanding that Blue Cross turn over 100% of its assets (valued at \$2.2 billion) to a charitable foundation. Blue Cross eventually agreed to transfer 100% of its assets to a charitable foundation. These assets were estimated at \$2.5 billion. In preparation for an upcoming merger between Wellpoint and HIS, Blue Cross agreed to additional funding of a charitable trust, bringing the total value of the charitable set-aside to \$3.3 billion.

*Source: Conversion of Blue Cross and Blue Shield Plans from Nonprofit to For-Profit Status, Consumers Union of U.S., Inc., West Coast Regional Office (10/10/95).*

## **Colorado**

Colorado passed legislation in 1996 requiring that Blue Cross, if it converts, to "specify a reasonable treatment for the benefit of the citizens of the State of Colorado." The legislation further provided that the transfer of consideration equal to the fair market value of Blue Cross to one or more charitable foundations would be deemed "reasonable treatment." The Commissioner of Insurance may allow all or a portion of the consideration being transferred to be stock of the for-profit corporation.

*Sources: Senate Bill 96-100  
Community Catalyst: A Comprehensive Study of Laws Governing Conversions, Mergers, and Acquisitions*

## **Georgia**

The legislature passed a law in 1995 allowing Blue Cross to convert to a for-profit insurance company. The legislation contained no requirement of a set-aside for a charitable trust. Blue Cross subsequently converted (by becoming a for-profit subsidiary of a newly-created holding company) and distributed 5 shares of stock to each of the 160,000 policyholders who requested it. (Only 70,000 reportedly requested it). Since that time, a group of nonprofit organizations has sued to recover alleged charitable assets on grounds that Blue Cross owed money to the public and that the legislature could not constitutionally forgive this debt to the public. The estimated value of the assets retained by Blue Cross is approximately \$400 million (fair market value of \$250 million plus surplus of \$138 million).

*Sources: \*The Georgia Healthcare News, v. 4, no. 11 (November 1997), p. 1-2.  
\*Community Catalyst/Consumers Union: State Case Studies (1997)  
\*Health Policy Tracking Service*

## **Kansas**

Kansas Blue Cross Blue Shield became a mutual in 1991 pursuant to legislation enacted by the Kansas legislature. In 1996, Kansas BCBS sought to merge with BCBS of Kansas City. The Attorney General and Kansas BCBS have sued each other, seeking declaratory judgments on whether the company has any charitable trust obligations.

*Sources:*            *Community Catalyst/Consumers Union: State Case Studies (1997)*  
*Blue Cross Blue Shield of Kansas v. Stovall, District Court of Shawnee County, Kansas, Petition for Quo Warranto and Declaratory Judgment (5/5/97), Answer and Counterclaim of Attorney General (6/16/97)*

## **Maine**

Legislation was filed in 1996 to allow Blue Cross to convert to a for-profit insurer. (Existing law already allowed Blue Cross to convert to a mutual). However, because of concerns about the legislation and questions over whether money should be set aside in a charitable trust, the legislature enacted a one-year moratorium on a Blue Cross conversion. The Maine Attorney General and Blue Cross reportedly worked out a tentative agreement under which Blue Cross, if it converted to a for-profit insurer, would make at least 90% of its assets available to the Maine public. The Maine legislature recently enacted legislation declaring Blue Cross and other nonprofit hospital and medical service corporations to be public charities and requiring that at least 90% of the assets be placed in a charitable trust in the event of an outright conversion. The legislation allows conversion to a for-profit insurer, but not to a mutual. The law does not apply to all types of restructurings.

*Sources:*            *\*Community Catalyst/Consumers Union: State Case Studies 1997*  
*\*Blue Cross Blue Shield of Maine, April 2, 1997 press release*  
*\*Public Law 1997, Chapter 344, Summary of the Maine Legislature's Office of Policy and Legal Analysis*

## **Maryland**

Blue Cross Blue Shield of Maryland submitted an application for restructuring to the Department of Insurance in 1994. Under the proposed restructuring, BCBS would create a new for-profit insurance company and a holding company that would in turn own the five for-profit HMOs already owned and operated by BCBS. BCBS would remain as a nonprofit entity. The Commissioner found that the proposed reorganization essentially would render the entire operation "for-profit." The Commissioner refused to approve the application because Maryland law does not allow a nonprofit to reorganize in a manner that would make the operation essentially for-profit but that would fall short of an outright conversion. However, existing Maryland

law does allow BCBS to pursue an outright conversion to either a for-profit company or a mutual. The law makes no mention of a charitable trust obligation.

*Source: Order of the Commissioner of Insurance re Blue Cross Blue Shield of Maryland Reorganization Plan, Case No. MIA-95-12/94 (January 20, 1995).  
\*Maryland Annotated Code, Insurance, §14-131 (stock conversion) and 14-132 (mutual conversion).*

## **Missouri**

Blue Cross Blue Shield restructured in 1994 by creating a for-profit managed care subsidiary, through which it was able to issue stock. BCBS transferred approximately 80% of its assets to the managed care subsidiary. The Commissioner of Insurance approved the reorganization but later began questioning the propriety of BCBS not having set aside funds in a charitable trust. In 1996, BCBS filed suit to obtain a declaratory judgment that it was not required to have set aside funds in a charitable trust. The trial court ruled that BCBS had exceeded its authority as a nonprofit by moving a substantial amount of its assets to a for-profit stock subsidiary. BCBS had appealed this decision.

*Sources: Blue Cross Blue Shield of Missouri v. Anqoff et al, Memorandum and Order (9/9/96), Case # CV196-619CC.  
Community Catalyst/Consumers Union: Conversion and Preservation of Charitable Assets of Blue Cross and Blue Shield Plans (1997).*

## **New Jersey**

Blue Cross Blue Shield of New Jersey filed a proposal to convert to a mutual insurer and to merge the mutual with Anthem, a for-profit insurer in another state. The Commissioner of Insurance rejected the application for merger because BCBS had provided no charitable set aside. BCBS appealed the Commissioner's decision to the New Jersey Superior Court. The Court ruled in 1977 that BCBS is a charitable institution and left the to the regulators (the Department of Insurance) the issue of how a charitable trust would be imposed, valued, and enforced.

*Source: Consumers Union/Community Catalyst: Conversion and Preservation of Charitable Assets of Blue Cross Blue Shield Plans.  
In the Matter of the Application of Blue Cross Blue Shield of New Jersey, Inc., for Conversion, Order and Decision (April 14, 1997).*

## **New York**

Empire Blue Cross Blue Shield (New York) formed several for-profit subsidiaries and announced in 1997 that it would "convert" to for-profit by transferring all of its

assets to those for-profit subsidiaries. Empire would then become a tax-exempt charitable foundation. Empire has offered to transfer 100% of the initial stock of the for-profit company to the charitable foundation, with the foundation divesting itself of most of the stock and reducing its ownership in the for-profit company over a period of years.

*Sources: Proposed Restructuring of Empire Blue Cross Blue Shield, Questions and Answers 1/22/97.  
Testimony by David Platter (Donaldson, Lufkin & Jenrette Securities Corporation) to New York State Assembly 4/11/97*

## **North Dakota**

Blue Cross Blue Shield of North Dakota proposed last year to convert to a mutual company. The North Dakota legislature subsequently enacted legislation declaring that "every nonprofit mutual insurance company is a charitable and benevolent organization and the laws of this state relating to and affecting nonprofit charitable and benevolent organizations are applicable..." The act was made retroactive to apply to a conversion or proposed conversion by Blue Cross to a nonprofit mutual.

*Sources: Community Catalyst/Consumers Union: Conversion and Preservation of Charitable Assets of Blue Cross Blue Shield Plans.  
North Dakota 1997 Session Laws, Chapter 255.*

## **Ohio**

Ohio Blue Cross proposed last year to form a joint venture with Columbia/HCA, a for-profit hospital chain and sought approval from the Ohio Insurance Department for the proposal. The proposal is reportedly still pending before the Department of Insurance. In the meantime, the Attorney General sued Blue Cross for recovery of charitable assets it contends are owed (at least \$300 million). This litigation, as well as additional litigation filed by Blue Cross policyholders, is pending at last report.

*Sources: Consumers Union/Community Catalyst: State Case Studies 1997.  
State of Ohio v. Blue Cross Blue Shield Mutual of Ohio, Complaint of Attorney General For Declaratory Judgment, Injunction and Other Relief.*

## **Texas**

Illinois Blue Cross Blue Shield and Texas Blue Cross Blue Shield agreed to merge in 1996 and sought approval from the Texas Department of Insurance. Illinois BCBS was a mutual. The Texas BCBS was a nonprofit health service corporation. The Texas Attorney General has sued to block the merger as a violation of Texas law

because, among other things, it allegedly divests Texans of monies that belong in a charitable trust. The estimated value of Texas BCBS is \$700,000,000. The AG contends that Texas BCBS is a charity and that most, if not all, of the \$700,000,000 in assets is subject to a charitable trust obligation.

The Texas legislature passed legislation in 1997 governing the conversion of mutual insurers to stock insurers (SB 1447). The law does not appear to explicitly address charitable trust issues.

*Source: Morales v. BCBS of Texas et al, Plaintiff's Original Petition, Including Declaratory Judgment Action and Contingent Request for Temporary and Permanent Injunctions (1996).*

## Virginia

Trigon (Blue Cross Blue Shield of Virginia) was a mutual benefit corporation until 1991, at which time it converted to a "mutual" corporation. In 1995, it proposed to convert to a for-profit company by merging Trigon with a proposed new stock corporation. The proposal would have provided for the distribution of stock and/or cash to its policyholders at a value estimated at \$1 to \$1.5 billion. (This estimate was based on a multiple of Trigon's annual earnings). Trigon's initial application to the State for conversion did not contain a set-aside for a charitable trust. The Virginia Attorney General intervened and argued that a charitable trust should be created.

In attempting to settle the issue of the ownership of the assets, the Attorney General and Trigon looked at various events and dates in Trigon's corporate history to find the date at which it would be appropriate to draw the line between assets belonging to the public and assets belonging to Trigon's policyholders. The two parties eventually agreed that the controlling date should be January 1, 1988 – the date on which the State of Virginia made Trigon begin paying premium taxes. They agreed that Trigon's surplus on December 31, 1987 – \$159 million – should be set aside in a charitable trust for the benefit of medical research.

The agreement was presented to the legislature. The legislature agreed with the proposition that December 31, 1987 was the appropriate dividing line, but made two changes: (1) it required an additional \$10 million to be set-aside by Trigon, bringing the total charitable set-aside to \$175 million, and (2) it required the money to be placed into the State Treasury instead of a charitable foundation.

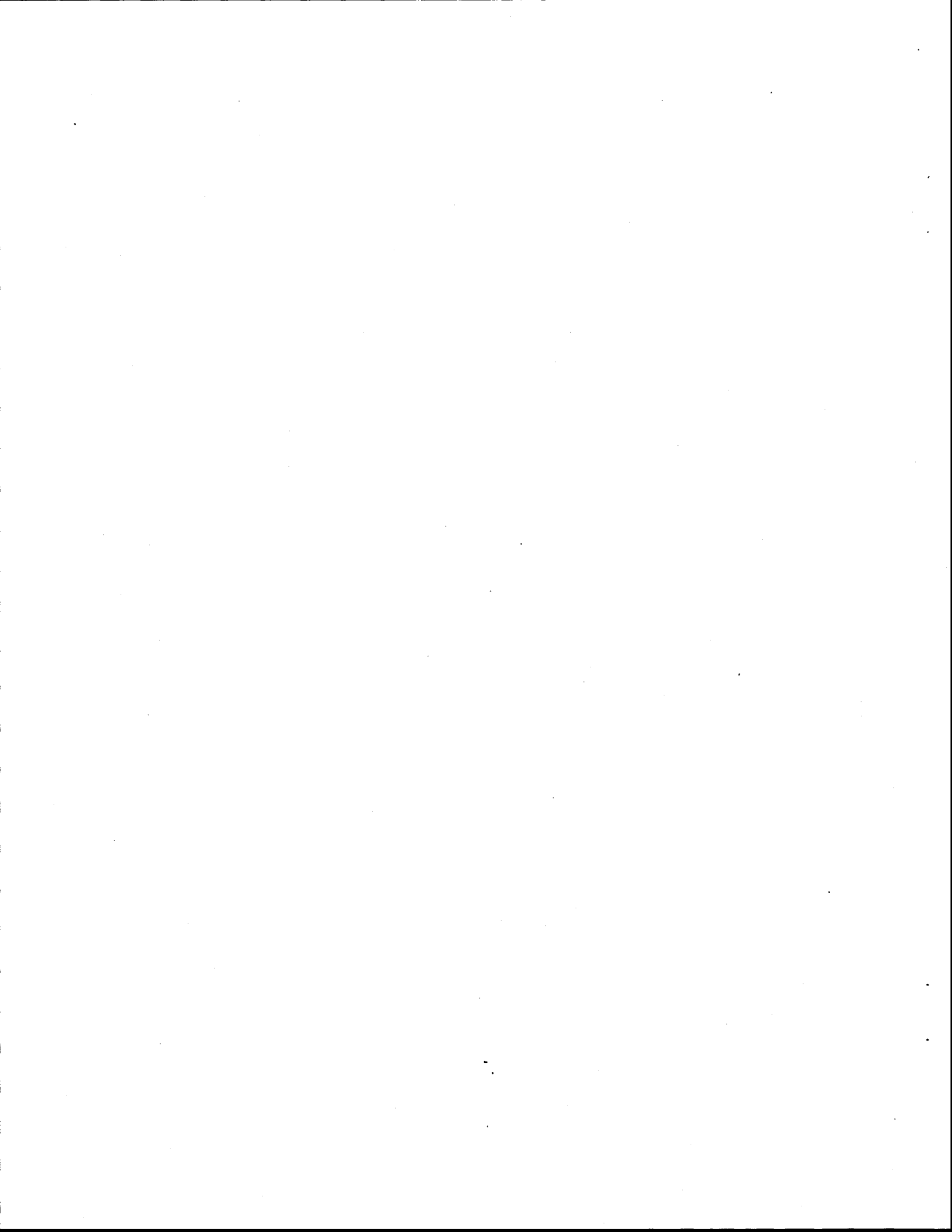
*Sources: \*Trigon Demutualization Fact Sheet, Office of the Attorney General  
\*Prehearing Brief of the Attorney General on the Application of  
Trigon to Convert to a Stock Corporation  
\*Community Catalyst/Consumers Union: State Case Studies*

§ 58-65-130. Amendments to certificate of incorporation.

Any corporation subject to the provisions of this Article and Article 66 of this Chapter may hereafter amend its charter in the following manner only.

- (1) a. A meeting of the board of directors, trustees or other governing authority shall be called in accordance with the bylaws specifying the amendment to be voted upon at such meeting.
  - b. If at such meeting two thirds of the directors, trustees or other governing authority present vote in favor of the proposed amendment, then the president and secretary shall under oath make a certificate to this effect, which certificate shall set forth the call for such meeting, a statement showing service of such call upon all directors, and a certified copy of so much of the minutes of the meeting as relate to the adoption of the proposed amendment.
  - c. Said officers shall cause said certificate to be published once a week for two consecutive weeks in a newspaper in Raleigh and in the county where the corporation's principal office is located, or posted at the courthouse door if no newspaper be published within the county. Said printed or posted notices shall be in such form and of such size as the Commissioner may approve, and in addition to setting forth in full the certificate required in paragraph b shall state that application for amending the corporation's charter in the manner specified has been proposed by the board of directors, trustees, or other governing authority, and shall also state the time set for the meeting of certificate holders thereby called to be held at the principal office of the corporation to take action on the proposed amendment. A true copy of such notice shall be filed with the Commissioner. Such publication and filing of notice shall be completed at least 30 days prior to the date set therein for the meeting of the certificate holders and due proof thereof shall be filed with the Commissioner at least 15 days prior to the date of such meeting. If the meeting at which the proposed amendment is to be considered is a special meeting, rather than a regular annual meeting of certificate holders, such special meeting can be called only after the Commissioner has given his approval in writing, and the published notice shall show the fact of such approval. At said meeting those present in person or represented by proxy shall constitute a quorum.
  - d. If at such certificate holders' meeting two thirds of those present in person or by proxy shall vote in favor of any proposed amendment, the president and secretary shall make a certificate under oath setting forth such fact together with the full text of the amendment thus approved. Said certificate shall, within 30 days after such meeting, be submitted to the Commissioner for his approval as conforming to the requirement of law, and it shall be the duty of the Commissioner to act upon all proposed amendments within 10 days after filing of such certificates with him. Should the Commissioner approve the proposed amendment or amendments, he shall certify this fact, together with the full text of such amendments as are approved by him, to the Secretary of State who shall thereupon issue the charter amendment in the usual form. Should the Commissioner disapprove of any amendment, then the same shall not be allowed.
- (2) All charters and charter amendments heretofore issued upon application of the board of directors, trustees or other governing authority of any corporations subject to the provisions of this Article and Article 66 of this Chapter are hereby validated.
  - (3) The charter of any corporation subject to the provisions of this Article and Article 66 of this Chapter may be amended to convert that corporation, so amending its charter, into either a mutual nonstock or stock accident and health insurance company or life insurance company subject to the provisions of Articles 1 through 64 of this Chapter provided the rights of the subscribers or certificate holders in the reserves and capital of such corporation are adequately protected under rules and regulations adopted by the Commissioner of Insurance. (1941, c. 338, s. 15; 1947, c. 820, s. 6; 1953, c. 1124, s. 2.)





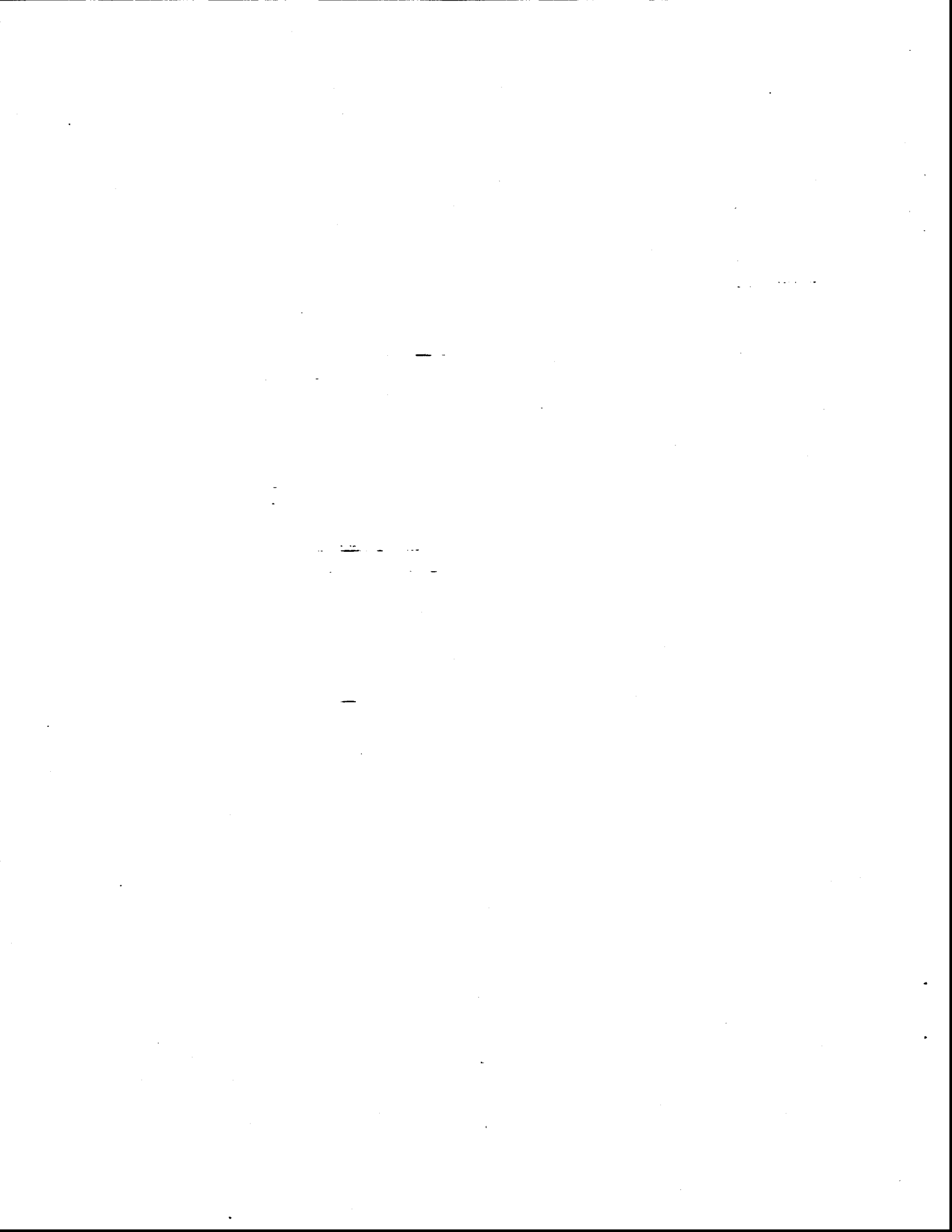
North Carolina General Assembly  
HISTORY OF SENATE BILL S 993  
MEDICAL SERVICE CORP. CHARTERS  
by: RAND

Date: 1/ 4/98  
Time: 12:42 p.m.  
Page: 1  
Leg. day:H-123/S-123

---

Introduced 4-21-97 by: RAND  
GS Chapters: 58

Date		Action
4-21-97	S	REF TO COM ON RULES &
4-29-97	S	REPTD FAV COM SUBSTITUTE
4-29-97	SA	COM SUBSTITUTE ADOPTED
4-29-97	S	PLACED ON CAL FOR 04-30
4-30-97	SA	AMEND ADOPTED #1
4-30-97	S	PASSED 2ND & 3RD READING
5- 1-97	H	REC FROM SENATE
5- 1-97	H	REF TO COM ON RULES
5-27-97	HA	REPTD FAV COM SUBSTITUTE
5-27-97	H	CAL PURSUANT RULE 36(A)
5-27-97	H	PLACED ON CAL FOR 05-28
5-28-97	H	POSTPONED TO 06-03
6- 3-97	HA	AMEND ADOPTED #1
6- 3-97	H	AMEND FAILED #2
6- 3-97	H	PASSED 2ND READING
6- 9-97	HA	AMEND ADOPTED #3,5,4
6- 9-97	H	AMEND FAILED #6
6- 9-97	H	PASSED 3RD READING
6-11-97	S	REC TO CONCUR H COM SUB
6-11-97	S	RE-REF COM ON RULES &
6-25-97	S	REPTD UNFAV FOR CONC
6-26-97	S	FAILED CONCUR IN COM SUB
7- 1-97	S	CONF COM APPOINTED
7- 2-97	H	CONF COM APPOINTED



GENERAL ASSEMBLY OF NORTH CAROLINA

SESSION 1997

S

3

SENATE BILL 993

Rules and Operations of the Senate Committee Substitute Adopted 4/29/97  
Third Edition Engrossed 4/30/97

Short Title: Medical Service Corp. Charters.

(Public)

---

Sponsors:

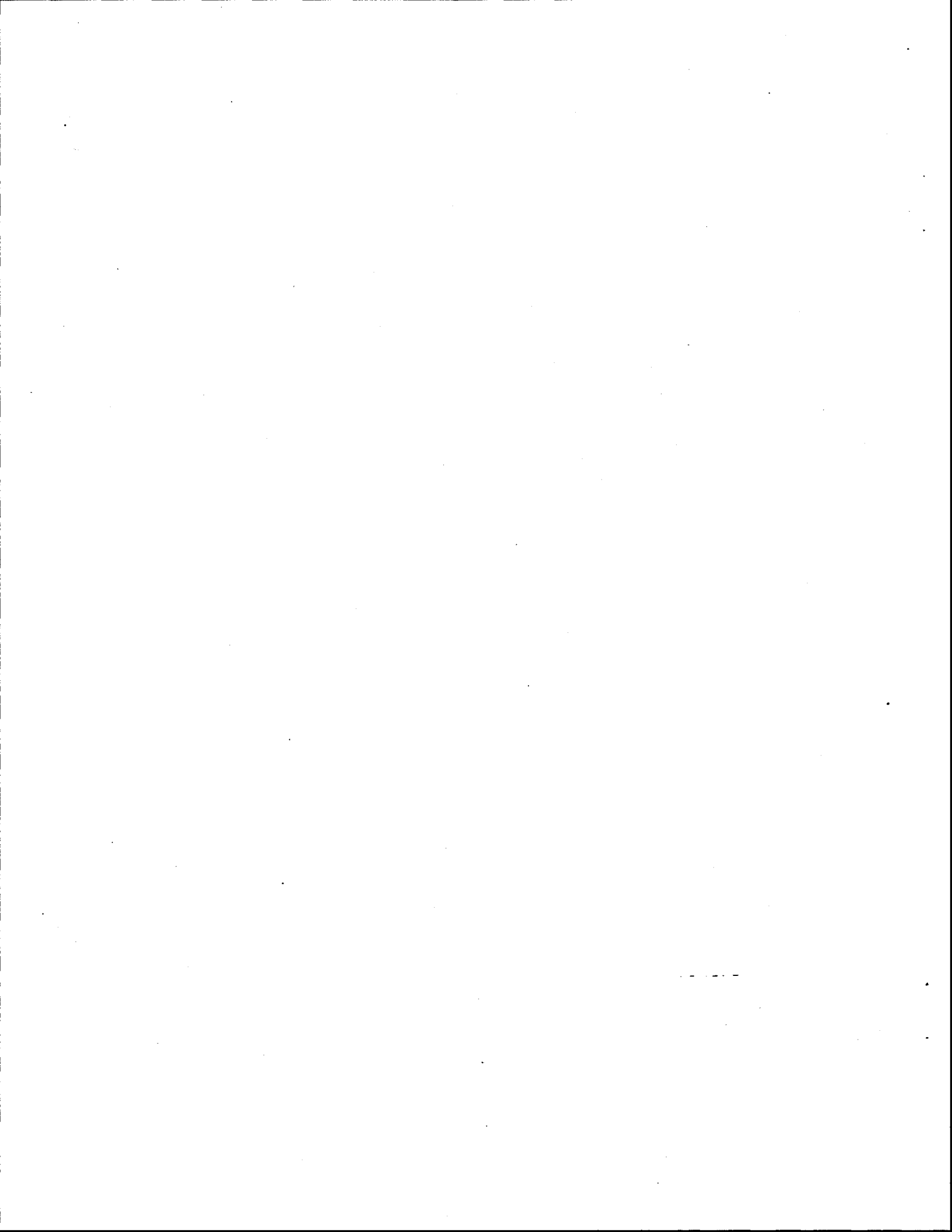
---

Referred to:

---

April 21, 1997

- 1                                   A BILL TO BE ENTITLED  
2 AN ACT TO AUTHORIZE THE COMMISSIONER OF INSURANCE TO ADOPT  
3 RULES TO PROTECT THE RIGHTS OF SUBSCRIBERS AND CERTIFICATE  
4 HOLDERS IN THE RESERVES AND CAPITAL OF HOSPITAL, MEDICAL,  
5 AND DENTAL SERVICE CORPORATIONS UPON CONVERSION.  
6 The General Assembly of North Carolina enacts:  
7           Section 1. The Commissioner of Insurance may adopt rules, after  
8 consultation with the Joint Legislative Commission on Governmental Operations, to  
9 protect adequately the rights of subscribers and certificate holders in the reserves and  
10 capital of corporations subject to the provisions of Articles 65 and 66 of Chapter 58  
11 of the General Statutes when those corporations amend their charters to convert into  
12 either a mutual nonstock or stock accident and health insurance company or life  
13 insurance company, as provided by G.S. 58-65-130(3).  
14           Section 2. This act is effective when it becomes law.



GENERAL ASSEMBLY OF NORTH CAROLINA

SESSION 1997

S

5

SENATE BILL 993

Rules and Operations of the Senate Committee Substitute Adopted  
4/29/97

Third Edition Engrossed 4/30/97  
House Committee Substitute Favorable 5/27/97  
Fifth Edition Engrossed 6/9/97

Short Title: Medical Service Corp. Charters.

(Public)

---

Sponsors:

---

Referred to:

---

April 21, 1997

1                                   A BILL TO BE ENTITLED  
2 AN ACT TO ESTABLISH PROCEDURES FOR CONVERSIONS BY HOSPITAL,  
3 MEDICAL, AND DENTAL SERVICE CORPORATIONS.  
4 The General Assembly of North Carolina enacts:  
5       Section 1. G.S. 58-65-130(3) reads as rewritten:  
6       "(3) The charter of any corporation subject to the  
7       provisions of this Article and Article 66 of this  
8       Chapter may be amended to convert that corporation,  
9       so amending its charter, into either a mutual  
10      nonstock or stock accident and health insurance  
11      company or life insurance company subject to the  
12      provisions of Articles 1 through 64 of this Chapter  
13      provided the rights of the subscribers or  
14      certificate holders in the reserves and capital of  
15      such corporation are adequately protected, ~~under~~  
16      ~~rules and regulations adopted by the Commissioner~~  
17      ~~of Insurance.~~ A corporation converting to a mutual  
18      nonstock or stock accident and health insurance  
19      company or life insurance company or otherwise

1 restructuring shall follow the provisions of G.S.  
2 58-65-131 through G.S. 58-65-134."

3 Section 2. Article 65 of Chapter 58 of the General  
4 Statutes is amended by adding the following new sections to read:  
5 "§ 58-65-131. Conversion; procedure.

6 (a) It is the intent of the General Assembly by the enactment  
7 of this section and G.S. 58-65-132 through G.S. 58-65-134 to  
8 create a procedure for a corporation subject to this Article to  
9 convert to a mutual nonstock or stock accident and health  
10 insurance company or life insurance company subject to Articles 1  
11 through 64 of this Chapter. The General Assembly recognizes the  
12 substantial and recent changes in market and health care  
13 conditions that are affecting these corporations and further  
14 recognizes the need for equal regulatory treatment and  
15 competitive equality for health care insurers. The General  
16 Assembly further finds that a procedure for conversion is in the  
17 best interest of policyholders because it will provide greater  
18 financial stability for the corporations' policyholders and a  
19 greater opportunity for the corporations to remain financially  
20 independent.

21 (b) As used in this section and G.S. 58-65-132 through G.S.  
22 58-65-134:

23 (1) 'Corporation' means a corporation subject to this  
24 Article that attempts to convert from a hospital,  
25 medical, or dental service corporation to a mutual  
26 nonstock or stock accident and health insurance  
27 company or life insurance company and that files a  
28 plan of conversion with the Commissioner under  
29 subsection (e) of this section.

30 (2) 'New corporation' means a corporation originally  
31 subject to this Article that has had its plan of  
32 conversion approved by the Commissioner under  
33 subsection (e) and that has actually converted to a  
34 mutual nonstock or stock accident and health  
35 insurance company or life insurance company.

36 (c) A corporation may amend its charter pursuant to this  
37 Article to convert the corporation to a mutual nonstock or stock  
38 health and accident insurance company or life insurance company  
39 subject to Articles 1 through 64 of this Chapter. The amended  
40 charter shall be filed with the Commissioner for approval  
41 pursuant to G.S. 58-65-130(3), together with a plan for  
42 conversion setting forth provisions for fulfilling the conditions  
43 necessary to effect the conversion and a designated date upon  
44 which the conversion shall become effective if these conditions

1 are fulfilled. Upon the designated date set forth in the plan,  
2 the corporation shall become subject to the applicable laws as  
3 provided in subsection (h) of this section and shall no longer be  
4 subject to this Article and Article 66 of this Chapter.

5 (d) A corporation subject to this Article shall file a plan  
6 for conversion with the Commissioner at least 120 days before the  
7 proposed date of conversion. The corporation shall reimburse the  
8 Department for the actual cost of reviewing, analyzing, and  
9 processing the application. The Commissioner may contract with  
10 experts or consultants to assist in reviewing the application.  
11 Contract costs for these personal professional services shall not  
12 exceed an amount which is reasonable and necessary for the review  
13 of the application. A personal professional services contract  
14 entered into under this subsection is exempt from Article 3C of  
15 Chapter 143 of the General Statutes. The corporation filing an  
16 application for conversion shall promptly pay, upon request, for  
17 all costs of these personal professional services.

18 (e) A corporation that has amended its charter to convert the  
19 corporation to a mutual nonstock or stock accident and health  
20 insurance company or life insurance company shall fulfill the  
21 conditions necessary to effect the conversion if the plan of  
22 conversion sets forth with specificity the following terms and  
23 conditions of the proposed conversion:

- 24 (1) The purpose of the conversion.
- 25 (2) The articles of incorporation of the new  
26 corporation, including a description of the classes  
27 of policyholders or shareholders.
- 28 (3) The bylaws of the new corporation.
- 29 (4) A description of any changes in the new  
30 corporation's mode of operations after conversion.
- 31 (5) A statement describing the manner in which the plan  
32 provides for the protection of all existing  
33 contractual rights of the corporation's subscribers  
34 or certificate holders for medical, hospital, or  
35 dental service or claims for reimbursement for  
36 those services, and the manner in which the plan  
37 protects the public interest.
- 38 (6) A statement that the new corporation assumes all  
39 assets and liabilities of the previous corporation.
- 40 (7) Documentation showing that the corporation, its  
41 board of directors, trustees or other governing  
42 authority and its subscribers or certificate  
43 holders have approved the plan in accordance with



- 1           the corporation's articles of incorporation and  
2           bylaws.
- 3           (8) The business plan of the new corporation,  
4           including, but not limited to, a comparative  
5           premium rate analysis of the new corporation's  
6           major plans and product offerings, that, among  
7           other things, compares actual premium rates for the  
8           three-year period before the filing of the  
9           application for conversion and forecasted premium  
10           rates for a three-year period following the  
11           proposed conversion. This rate analysis shall  
12           address the forecasted effect, if any, of the  
13           proposed conversion on the cost to subscribers or  
14           policyholders of the new corporation and on the new  
15           corporation's underwriting profit, investment  
16           income, and loss and claim reserves, including the  
17           effect, if any, of adverse market or risk selection  
18           upon these reserves. Any information provided  
19           under this subsection shall receive confidential  
20           treatment pursuant to G.S. 58-19-40.
- 21           (9) The plan provides for definite conditions to be  
22           fulfilled by a designated early date upon which the  
23           conversion will be deemed effective.
- 24           (f) The Commissioner of Insurance shall approve the plan of  
25           conversion and issue a certificate of authority to the filing  
26           corporation to transact insurance in this State pursuant thereto  
27           if the Commissioner finds all of the following:
- 28           (1) The plan of conversion meets the requirements of  
29           subsection (e) of this section.
- 30           (2) Upon conversion, the new corporation will meet the  
31           applicable standards and conditions under this  
32           Chapter, including applicable minimum surplus  
33           requirements.
- 34           (3) The plan would not be contrary to law nor to the  
35           rights of the subscribers or certificate holders in  
36           the reserves and capital of the corporation.
- 37           (4) No director, officer, or employee of any hospital,  
38           medical and dental service corporation will  
39           receive:
- 40           a. Any fee, commission, compensation or other  
41           valuable consideration for aiding, promoting,  
42           or assisting in the conversion of the  
43           hospital, medical and dental service  
44           corporation to a domestic mutual insurer,

- 1                   other than compensation paid to any director,  
2                   officer, or employee of the corporation in the  
3                   ordinary course of business; or  
4            b.   Any distribution of the assets, surplus, or  
5                   capital of the corporation as part of a  
6                   conversion.
- 7            (5)   The corporation has complied with all applicable  
8                   requirements of this Chapter, and disciplinary  
9                   action is not warranted against the corporation.
- 10           (6)   The plan is fair and equitable, and not prejudicial  
11                   to the subscribers and certificate holders of the  
12                   corporation and the subscribers and policyholders  
13                   of the new corporation.
- 14           (7)   The plan is in the public interest.
- 15           (g)   A plan of conversion that meets the requirements of  
16                   subsection (e) of this section and is approved by the  
17                   Commissioner pursuant to subsection (f) is rebuttably presumed to  
18                   protect adequately the rights of the subscribers or certificate  
19                   holders in the reserves and capital of the corporation and to be  
20                   fair and equitable and not prejudicial to the subscribers or  
21                   certificate holders of the corporation, the subscribers or  
22                   policyholders of the new corporation, and the public interest,  
23                   except in any declaratory judgment or other legal action brought  
24                   by the Attorney General.
- 25           (h)   The Commissioner of Insurance and the Attorney General may  
26                   seek a declaratory judgment or take any other legal action  
27                   necessary to enforce the charitable trust provisions of G.S. 58-  
28                   65-134.
- 29           (i)   Upon completion of the corporation's conversion as  
30                   provided for in this section and G.S. 58-65-132 through G.S. 58-  
31                   65-134, the new corporation shall be subject to and comply with  
32                   all applicable laws and regulations applicable to domestic  
33                   insurers.
- 34           (j)   The provisions of subdivision (f)(4) of this section shall  
35                   apply to any subsequent conversion by the new corporation.  
36                   "§ 58-65-132. Rules and procedures.
- 37           (a)   Upon receiving an application to convert, the Commissioner  
38                   shall publish a notice in one or more newspapers of general  
39                   circulation in the corporation's service area describing the name  
40                   of the corporation, the nature of the plan filed under G.S. 58-  
41                   65-131(d), and the date of receipt of the plan. The notice shall  
42                   indicate that the Commissioner will solicit public comments and  
43                   hold a public hearing on the application.

1 (b) All applications, reports, plans, or other documents under  
2 this section are public records unless otherwise provided in this  
3 Chapter. The Commissioner shall provide the public with prompt  
4 and reasonable access to public records relating to conversion of  
5 the corporation. Access to public records covered by this  
6 section shall be made available at least one month before a  
7 solicitation for public comments or public hearing scheduled  
8 under this section.

9 (c) Before approving a conversion, the Commissioner shall  
10 solicit public comments in written form and shall hold at least  
11 one public hearing about the corporation's proposal to comply  
12 with the requirements for conversion.

13 (d) The Commissioner shall approve a conversion if he finds  
14 that the corporation has met all requirements contained in G.S.  
15 58-65-130 through G.S. 58-65-134.

16 "§ 58-65-133. Restructuring of corporation.

17 (a) A corporation that intends to restructure must obtain the  
18 prior approval of the Commissioner.

19 (b) For purposes of this section, a 'restructure':

20 (1) Is the sale, lease, conveyance, exchange, transfer,  
21 or other similar disposition of a substantial  
22 amount of the corporation's assets, as determined  
23 by the Commissioner, to an entity other than a  
24 nonprofit business or entity. Nothing in this  
25 section prohibits the Commissioner from  
26 consolidating actions taken by the corporation for  
27 the purpose of treating the consolidated actions as  
28 a restructuring of the corporation.

29 (2) Does not include any sales or purchases undertaken  
30 in the normal and ordinary course of the  
31 corporation's business. The Commissioner may  
32 request information from the corporation to verify  
33 that transactions qualify as occurring in the  
34 normal and ordinary course of corporate business.

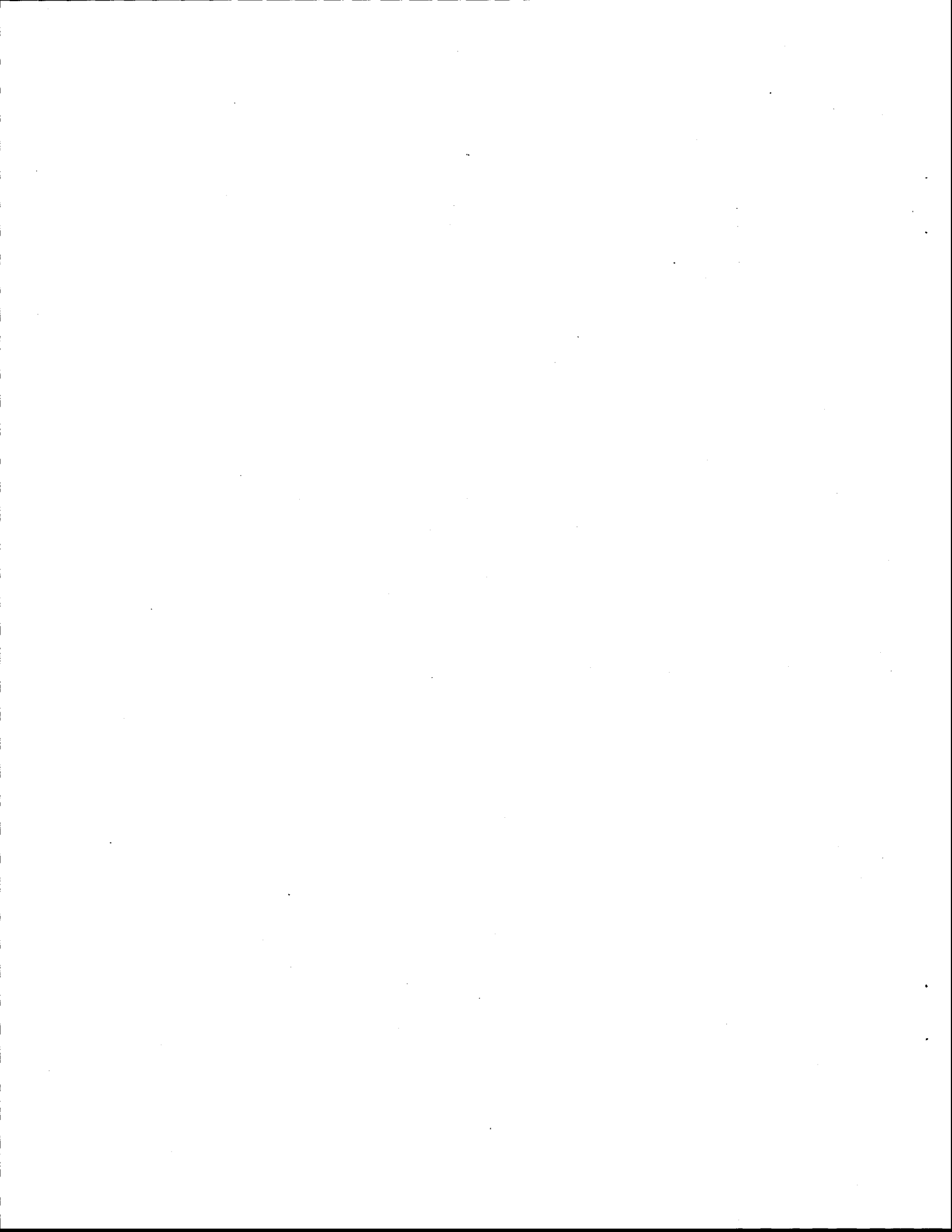
35 (c) The Commissioner shall not approve any restructuring that  
36 in the Commissioner's opinion seeks to effect a conversion unless  
37 the provisions of G.S. 58-65-130 through G.S. 58-65-132 and G.S.  
38 58-65-134 are met with respect to the restructuring.

39 "§ 58-65-134. Distribution of assets.

40 In evaluating the interest of the subscribers, policyholders,  
41 and the public pursuant to G.S. 58-65-131(f), and after  
42 considering the portion of the corporation's surplus, if any,  
43 that belongs to the subscribers or policyholders of the  
44 corporation and new corporation, the Commissioner, with the

1 advice of the Attorney General, shall consider what portion of  
2 the corporation's surplus is subject to a charitable trust for  
3 the benefit of the citizens of North Carolina. The corporation  
4 shall provide to the Commissioner, at the Commissioner's request,  
5 information necessary to determine the appropriate fair market  
6 value of any charitable trust amount."

7           Section 3. This act is effective when it becomes law.





**DEPARTMENT OF INSURANCE**

*State of North Carolina*

P. O. Box 26387

RALEIGH, N. C. 27611-6387

**JIM LONG**  
COMMISSIONER OF INSURANCE

**GENERAL COUNSEL**  
(919) 715-0011

**NORTH CAROLINA DEPARTMENT OF INSURANCE  
REMARKS OF 1/5/98 TO THE BCBS CONVERSION  
LEGISLATIVE STUDY COMMISSION**

**I. Introduction and the Department of Insurance's Role.**

The North Carolina Department of Insurance ("DOI") would like to thank the Study Commission for the opportunity to participate in this most important issue. The DOI's General Counsel, Peter A. Kolbe, will represent the DOI in lieu of the Commissioner of Insurance ("the Commissioner") because the most recent version of S.B. 993 provides for the Commissioner to serve as the decision maker with respect to Blue Cross Blue Shield's ("BCBS") charitable trust obligations. Given the role of the Commissioner as contemplated by S.B. 993, the Commissioner himself cannot take any substantive position on the charitable trust issues without prejudicing any proceedings in which he would serve as a decision maker.

However, the Commissioner does view the BCBS conversion issue as one of tremendous importance to both BCBS's subscribers ("policyholder") and the people of North Carolina. Consequently, the Commissioner has directed his staff to develop positions on the conversion while maintaining a "Chinese wall" around himself to preserve his impartiality.

The positions of the DOI staff are the result of the efforts of an internal DOI working group which the Commissioner established nearly two years ago. This working group was formed to follow and analyze various aspects of for profit conversions in light of the rash of conversion activity amongst Blue Cross Blue Shield plans across the country. Contributors to this working group are the DOI's General Counsel, Legislative Counsel, Chief Actuary, Chief Financial Examiner, head of the Life and Health Division, accountants, and life and health actuaries. Various other DOI employees have also been involved in the working group without sitting as permanent members of the same.

In the two years that the DOI has been looking at the conversion issue, it has benefited tremendously from its affiliation with the National Association of Insurance Commissioners ("NAIC") as well as with individual state insurance regulators in our sister states. The information provided by the NAIC and other states has allowed the DOI to gain what it believes to be an excellent background in the various problems and issues

attendant to any BCBS conversion to "for profit" status. It is the DOI's sincere desire to serve as a resource to the members of this Study Commission, and it looks forward to providing any assistance or knowledge it can.

## II. DOI Positions on Certain Substantive Conversion Issues.

While there are dozens of issues to be addressed in any conversion, and with the latest version of S.B. 993 in particular, the time constraints at this first meeting mandate brevity. Consequently, only a very few of the DOI's positions will be addressed at this first meeting. These positions are as follows:

### A. A Charitable Trust Should Be Imposed on the Assets of BCBS.

The DOI believes that Blue Cross Blue Shield is and has been a non profit "charitable and benevolent organization" such that assets representing its fair market value are subject to a charitable trust for the people of North Carolina should it convert to "for profit" status, either as a mutual insurer or as a stock insurer. The basis for this belief is set out in a legal opinion by Peter A. Kolbe, the DOI's General Counsel, dated May 22, 1997 (a copy of which is attached to these DOI Remarks as Exhibit "A").

The DOI's legal position has been bolstered by a recent New Jersey appellate decision wherein a New Jersey Appeals Court held that Blue Cross Blue Shield of New Jersey was a "charitable and benevolent institution." The basis of the New Jersey Appellate Court's decision was the language of the statute which created Blue Cross Blue Shield of New Jersey, which language described that entity as "a charitable and benevolent institution." This language is almost identical to that found in the North Carolina legislation which allowed for our BCBS plan. Former N.C.G.S. § 57-14 declared entities such as BCBS to be "charitable and benevolent organizations" and thus entitled to tax breaks. Many of the other arguments of Blue Cross Blue Shield of New Jersey that it was not a charity, such as the argument that it received monies from premiums as opposed to charitable donations and thus was not a charity, were rejected by the Court. Many of these arguments unsuccessfully espoused by Blue Cross Blue Shield of New Jersey have recently been raised by our own BCBS. (A copy of the New Jersey opinion is attached to these DOI remarks as Exhibit "B").

### B. Imposition of a Charitable Trust Must Not Destroy the Rights of BCBS Policyholders.

While the DOI believes that imposition of a charitable trust is appropriate, doing so should not obviate the rights of BCBS's policyholders. Policyholders have three rights with respect to the assets of BCBS.

First, they have rights in certain assets of the company which are dedicated to claims liabilities. In other words, policyholders have a right to have their claims paid.

Second, policyholders have a right to have their policies with an insurer which is as financially healthy post-conversion as it was pre-conversion. The significant weakening of BCBS by pulling out cash assets in a conversion could, in essence, create a situation where suddenly policyholders have their policies with a fiscally weaker insurer than from which they originally bought coverage.

Third, to the extent that BCBS converts to "mutual status," which both our current law (N.C.G.S. § 58-65-130) and S.B. 993 permit, the policyholders would become owners of the company, at least to the extent of any incremental increase in the value of BCBS from the date of its mutual conversion to the date of any subsequent stock conversion.

The Commissioner has the statutory duty to look after these policyholder rights, and S.B. 993 recognizes this in that it permits the Commissioner to disapprove a conversion if policyholder rights are not protected. While there has been something of a recent "feeding frenzy" over the charitable trust issue, the DOI asks the members of the Study Commission to take into consideration policyholder rights in its deliberations.

**C. Mutualization Poses Grave Problems in a Conversion.**

The DOI adamantly opposes the ability of BCBS to mutualize, as is allowed by current law and S.B. 993. Mutualization is a bad idea in the conversion context for three reasons.

First, upon mutualization there would exist two classes of owners of BCBS - the public and the mutual policyholders. The mutual policyholders would own at least any increase in the value of BCBS from the date of mutualization to the date of any subsequent conversion to a stock company. In essence, if mutual policyholders would own some assets of BCBS, then there would necessarily be fewer assets left to be placed in a charitable trust for the people of North Carolina.

Second, upon conversion to mutual company status, little or no money could come out of BCBS for charitable trust purposes. Simply put, if money is ripped out of the new mutual company it must come from pools dedicated to claims payments or from "unassigned funds" which are probably necessary to allow the company to continue to remain healthy and to grow. This is in contrast to conversion to a stock company, in



which new money would flow in to BCBS from an initial public stock offering. In a stock offering, the proceeds of the offering could go to a charitable trust without taking a dime of current cash from BCBS. However, in a mutualization, the depletion of assets from BCBS for charitable trust purposes would not be offset by new monies flowing in as would be the case in a stock conversion, to the potential detriment of policyholders.

Third, mutualization raises the potential of a "mutual holding company" scheme whereby a mutual company splits into a mutual holding company and a stock insurance subsidiary. This scheme allows isolation of mutual policyholder rights at the holding company level without enjoyment of the profits of the stock subsidiary. Also, there is some doubt that assets for a charitable trust could be taken out of the mutual holding company for the reasons stated, even though the mutual holding company has a stock subsidiary. While North Carolina does not allow mutual holding companies, many states do, and a mutualized BCBS could potentially merge with a mutual company in another state which does allow for mutual holding companies.

Consequently, the DOI opposes allowing BCBS to mutualize.

D. Valuation

There is currently a "feeding frenzy" about using the "reserves" and "surplus" of BCBS for charitable trust purposes. These are dangerous ideas because most of BCBS's current assets, which include reserves and surplus, are necessary for the company to remain healthy and to meet its claims obligations. The key in the DOI's view is placing the entire fair market value of the BCBS in a charitable trust without stripping away its reserves, surplus, etc. Placing the fair market value of BCBS in a charitable trust without depleting necessary assets could be accomplished by 1) BCBS creating stock and giving it to the charitable trust or 2) BCBS could make an initial public offering of stock in the capital markets and place the cash proceeds in the charitable trust, although both approaches have some difficulties.

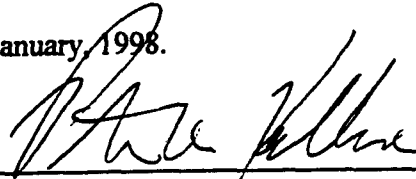
E. S.B. 993 Is the Best Starting Point for Discussion of the Conversion Issue.

S.B. 993 provides a solid format for discussion of all conversion issues. While it has some problems - the DOI thinks it lacks certain things while also believing certain aspects of it should be deleted - it represents a comprehensive framework upon which to build.

III. Conclusion

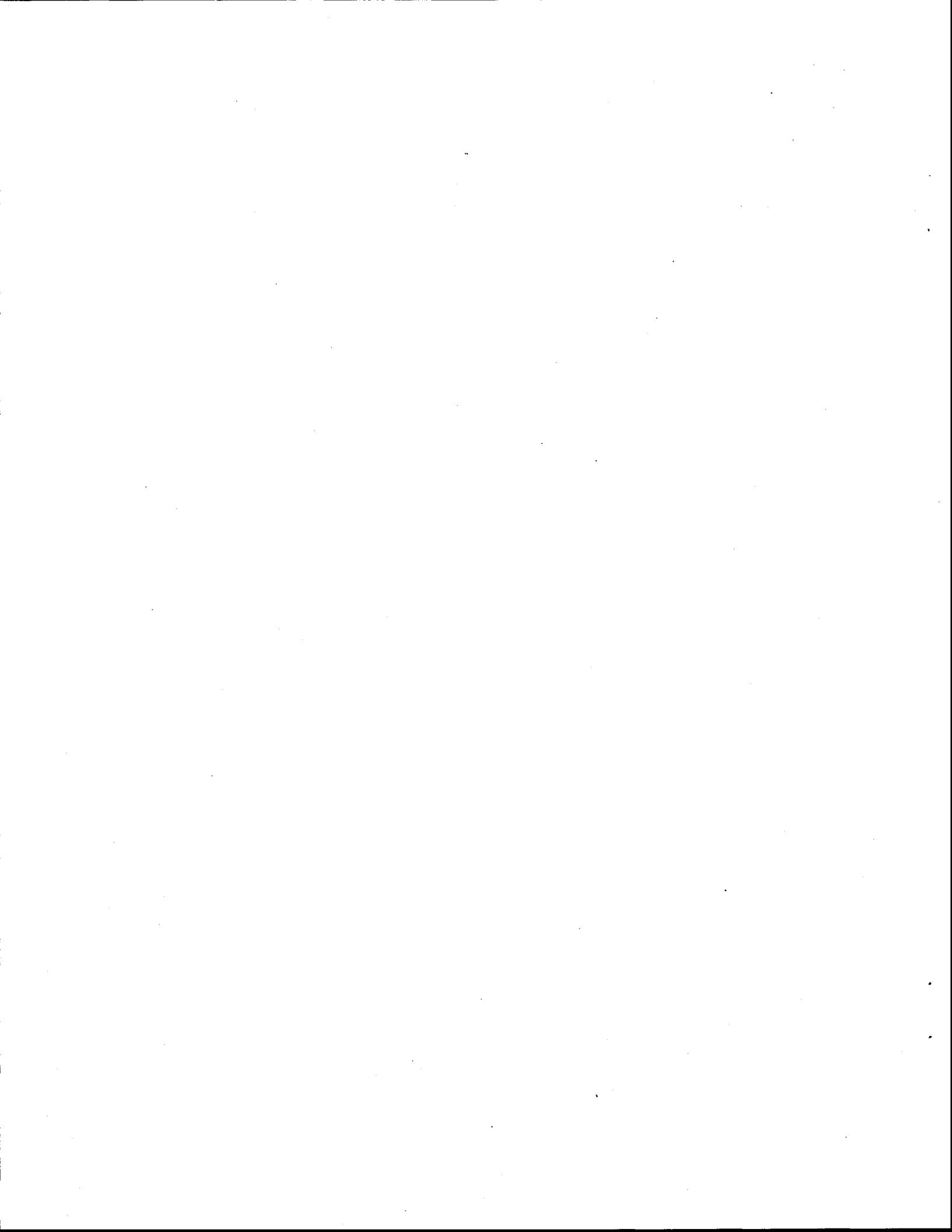
The DOI again thanks the Study Commission for the opportunity to participate and looks forward to serving as a resource.

Respectfully submitted, this 5<sup>th</sup> day of January, 1998.

A handwritten signature in black ink, appearing to read "Peter A. Kolbe", written over a horizontal line.

Peter A. Kolbe  
General Counsel

Attachments (Exhibits A and B)





DEPARTMENT OF INSURANCE  
*State of North Carolina*

P. O. Box 26387  
RALEIGH, N. C. 27611-6387

JIM LONG  
COMMISSIONER OF INSURANCE

GENERAL COUNSEL  
(919) 715-0011

MEMORANDUM

TO: Dascheil Propes  
Assistant Commissioner

FROM: Peter A. Kolbe  
General Counsel

RE: BCBS Conversion

DATE: May 22, 1997

You had asked me to provide you with some points on the basis for asserting a charitable trust against North Carolina Blue Cross Blue Shield's surplus in the event of its conversion to a stock company. In this memorandum, "NCBCBS" refers to NCBCBS itself and its two predecessor corporations. This memorandum is a little more detailed than what you requested, but I think that you can easily extrapolate the information which you are seeking.

Charitable Trust Creation

At common law, the creation of a non-profit organization with charitable or other social welfare purposes results in a charitable trust that is irrevocably dedicated to the organization's original mission. To the extent a non-profit entity carries out charitable or public welfare purposes, the general public is essentially an owner and shareholder of the same. The money made by such a non-profit must remain with the non-profit and be used to further its charitable or public welfare purposes, or for some substantially similar purpose under the *Cy pres* doctrine.

Although such non-profit corporations exist for the public good, they often have built up massive reserves, assets and surpluses over the many years in which no taxes were paid on those monies. In determining whether the charitable trust doctrine should apply to an organization, one needs to look at both the purpose of the organization and its tax status. While it is logical to believe that tax exemptions are only granted by governments to entities serving some public benefit, even if such were not the case, communities give up millions of dollars in revenue from non-profit corporations' tax exemptions. Simply put, the public's tax burden pays what would

*Chron file*

otherwise be the non-profit's share. These tax benefits alone may give rise to the application of a charitable trust.

### **Factors Used in Determining the Existence of a Charitable Trust**

In determining whether a non-profit corporation is subject to the charitable trust doctrine, courts have considered the following:

- 1) do the bylaws or articles of incorporation of the non-profit specify that it was established for a charitable purpose or to fulfill a public need or to serve the community?
- 2) do a state's laws indicate that the non-profit was created in whole or in part for charitable purposes or to fulfill a public need or to serve the community?
- 3) does the non-profit receive tax exemptions or breaks because it fulfills a public need or provides a public service?
- 4) does the non-profit file tax returns under an IRS tax classification of a charitable [501(c)(3)] or social welfare [501(c)(4)] organization?
- 5) what actual public welfare benefits does the non-profit provide?

It should be noted that the factors above include the existence of a charitable purpose, but such is not absolutely necessary in applying the charitable trust doctrine. For example, an entity which serves a public need but which does not give away health care insurance, does not accept donations, and files under IRS Regulation 501(c)(4) [non charity] may still be considered a "charity" so as to be subject to a charitable trust. (See In re application of Blue Cross and Blue Shield of New Jersey, Inc., for Conversion to a Domestic Mutual Insurer, Superior Court of New Jersey - Essex County, Docket No. ESX-L-1591-97.)

### **Application of Charitable Trust Determination Factors to NCBCBS**

#### **Bylaws And Articles**

Neither the corporate documents of NCBCBS nor of its predecessor corporations mention any sort of charitable purpose or public benefit.

#### **Legislative Enactment Indicating a Charitable and Benevolent Organization**

NCBCBS exists under the terms of a legislative enactment. More specifically, the Medical Services Corporation Act became law in 1941 and provided for the existence of NCBCBS and similar entities. In its original version, N.C.G.S. § 57-14 (now article 65 of Chapter 58) declared that a hospital service corporation such as NCBCBS was a "charitable and

benevolent corporation" and was entitled to tax exemptions based on that charitable and benevolent status. While the Medical Services Corporation Act was amended in 1973 and deleted the reference to a "charitable and benevolent corporation," NCBCBS continued forward from that date with tax breaks based on its charitable and public welfare status. (See discussion on tax breaks, infra). So, despite the deletion of the referenced language, the fact that NCBCBS received charity engendered tax breaks after such deletion indicates that, regardless of what wording was used, the North Carolina General Assembly continued to recognize it as providing charitable or public benefits.

### Tax Breaks

From its creation in 1941, NCBCBS paid no federal income tax until 1987. Although NCBCBS apparently never claimed an exemption as an IRS 501(c)(3) charity, until 1987 it did claim a tax exemption as a "social welfare organization" under IRS 501(c)(4). This tax status is important because, in determining the applicability of the charitable trust doctrine, courts across the country have looked not only to 501(c)(3) "charity" status, but also to 501(c)(4) status.

While the Tax Reform Act of 1986 deprived NCBCBS of its 501(c)(4) status, until that time BCBS enjoyed large federal tax breaks, and the public paid more in taxes in consequence thereof. That same Act provides that BCBS organizations may qualify for a special deduction from tax, 26 U.S.C. § 833. In any event, for most of its existence NCBCBS was calling itself a "social welfare organization" under 501(c)(4) as an admission that it existed for a public good or benefit.

On the state level, NCBCBS has enjoyed a lower premium tax rate than other domestic companies for years. While domestic carriers pay 1.9% of premiums pursuant to N.C.G.S. § 105-228.5, NCBCBS pays only ½ of 1% of premiums. Similarly, NCBCBS pays no regulatory surcharge pursuant to N.C.G.S. § 58-6-25 while other domestic companies pay 7.25% of their premium taxes as a surcharge. While BCBS argues that it is a de facto mutual company, mutual companies do not enjoy such tax breaks. What then is the difference for the preferential state tax status given to NCBCBS? The logical answer is that it fulfills a public good or purpose. This conclusion is borne out by the 1973 Amendments to the Medical Services Corporation Act, which originally defined NCBCBS as a "charitable and benevolent organization" which paid no state taxes. In 1973 that wording was deleted from the Act, and NCBCBS had to pay a premium tax of 1/3 of 1%, a rate far lower than that paid by other companies. Thus, despite the removal of the terms "charitable" and "benevolent," the only basis for a continuing state tax brake must have been the fact that the General Assembly continued to recognize NCBCBS's role as a charity or as serving the public good.

### NCBCBS Has Acted for the Public Good

Throughout its history, NCBCBS has served the public good of North Carolina. Three examples of this are as follows. First, the very creation of NCBCBS was in part to provide a

source of coverage for consumers. (Walter McNerney. 1996. "Big Question for the Blues: Where to Go From Here?" *Inquiry* 33(2):110-117). Second, up until at least 1973, NCBCBS offered "Easy Joining Days." a form of open enrollment whereby *anyone* in the state could apply for coverage without medical underwriting. Such action was virtually unheard of with respect to individual policies, and was a tremendous benefit to North Carolinians who may not have been insurable by other carriers. Third. NCBCBS currently offers its Access Program whereby, if an individual cannot obtain health coverage through other insurers, NCBCBS will write a limited benefit policy although without any subsidization of premiums. In essence then. through its Access Program, NCBCBS is an insurer of last resort to the citizens of this state. Through these three examples, it is apparent that NCBCBS does serve a public benefit.

### Conclusion

Given the fact that NCBCBS was created as a charitable and benevolent organization, received and continues to receive tax breaks in recognition of that status. and has and does serve the public welfare of this state. it is appropriate to apply the charitable trust doctrine to it. The failure to do so would constitute the unjust enrichment of NCBCBS and its future stockholders in a conversion.

Exhibit "B"

State of New Jersey





## State of New Jersey

DEPARTMENT OF LAW AND PUBLIC SAFETY  
DIVISION OF LAW  
RICHARD J. HUGHES JUSTICE COMPLEX  
25 MARKET STREET  
CN 117  
TRENTON, NJ 08625-0117  
E-Mail: goldmmic@law.dol.lps.state.nj.us

CHRISTINE TODD WHITMAN  
Governor

PETER VERNIERO  
Attorney General

JAYNEE LAVECCHIA  
Assistant Attorney General  
Director

(609) 292-7669

October 24, 1997

Greg Stites  
National Association of  
Insurance Commissioners  
120 West 12th Street, Suite 11  
Kansas City, MO 64113

Re: I/M/O of the Application of BC/BS NJ For  
Conversion to a Domestic Mutual Insurer  
Pursuant to N.J.S.A. 17:48E-45  
Docket No. A-4505-96T1

Dear Mr. Stites:

For your information, enclosed is a copy of the Appellate Division opinion in the above-captioned matter affirming Judge Weiss' ruling that BC/BS NJ is a charitable and benevolent institution.

Sincerely yours,

PETER VERNIERO  
ATTORNEY GENERAL OF NEW JERSEY

By: Michael E. Goldman  
Michael E. Goldman  
Deputy Attorney General

MEG/mf  
Encl.

F:\BCBS\STITES.LTR

NOT FOR PUBLICATION WITHOUT THE  
APPROVAL OF THE APPELLATE DIVISION

SUPERIOR COURT OF NEW JERSEY  
APPELLATE DIVISION  
A-004505-96T1

FILING DATE  
APPELLATE DIVISION

In The Matter of the Application  
of Blue Cross and Blue Shield of  
New Jersey, Inc., For  
Conversion to a Domestic  
Mutual Insurer Pursuant  
to N.J.S.A. 17:48E-45 to -48.

OCT 24 1997

  
Clerk

---

Argued September 30, 1997 - Decided **OCT 24 1997**

Before Judges Long, Kimmelman, and Bilder.

On appeal from the Superior Court of New  
Jersey, Law Division, Essex County.

Andrew T. Berry argued the cause for appellant  
(McCarter & English, attorneys; Mr. Berry and  
B. John Pendelton, Jr., of counsel; Mr.  
Pendelton, Michael A. Guariglia, Gerard G.  
Brew, Beth Yingling, and Andrew O. Bunn, on  
the brief).

Michael E. Goldman, Deputy Attorney General  
argued the cause for respondent Commissioner  
of Banking and Insurance (Peter Verniero,  
Attorney General, and Drinker Biddle & Reath,  
attorneys; (Jaynee Lavecchia, Assistant  
Attorney General, of counsel; Mr. Goldman,  
Samuel W. Lambert, III, Charles H. Wampold,  
III, Daniel W. Krane and Paul E. Saint-  
Antoine, on the brief).

Zazzali, Zazzali, Fagella and Nowak, attorneys  
for amicus curiae Subscriber (James R.  
Zazzali, of counsel; Mr. Zazzali and Aileen M.  
O'Driscoll, on the brief).

Renee Steinhagen, attorney for amicus curiae  
New Jersey Citizen Action and the Public  
Interest Law Center of New Jersey (Ms.  
Steinhagen, of counsel and on the brief).

Julie Silas, Mark Scherzer, A. Christopher Wieber and Louis S. Raveson, attorneys for amicus curiae Consumers Union of U.S., Inc.; Natalie Seto and Mr. Raveson, attorneys for amicus curiae Community Catalyst Inc. (Mr. Scherzer and Mr. Wieber, of counsel and on the brief).

PER CURIAM

Blue Cross and Blue Shield of New Jersey, Inc. ("BCBSNJ") appeals from the entry of judgment declaring it to be a "charitable and benevolent institution" within the meaning of N.J.S.A. 47:48E-41.

The case arose on October 15, 1996 when BCBSNJ filed an application with the Department of Banking and Insurance (the "Department") seeking approval of its plan for conversion from non-profit health service corporation status to for-profit domestic mutual insurer status. The conversion was part of a merger agreement between BCBSNJ and Anthem Insurance Companies, Inc., an Indiana based, for-profit mutual insurance company.

By letter dated November 14, 1996, the Department advised BCBSNJ that its conversion plan was incomplete and requested that additional information be provided. More particularly, the Department stated:

(19) Please provide a detailed statement setting forth the amount of any funds that have been donated to BCBS or any affiliate since its formation, describing any restrictions with respect to such funds. Furthermore, please set forth the amount of any funds, whether or not donated, which have been set aside by BCBS or an affiliate for charitable, non-profit, or other specific restricted purposes.

(20) Please explain how the proposed Conversion, the Subsequent Transactions, and the Associated Transactions will further BCBS's purposes as a social welfare organization.

BCBSNJ responded to the Department's letter on December 6, 1996, providing some additional information and also objecting to the questions regarding BCBSNJ's charitable obligations: It stated in part:

In so far as your letter interposes questions with respect to the creation of a charitable trust, or in any other way asks questions with respect to whether or not BCBSNJ has "charitable assets", we believe that such questions to the extent they are appropriate, may be posed only by the Attorney General; and that answers may not be required by the Department as a condition precedent to acceptance of the filing. We note, however, that such questions have been answered by the enactment of N.J.S.A. 17:48E-45, et seq. which specifically provides for the transfer of all of BCBSNJ's assets to a mutual company and conveyance of ownership of that company to its members. We believe the rejection on the grounds stated that such information is necessary for consideration of the filing is also not appropriate and unsupported by law.

The Attorney General informed BCBSNJ by letter on December 31, 1996, that he had advised the Commissioner of Banking and Insurance (the "Commissioner") to regard BCBSNJ as a statutory charitable organization and as a charity under the common law.

On January 6, 1997, BCBSNJ filed a Notice of Appeal from the Department's November 14, 1996 letter. Despite the pending appeal, the Department, by letter dated January 29, 1997 again advised

BCBSNJ that its application remained incomplete and requested additional information.<sup>1</sup>

BCBSNJ filed an Action in Lieu of Prerogative Writs on February 10, 1997, seeking among other things, a judgment that it is not a charity; a declaration enjoining the Commissioner from imposing any charitable exactions on it; and a declaration that its mutualization application is complete and approved. BCBSNJ then filed an Order to Show Cause on February 13, 1997 to which the Department filed an opposition and a Motion to Dismiss. The Order to Show Cause contained the same prayers for relief as the complaint.

At oral argument before Alvin Weiss, A.J.S.C., BCBSNJ withdrew from consideration all issues except for the question of whether it is a "charity under applicable law." Judge Weiss declared the language of relevant statutes, N.J.S.A. 17:48E-41, its predecessor N.J.S.A. 17:48-18 and N.J.S.A. 17:48A-24 to be clear and unequivocal:

But based on the plain language of the Statute, and the history on -- and the fact that this Statute has been in existence since 1938, I am satisfied that a declaratory judgment should be entered declaring that Blue Cross/Blue Shield of America -- of New Jersey, Inc., rather, is a charitable institution.

The court is not in any way passing on any of the other questions which were initially raised by the plaintiffs, such as if there is a charitable institution, how much or what portion of its assets the Commissioner may require as a charitable exaction, if any. That the Court leaves to the expertise of the

---

BCBSNJ ultimately advised the Department that it would not respond due to the pendency of appellate review.

Commissioner and the proceedings -- and the administrative proceedings before the Commissioner.

The sole issue again which this Court is deciding is that Blue Cross and Blue Shield of New Jersey, Inc. is a charitable and benevolent institution and nothing further.

An appeal from the order memorializing this ruling was filed on April 18, 1997. On that same date BCBSNJ moved before us to accelerate the briefing schedule and to consolidate this appeal with the previous related appeal. The Department moved to dismiss the earlier appeal and opposed to BCBSNJ's motion. On May 14, 1997, we granted the motion to accelerate the briefing schedule, denied the motion for consolidation as moot and dismissed the earlier appeal as premature.

On appeal, BCBSNJ argues that its assets cannot be impressed with a charitable obligation because it is not a public benefit organization; that cy pres is not relevant because BCBSNJ is not a charitable trust; that the Commissioner is without power to authorize a charitable exaction as a condition of mutualization; and that the Commissioner cannot constitutionally impose charitable obligations on BCBSNJ's assets. To the extent that each of these points involves the question of the Commissioner's power to exact a charitable contribution from BCBSNJ it raises an issue specifically waived below. More importantly, each exceeds the reach of Judge Weiss's extremely circumscribed opinion by suggesting that he ruled and, in turn, that we rule, on the Commissioner's right to exact a charitable obligation from BCBSNJ. Judge Weiss made no ruling on that issue. Indeed, he specifically

left that issue open. The sole point of his opinion, and all that is before us, is the question of whether BCBSNJ is a "charitable and benevolent institution." The answer to that limited question is a resounding "yes." "Charitable and benevolent" are the words used by the Legislature to describe BCBSNJ in N.J.S.A. 17:48-18, N.J.S.A. 17:48A-24, and N.J.S.A. 17:48E-41.

N.J.S.A. 17:48-18 provides:

Every corporation subject to the provisions of this chapter is hereby declared to be a charitable and benevolent institution, and all of its funds shall be exempt from every State, county, district, municipal and school tax other than taxes on real estate and equipment. (emphasis added).

Similarly, N.J.S.A. 17:48A-24 provides:

Any corporation subject to the provisions of this act is hereby declared to be a charitable and benevolent institution, and its funds and property shall be exempt from taxation by the State or any political subdivision thereof. (emphasis added).

N.J.S.A. 17:48E-41 also provides:

A health service corporation subject to the provisions of this act is hereby declared to be a charitable and benevolent institution and all of its funds shall be exempt from every State, county, district, municipal and school tax other than taxes on real estate and equipment and taxes on premiums pursuant to P.L. 1945, c. 132 (C.54:18A-1 et seq.) as provided by section 16 of that act (C.54:18A-9). (emphasis added).

In reaching the ineluctable conclusion that these statutes characterize BCBSNJ as a charitable and benevolent institution, Judge Weiss properly relied upon Merin v. Maglaki, 126 N.J. 430, 434 (1992), where the Supreme Court held that the "construction of

any statute begins with consideration of its plain language" and State v. Butler, 89 N.J. 220 (1982) where it was announced that the court "need delve no deeper than the act's literal terms" when it is "clear and unambiguous on its face and admits of only one interpretation". Id. at 226. Applying these canons of construction, along with the well settled principle that the legislature has the right to declare the status of institutions, (State v. LeVien, 82 N.J. Super. 29, 33 (Law Div. 1963), aff'd, 44 N.J. 323 (1965)), Judge Weiss reached the only possible conclusion on the limited issue before him. We affirm substantially for the reasons he expressed in his oral opinion of March 24, 1997.

This opinion should not be viewed as a ruling on the right or authority of the Commissioner to take any further action in this proceeding with respect to BCBSNJ. Such issues were not before Judge Weiss, are not before us, and are in no way resolved by our holding.

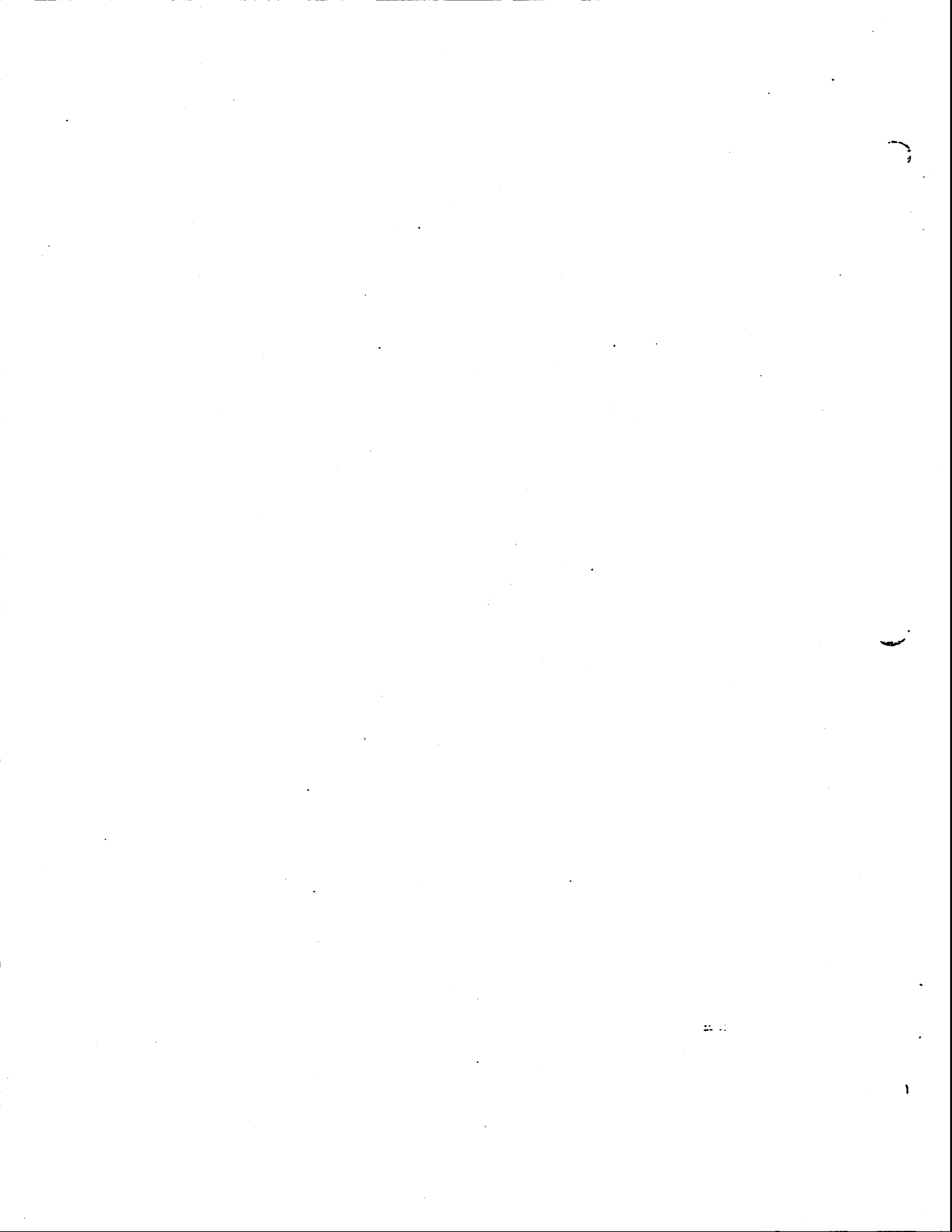
Affirmed.

I hereby certify that the foregoing is a true copy of the original on file in my office.

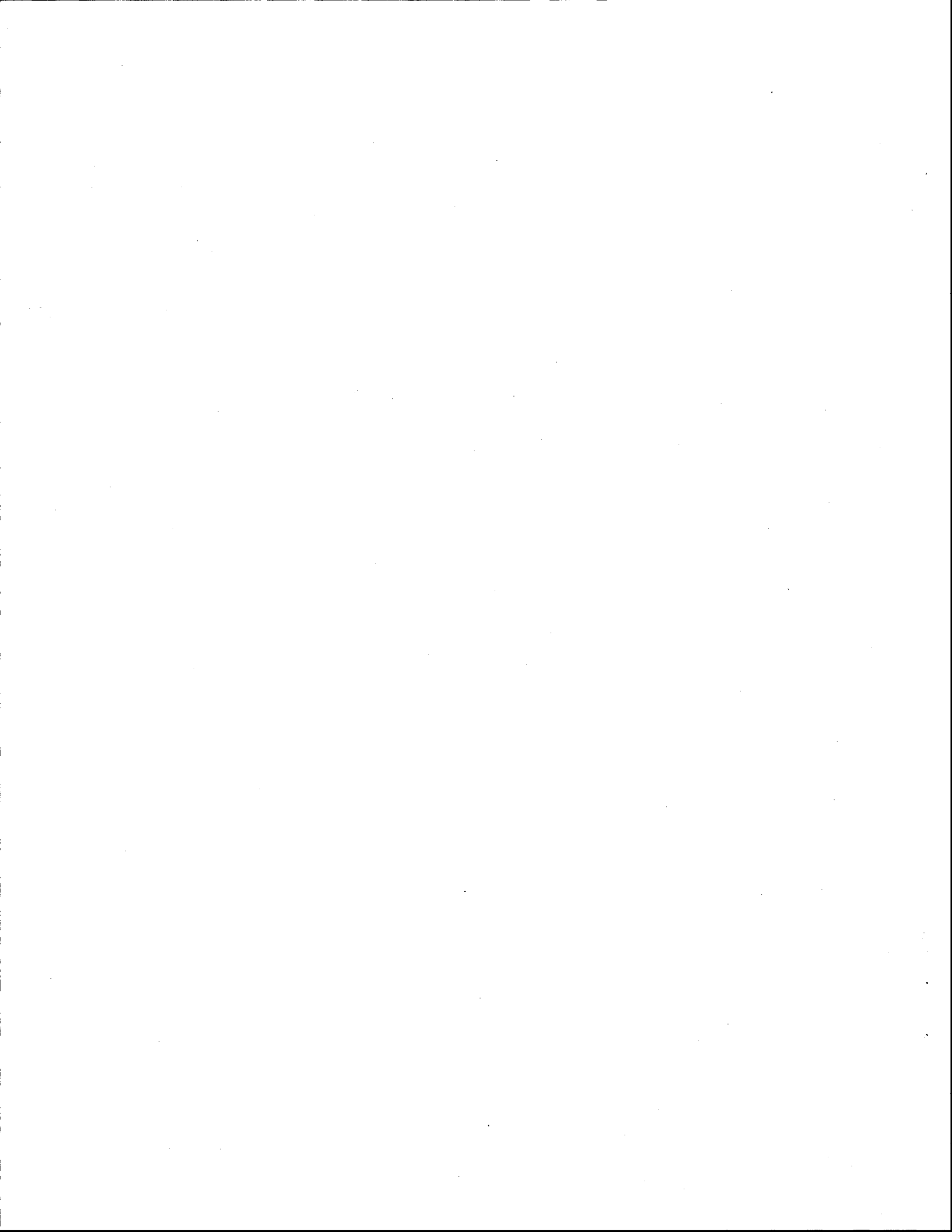


Clerk





## **D. House Floor Amendments**





NORTH CAROLINA GENERAL ASSEMBLY  
AMENDMENT  
Senate Bill 993

AMENDMENT NO. 1  
(to be filled in by  
Principal Clerk)  
Page 1 of 2

S993-ARN-002

Date JUN 3 1997, 1997

Comm. Sub.  [X]  
Amends Title  []  
Fourth Edition

Representative Hackney

- 1  
2 moves to amend the bill on page 2, line 27, by deleting  
3 "Commissioner," and inserting "Commissioner for approval pursuant  
4 to G.S. 58-65-130(3),";  
5  
6 and on page 4, between lines 19 and 20, by inserting the  
7 following two new subdivisions:  
8  
9 "(6) The plan is fair and equitable, and not prejudicial to  
10 the subscribers and certificate holders of the  
11 corporation and the subscribers and policyholders of the  
12 new corporation.  
13 (7) The plan is in the public interest.";  
14  
15 and on page 4, lines 24-25 by rewriting those lines to read as  
16 follows:  
17  
18 "subscribers or certificate holders of the corporation, the  
19 subscribers or policyholders of the new corporation, and the  
20 public interest, except in any declaratory judgment or other  
21 legal action brought by the Attorney General."  
22  
23



NORTH CAROLINA GENERAL ASSEMBLY  
AMENDMENT  
Senate Bill 993

AMENDMENT NO. \_\_\_\_\_  
(to be filled in by  
Principal Clerk)  
Page 2 of 2

S993-ARN-002

SIGNED *J. Jackson*  
Amendment Sponsor

SIGNED \_\_\_\_\_  
Committee Chair if Senate Committee Amendment

ADOPTED JUN 3 1997 FAILED \_\_\_\_\_ TABLED \_\_\_\_\_

*109-3 EV*  
*Sticker*



NORTH CAROLINA GENERAL ASSEMBLY  
AMENDMENT  
Senate Bill 993

AMENDMENT NO. 2  
(to be filled in by  
Principal Clerk)

S993-ARN-005

Page 1 of 1

Date JUN 3 1997, 1997

Comm. Sub. [X]  
Amends Title []  
Fourth Edition

Representative Howard

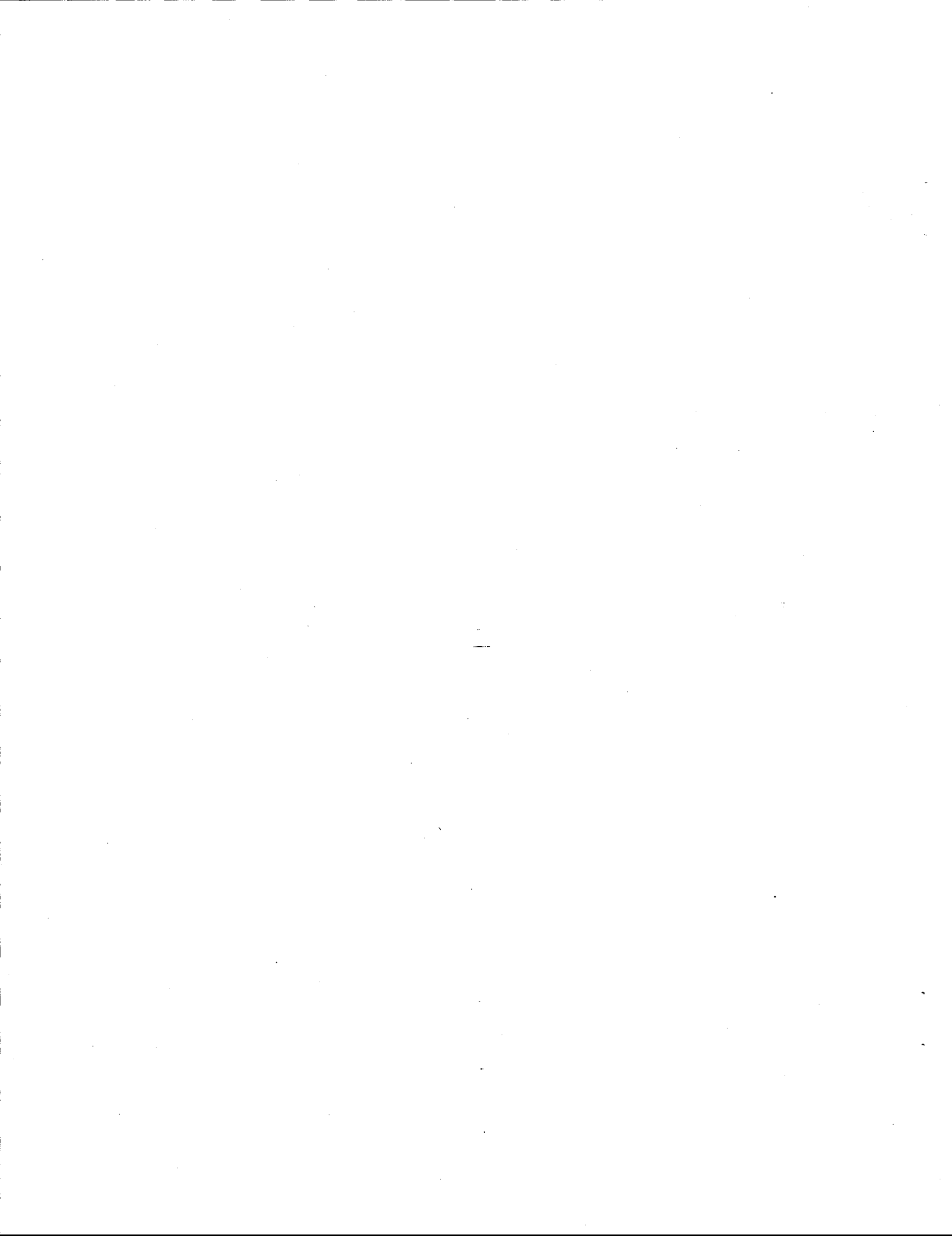
- 1  
2 moves to amend the bill on page 4, line 6, by rewriting that line  
3 to read: "corporation, nor to the rights of the public. The  
4 Commissioner shall consider what portion of the corporation's  
5 surplus, if any, is subject to a charitable trust for the benefit  
6 of the citizens of North Carolina, and shall require that portion  
7 of the assets to be distributed as follows:  
8       (1) To a high-risk health insurance pool for the  
9       uninsured if such a pool is in existence at the  
10       time.  
11       (2) Otherwise, to a nonprofit foundation for the  
12       improvement of the health care of all North  
13       Carolinians, as approved by the Commissioner, or as  
14       directed by the General Assembly."  
15

SIGNED [Signature]  
Amendment Sponsor

SIGNED \_\_\_\_\_  
Committee Chair if Senate Committee Amendment

ADOPTED \_\_\_\_\_ FAILED JUN 3 1997 TABLED \_\_\_\_\_

39-71 EV  
[Signature]





NORTH CAROLINA GENERAL ASSEMBLY  
AMENDMENT  
Senate Bill 993

AMENDMENT NO. 3  
(to be filled in by  
Principal Clerk)  
Page 1 of 1

S993-ARN-007

Date JUN 9 1997, 1997

Comm. Sub.  [X]  
Amends Title  []  
Fourth Edition

Representative Buddor

- 1
- 2 moves to amend the bill on page 3, line 15, by deleting
- 3 "services." and inserting "services, and the manner in which the
- 4 plan protects the public interest.";
- 5
- 6 and on page 4, between lines 32 and 33, by inserting the
- 7 following new subsection:
- 8
- 9 "(j) The provisions of subdivision (f)(4) of this section shall
- 10 apply to any subsequent conversion by the new corporation.";
- 11
- 12 and on page 4, line 21 by inserting immediately before the word
- 13 "presumed" the word "rebuttably".
- 14
- 15

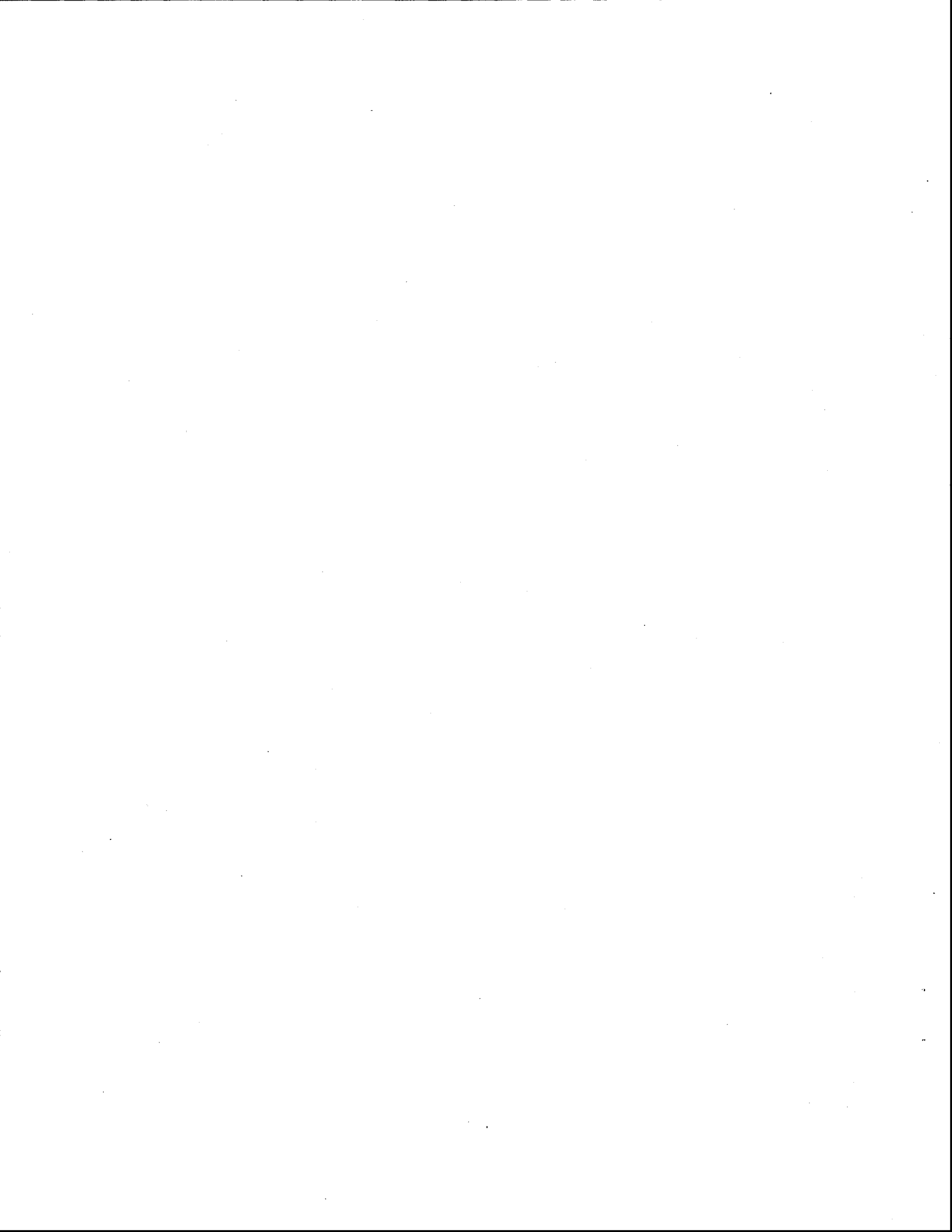
SIGNED [Signature]  
Amendment Sponsor

SIGNED \_\_\_\_\_  
Committee Chair if Senate Committee Amendment

ADOPTED JUN 9 1997 FAILED \_\_\_\_\_ TABLED \_\_\_\_\_

109-2 EV  
[Signature]







NORTH CAROLINA GENERAL ASSEMBLY  
AMENDMENT  
Senate Bill 993

AMENDMENT NO. 4  
(to be filled in by  
Principal Clerk)  
Page 1 of 3

S993-ARN-006

Date JUN 9 1997, 1997

Comm. Sub. [X]  
Amends Title []  
Fourth Edition

Representative Hurley

1  
2 moves to amend the bill, as amended by Amendment #1, on page 5,  
3 between lines 8 and 9, by inserting the following:

4  
5 "58-65-133. Restructuring of corporation.

6 (a) A corporation that intends to restructure must obtain the  
7 prior approval of the Commissioner.

8 (b) For purposes of this section, a "restructure":

9 (1) Is the sale, lease, conveyance, exchange, transfer,  
10 or other similar disposition of a substantial  
11 amount of the corporation's assets, as determined  
12 by the Commissioner, to an entity other than a  
13 nonprofit business or entity. Nothing in this  
14 section prohibits the Commissioner from  
15 consolidating actions taken by the corporation for  
16 the purpose of treating the consolidated actions as  
17 a restructuring of the corporation.

18 (2) Does not include any sales or purchases undertaken  
19 in the normal and ordinary course of the  
20 corporation's business. The Commissioner may  
21 request information from the corporation to verify  
22 that transactions qualify as occurring in the  
23 normal and ordinary course of corporate business.

24 (c) The Commissioner shall not approve any restructuring that  
25 in the Commissioner's opinion seeks to effect a conversion unless  
26 the provisions of G.S. 58-65-130 through G.S. 58-65-132 and G.S.  
27 58-65-134 are met with respect to the restructuring.



NORTH CAROLINA GENERAL ASSEMBLY  
AMENDMENT  
Senate Bill 993

AMENDMENT NO. 4  
(to be filled in by  
Principal Clerk)

S993-ARN-006

Page 2 of 3

- 1 "58-65-134. Distribution of assets.  
2 In evaluating the interest of the subscribers, policyholders  
3 and the public pursuant to G.S. 58-65-131(f), and after  
4 considering the portion of the corporation's surplus, if any,  
5 that belongs to the subscribers or policyholders of the  
6 corporation and new corporation, the Commissioner, with the  
7 advice of the Attorney General, shall consider what portion of  
8 the corporation's surplus is subject to a charitable trust for  
9 the benefit of the citizens of North Carolina, and that amount  
10 shall be placed in a new or existing nonprofit charitable  
11 foundation for the improvement of health care of all North  
12 Carolinians or shall be placed as directed by the General  
13 Assembly. The corporation shall provide to the Commissioner, at  
14 the Commissioner's request, information necessary to determine  
15 the appropriate fair market value of any charitable trust  
16 amount." #5  
17  
18 and on page 1, lines 14-17, by rewriting the sentence that begins  
19 on line 14 to read: "A corporation converting to a mutual  
20 nonstock or stock accident and health insurance company or life  
21 insurance company or otherwise restructuring shall follow the  
22 provisions of G.S. 58-65-131 through 58-65-134."  
23  
24 and on page 2, line 2; page 2, line 12; and page 4, line 31 by  
25 adding after "G.S. 58-65-132" each time it appears the phrase  
26 "through G.S. 58-65-134";  
27  
28 and on page 5, lines 7 and 8, by deleting "G.S. 58-65-130, G.S.  
29 58-65-131, and this section" and inserting "G.S. 58-65-130  
30 through G.S. 58-65-134";  
31  
32 and on page 4, lines 26-29 by rewriting those lines to read:  
33  
34 "(h) The Commissioner of Insurance and the Attorney General may  
35 seek a declaratory judgment or take any other legal action  
36 necessary to enforce the charitable trust provisions of G.S. 58-  
37 65-134."  
38



NORTH CAROLINA GENERAL ASSEMBLY  
AMENDMENT  
Senate Bill 993

AMENDMENT NO. 4  
(to be filled in by  
Principal Clerk)  
Page 3 of 3

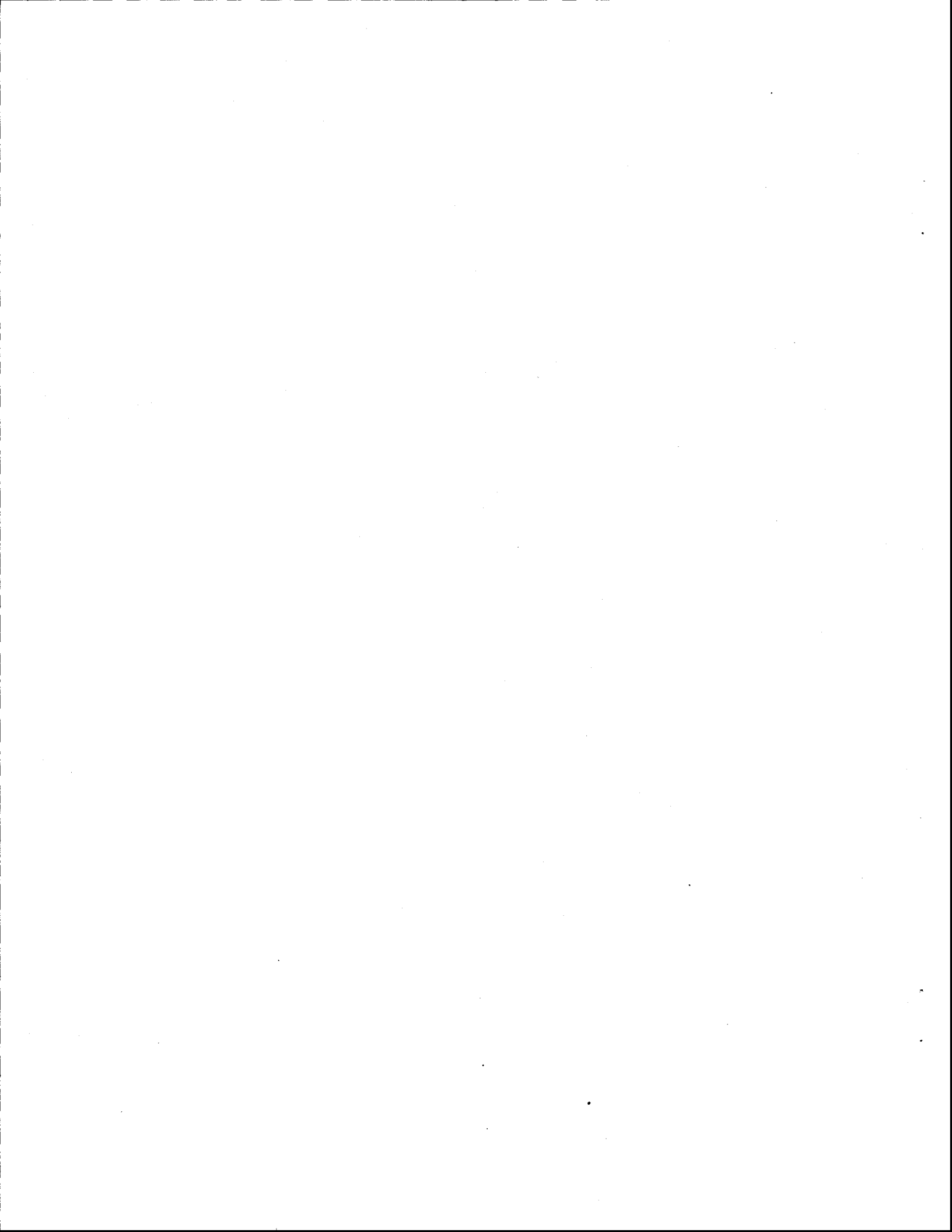
S993-ARN-006

SIGNED Bill Curley  
Amendment Sponsor

SIGNED \_\_\_\_\_  
Committee Chair if Senate Committee Amendment

ADOPTED JUN 9 1997 FAILED \_\_\_\_\_ TABLED \_\_\_\_\_

67-47 EV  
D. Hicks



NORTH CAROLINA GENERAL ASSEMBLY AMENDMENT

(Please type or use ballpoint pen)

EDITION No. \_\_\_\_\_

H. B. No. \_\_\_\_\_

DATE 6/9/97

S. B. No. 993 SCS

Amendment No. 5 (adding #4)  
(to be filled in by  
Principal Clerk)

COMMITTEE SUBSTITUTE \_\_\_\_\_

Rep.) \_\_\_\_\_  
          ) Hackney  
Sen.) \_\_\_\_\_

Hinley amendment (#4)

1 moves to amend the bill on page \_\_\_\_\_, line \_\_\_\_\_

2 ( ) WHICH CHANGES THE TITLE

3 by \_\_\_\_\_

4 placing a period after the  
5 word "Carolina" on p 2  
6 line 9, and by deleting  
7 the balance of the sentence

9 \_\_\_\_\_

10 \_\_\_\_\_

11 \_\_\_\_\_

12 \_\_\_\_\_

13 \_\_\_\_\_

14 \_\_\_\_\_

15 \_\_\_\_\_

16 \_\_\_\_\_

17 \_\_\_\_\_

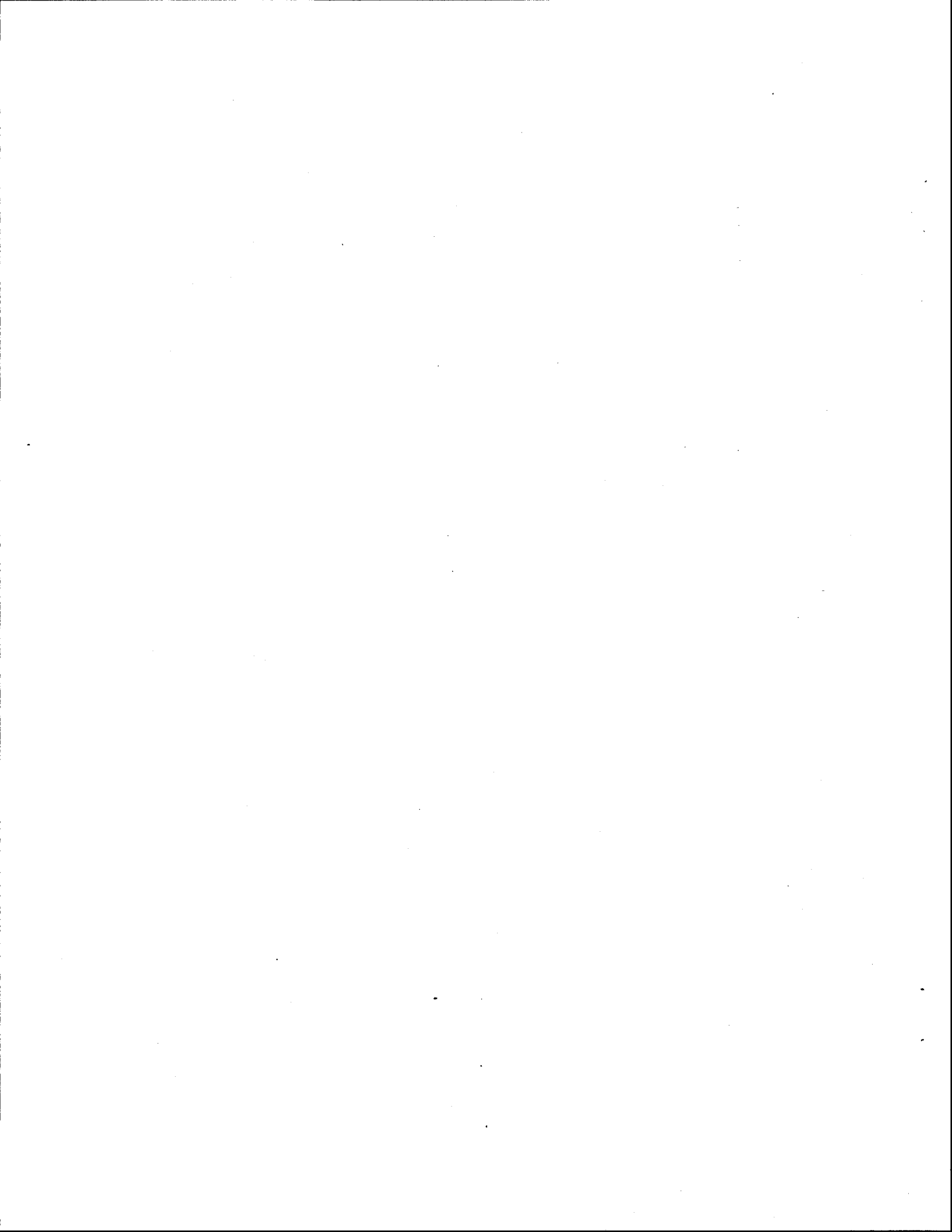
18 \_\_\_\_\_

19 \_\_\_\_\_

SIGNED Hackney

ADOPTED 6/9/97 FAILED \_\_\_\_\_ TABLED \_\_\_\_\_

103-9 EV  
Wick





NORTH CAROLINA GENERAL ASSEMBLY  
AMENDMENT  
Senate Bill 993

AMENDMENT NO. 6  
(to be filled in by  
Principal Clerk)  
Page 1 of 1

S993-ARM-001

Date June 5, 1997  
JUN 9 1997

Comm. Sub. [yes]  
Amends Title [no]  
Fourth Edition

Representative Gamble

1 moves to amend the bill on page 1, line 17,  
2 by adding a new sentence to read:

3  
4 "A new corporation, as defined in G.S. 58-65-131(b)(2), shall also  
5 follow the applicable provisions of G.S. 58-65-131 and G.S. 58-65-  
6 132 upon any further conversion or restructuring."  
7

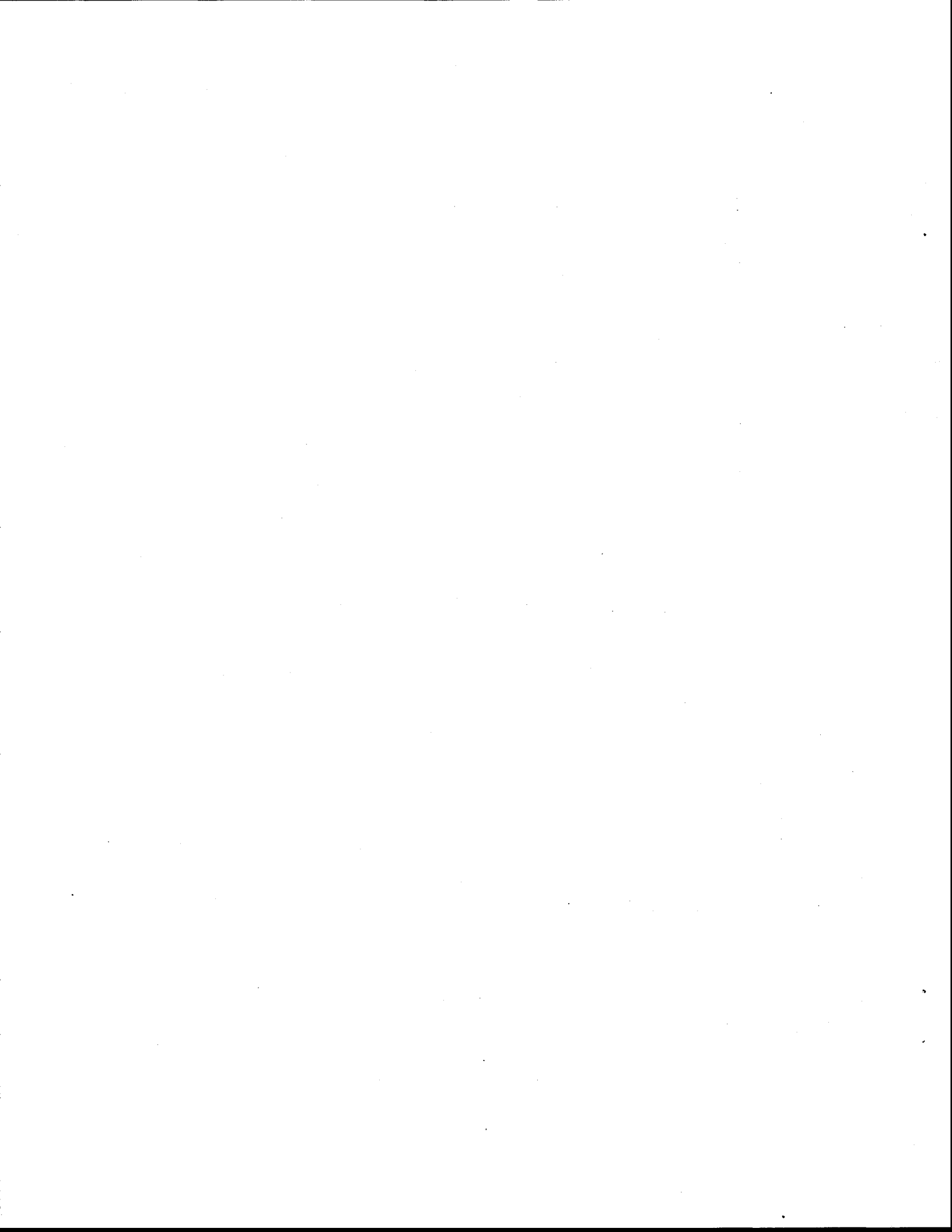
SIGNED J.R. Gamble  
Amendment Sponsor

SIGNED \_\_\_\_\_  
Committee Chair if Senate Committee Amendment

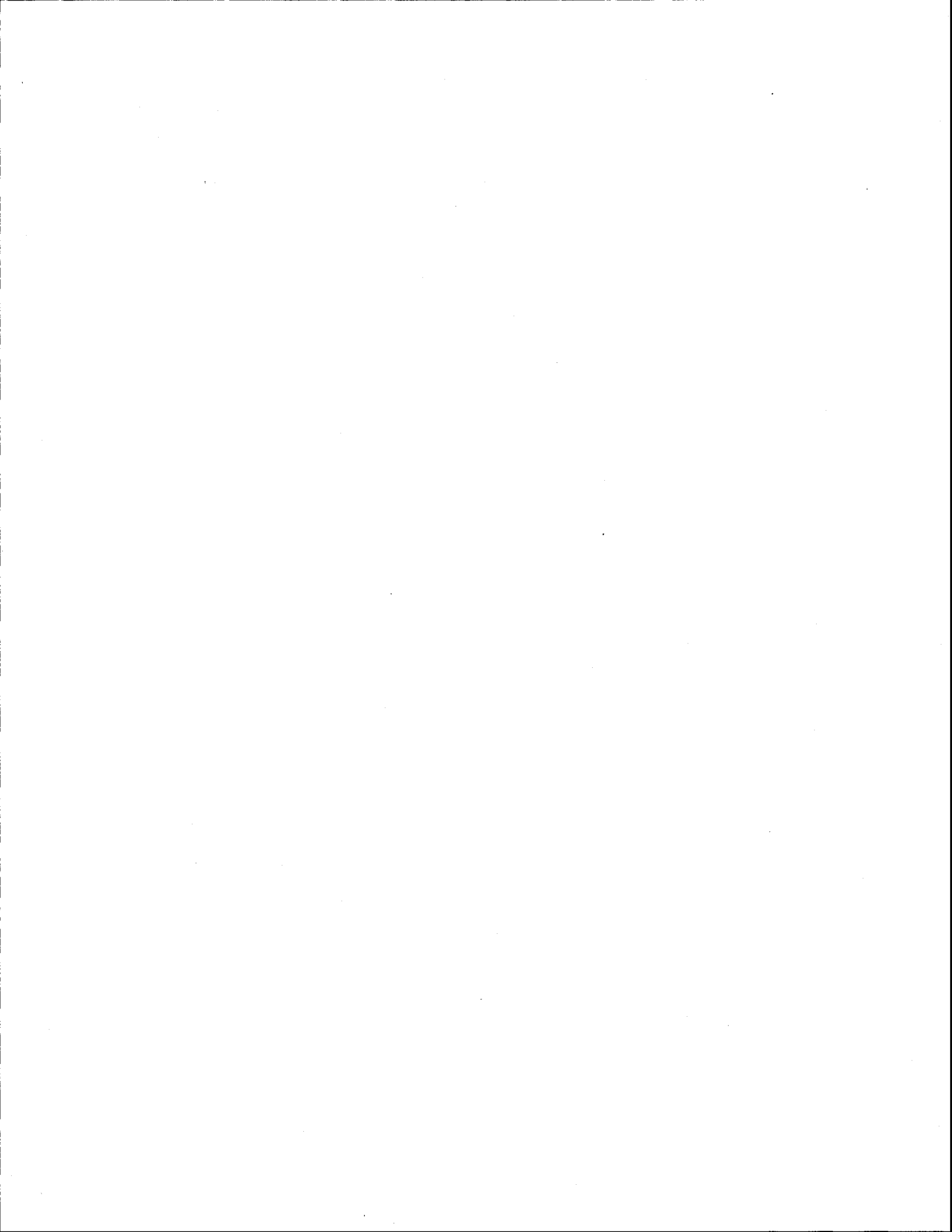
ADOPTED \_\_\_\_\_ FAILED JUN 9 1997 TABLED \_\_\_\_\_

55-58 EV  
J. Weber





## **E. Legal Opinions**





DEPARTMENT OF INSURANCE

State of North Carolina

P. O. Box 26287  
RALEIGH, N. C. 27611-6287

JIM LONG  
COMMISSIONER OF INSURANCE

GENERAL COUNSEL  
(919) 713-0011

MEMORANDUM

TO: Dascheil Propes  
Assistant Commissioner

FROM: Peter A. Kolbe  
General Counsel

RE: BCBS Conversion

DATE: May 22, 1997

You had asked me to provide you with some points on the basis for asserting a charitable trust against North Carolina Blue Cross Blue Shield's surplus in the event of its conversion to a stock company. In this memorandum, "NCBCBS" refers to NCBCBS itself and its two predecessor corporations. This memorandum is a little more detailed than what you requested, but I think that you can easily extrapolate the information which you are seeking.

Charitable Trust Creation

At common law, the creation of a non-profit organization with charitable or other social welfare purposes results in a charitable trust that is irrevocably dedicated to the organization's original mission. To the extent a non-profit entity carries out charitable or public welfare purposes, the general public is essentially an owner and shareholder of the same. The money made by such a non-profit must remain with the non-profit and be used to further its charitable or public welfare purposes, or for some substantially similar purpose under the *Cy pres* doctrine.

Although such non-profit corporations exist for the public good, they often have built up massive reserves, assets and surpluses over the many years in which no taxes were paid on those monies. In determining whether the charitable trust doctrine should apply to an organization, one needs to look at both the purpose of the organization and its tax status. While it is logical to believe that tax exemptions are only granted by governments to entities serving some public benefit, even if such were not the case, communities give up millions of dollars in revenue from non-profit corporations' tax exemptions. Simply put, the public's tax burden pays what would

otherwise be the non-profit's share. These tax benefits alone may give rise to the application of a charitable trust.

### Factors Used in Determining the Existence of a Charitable Trust

In determining whether a non-profit corporation is subject to the charitable trust doctrine, courts have considered the following:

- 1) do the bylaws or articles of incorporation of the non-profit specify that it was established for a charitable purpose or to fulfill a public need or to serve the community?
- 2) do a state's laws indicate that the non-profit was created in whole or in part for charitable purposes or to fulfill a public need or to serve the community?
- 3) does the non-profit receive tax exemptions or breaks because it fulfills a public need or provides a public service?
- 4) does the non-profit file tax returns under an IRS tax classification of a charitable [501(c)(3)] or social welfare [501(c)(4)] organization?
- 5) what actual public welfare benefits does the non-profit provide?

It should be noted that the factors above include the existence of a charitable purpose, but such is not absolutely necessary in applying the charitable trust doctrine. For example, an entity which serves a public need but which does not give away health care/insurance, does not accept donations, and files under IRS Regulation 501(c)(4) [non charity] may still be considered a "charity" so as to be subject to a charitable trust. (See In re application of Blue Cross and Blue Shield of New Jersey, Inc., for Conversion to a Domestic Mutual Insurer, Superior Court of New Jersey - Essex County, Docket No. ESX-L-1591-97.)

### Application of Charitable Trust Determination Factors to NCBCBS

#### Bylaws And Articles

Neither the corporate documents of NCBCBS nor of its predecessor corporations mention any sort of charitable purpose or public benefit.

#### Legislative Enactment Indicating a Charitable and Benevolent Organization

NCBCBS exists under the terms of a legislative enactment. More specifically, the Medical Services Corporation Act became law in 1941 and provided for the existence of NCBCBS and similar entities. In its original version, N.C.G.S. § 57-14 (now article 65 of Chapter 58) declared that a hospital service corporation such as NCBCBS was a "charitable and

benevolent corporation" and was entitled to tax exemptions based on that charitable and benevolent status. While the Medical Services Corporation Act was amended in 1973 and deleted the reference to a "charitable and benevolent corporation," NCBCBS continued forward from that date with tax breaks based on its charitable and public welfare status. (See discussion on tax breaks, infra). So, despite the deletion of the referenced language, the fact that NCBCBS received charity engendered tax breaks after such deletion indicates that, regardless of what wording was used, the North Carolina General Assembly continued to recognize it as providing charitable or public benefits.

### Tax Breaks

From its creation in 1941, NCBCBS paid no federal income tax until 1987. Although NCBCBS apparently never claimed an exemption as an IRS 501(c)(3) charity, until 1987 it did claim a tax exemption as a "social welfare organization" under IRS 501(c)(4). This tax status is important because, in determining the applicability of the charitable trust doctrine, courts across the country have looked not only to 501(c)(3) "charity" status, but also to 501(c)(4) status.

While the Tax Reform Act of 1986 deprived NCBCBS of its 501(c)(4) status, until that time BCBS enjoyed large federal tax breaks, and the public paid more in taxes in consequence thereof. That same Act provides that BCBS organizations may qualify for a special deduction from tax. 26 U.S.C. § 853. In any event, for most of its existence NCBCBS was calling itself a "social welfare organization" under 501(c)(4) as an admission that it existed for a public good or benefit.

On the state level, NCBCBS has enjoyed a lower premium tax rate than other domestic companies for years. While domestic carriers pay 1.9% of premiums pursuant to N.C.G.S. § 105-228.5, NCBCBS pays only 1/2 of 1% of premiums. Similarly, NCBCBS pays no regulatory surcharge pursuant to N.C.G.S. § 58-6-25 while other domestic companies pay 7.25% of their premium taxes as a surcharge. While BCBS argues that it is a de facto mutual company, mutual companies do not enjoy such tax breaks. What then is the difference for the preferential state tax status given to NCBCBS? The logical answer is that it fulfills a public good or purpose. This conclusion is borne out by the 1973 Amendments to the Medical Services Corporation Act which originally defined NCBCBS as a "charitable and benevolent organization" which paid no state taxes. In 1973 that wording was deleted from the Act, and NCBCBS had to pay a premium tax of 1/3 of 1%, a rate far lower than that paid by other companies. Thus, despite the removal of the terms "charitable" and "benevolent," the only basis for a continuing state tax brake must have been the fact that the General Assembly continued to recognize NCBCBS's role as a charity or as serving the public good.

### NCBCBS Has Acted for the Public Good

Throughout its history, NCBCBS has served the public good of North Carolina. Three examples of this are as follows. First, the very creation of NCBCBS was in part to provide a

source of coverage for consumers. (Walter McNerney, 1996. "Big Question for the Blues: Where to Go From Here?" *Inquiry* 33(2):110-117). Second, up until at least 1973, NCBCBS offered "Easy Joining Days," a form of open enrollment whereby *anyone* in the state could apply for coverage without medical underwriting. Such action was virtually unheard of with respect to individual policies, and was a tremendous benefit to North Carolinians who may not have been insurable by other carriers. Third, NCBCBS currently offers its Access Program whereby, if an individual cannot obtain health coverage through other insurers, NCBCBS will write a limited benefit policy although without any subsidization of premiums. In essence then, through its Access Program, NCBCBS is an insurer of last resort to the citizens of this state. Through these three examples, it is apparent that NCBCBS does serve a public benefit.

### Conclusion

Given the fact that NCBCBS was created as a charitable and benevolent organization, received and continues to receive tax breaks in recognition of that status, and has and does serve the public welfare of this state, it is appropriate to apply the charitable trust doctrine to it. The failure to do so would constitute the unjust enrichment of NCBCBS and its future stockholders in a conversion.



**State of North Carolina**

Department of Justice

P. O. BOX 620

RALEIGH

27602-0620

**MICHAEL F. EASLEY**  
ATTORNEY GENERAL

July 21, 1997

**Honorable Wib Gulley**  
408 Legislative Office Building  
Raleigh, North Carolina 27601-2808

**RE: Legislation Dealing With Possible Conversion of Blue Cross And Blue Shield Of North Carolina**

Dear Senator Gulley:

You request our advice on the following questions:

1. Are there any legal barriers to the General Assembly requiring that the full fair market value of Blue Cross be placed in a charitable trust should Blue Cross convert from nonprofit to for-profit status?
2. Would the State's operating budget be adequately protected if the General Assembly took this course of action?

We will respond to your questions in the order set forth above.

1.

It appears that the only legal barriers to the General Assembly requiring that the full market value ("net assets") of Blue Cross and Blue Shield of North Carolina ("BCBSNC") be placed in a charitable trust should Blue Cross convert from nonprofit to for-profit status are the State and United States Constitutions. Article 19 of the North Carolina Constitution and the Fifth and Fourteenth Amendments to the Constitution of the United States prohibit the taking of private property by the State of North Carolina without just compensation. See *Browning v. North Carolina State Highway Commission*, 263 N.C. 130, 139 S.E.2d 227 (1964); *De Bruhl v. State Highway and Public Works Commission*, 247 N.C. 671, 102 S.E.2d 229 (1958).





Honorable Wib Gulley  
July 21, 1997  
Page 2

The most likely scenario is that upon conversion BCBSNC and/or its subscribers would file a declaratory judgment action against the State asking for a declaration that forced dedication of its net assets to a public purpose is unconstitutional on the grounds that it is a taking of private property for a public use. If the assets of BCBSNC belong to the public there is no taking under either the North Carolina Constitution or the Constitution of the United States. As you are aware, it is the Attorney General's position that upon conversion the net assets of BCBSNC would belong to the public. The ultimate arbiter of this question is, of course, the judiciary.

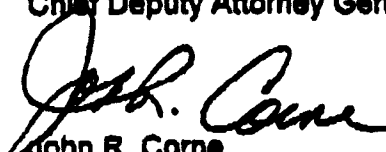
2.

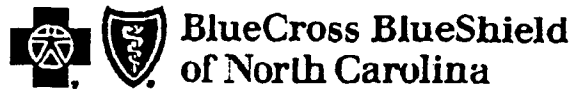
The constitutionality of a determination by the General Assembly that the net assets of BCBSNC must be placed in trust for the public benefit upon conversion will definitely be challenged and, most certainly, before any conversion is effectuated. Under a federal constitutional claim, plaintiffs are entitled to only injunctive relief and attorneys' fees if they prevail. 42 U.S.C. § 1983, 42 U.S.C. § 1988. Under a State constitutional claim, plaintiffs are entitled to the fair market value of the private property taken. Under either constitutional theory, the net assets of BCBSNC would likely not be transferred prior to a judicial determination. If the net assets had been transferred (either in the form of stock or by cash payment), a court would order them returned to the rightful owner. Therefore, attorneys' fees would be the only monetary relief that could be recovered from the State in the event BCBSNC converts and the net assets are not required to be dedicated to a public purpose and that required dedication is declared unconstitutional.

Should you have any further questions, please contact this office.

Sincerely yours,

  
Andrew A. Venore, Jr.  
Chief Deputy Attorney General

  
John R. Corne  
Special Deputy Attorney General



## Introductory Remarks

By Rhone Sasser  
Chairman of the Board of Trustees  
Blue Cross and Blue Shield of North Carolina

to the  
Legislative Study Commission

February 3, 1998

Good morning, Mr. Chairman and members of the commission.

I am Rhone Sasser, Chairman of the Board of Trustees for Blue Cross and Blue Shield of North Carolina.

I am here today, as is Ken Otis, President and Chief Executive Officer of Blue Cross, to share with you our views on the conversion issue.

We appreciate this opportunity to talk with you this morning.

I would like to give you all a little background on Blue Cross and Blue Shield of North Carolina.

(pause)

Blue Cross is the largest provider of health insurance in the state, with 1.6 million customers.

Our mission is delivering high-quality, affordable health care.

We have a 65-year tradition of being North Carolina's hometown insurer.

Nearly one in four North Carolinians is part of the Blue Cross and Blue Shield family.

We are an independent company, one of 56 separate licensees of the Blue Cross and Blue Shield Association.

While there are many health insurance companies that do business in this state and serve their customers well, we are different.

We are one of only two nonprofit medical service corporations in North Carolina, and the only one that provides general medical coverage.

We provide health care coverage regardless of people's medical condition.

We serve all 100 counties in the state, which means we cover the rural, less populated areas.

Other insurers come in from outside the state because they want to serve the urban areas.

We serve everyone.

And we are one of only three health plans in North Carolina to have earned full, three-year national accreditation from the National Committee for Quality Assurance, a watchdog organization that rates managed care plans.

(pause)

I am proud to serve as chairman of the board of trustees of this company. I have been on the board for 12 and a half years.

Our board is made up of many highly respected North Carolinians, a number of whom you may know,

Like Shirley Frye, Vice President of Community Affairs, WFMY;

Vic Hackley, former President of the NC Community College System;

And Jim Williams, an attorney in Greensboro with Brooks, Pierce.

Many of our board members have served this company for a long period of time, some even back to the 1970s.

As a result, we have seen the tremendous changes that have come about in the health care industry.

We all have a true sense of the mission of Blue Cross.

It is our job as board members to guide Blue Cross through the challenges we face in today's challenging health care market.

(pause)

I am a lifelong North Carolinian.

Today, I live on the farm where I was born and reared near Whiteville in the southeastern part of our state.

I understand the importance of Blue Cross to the citizens of this state.

Let me assure you on behalf of the board that Blue Cross is committed to seeing that North Carolinians are provided quality and affordable health care for the years to come.

That's our mission ... today, in the past, and in the future.

In the twelve and a half years I've served on this board, I have witnessed tremendous changes in how health care services are provided and paid for.

As we look across the nation, we see even greater change ahead.

We don't pretend to have all the answers, but to continue our mission we must be strong and operate under laws that give us the flexibility to remain competitive.

I can assure you that we have no plans to convert, but in the changing healthcare environment we must not preclude ourselves from doing so if necessary to meet the needs of our customers.

Now I'd like to ask Ken Otis to share more of the specifics of our thoughts on the issue of conversion.

Ken...

**Our Commitment to North Carolina**

**by Ken Otis**

**President & Chief Executive Officer  
Blue Cross and Blue Shield of North Carolina**

**to the  
Legislative Study Commission**

**February 3, 1998**



Thanks, Rhone.

Good morning, Mr. Chairman and members of the commission.

I'm Ken Otis, president and chief executive officer of Blue Cross and Blue Shield of North Carolina.

I appreciate the opportunity to share with you Blue Cross and Blue Shield of North Carolina's views on the conversion issue.

Since the General Assembly adjourned last August, we have used the intervening time to make a fresh, comprehensive study of the conversion issue.

We have tried to approach our review with no preconceived notions ... except one: to do what is fair for the people of North Carolina, our customers and the long-term health of our company.

In many respects, the question is fairly straightforward -- what are the rules and conditions under which a medical service corporation such as Blue Cross and Blue Shield of North Carolina can convert to an investor-owned company?

As we all know, there are a number of diverse opinions about how that question should be answered. There has not been a lack of commentary.

This morning I'd like to give you our perspective on this issue and share with you four principles Blue Cross has adopted as the foundation for a fair resolution.

I am here today -- we all are here today -- because nearly a year ago a few legislative proposals surfaced regarding what rules should govern a possible Blue Cross conversion.

While a conversion has been authorized under state law since 1953, some legislators and the Department of Insurance were concerned about the absence of clear cut rules that would govern such a conversion.

The issue was also raised -- I believe -- because a few Blue plans in other states had converted their status or were in the process of converting.

We are not here today because Blue Cross was considering a change in status.

We did not initiate the issue of conversion. It was not on our radar screen. It is not something we planned or are currently planning. But we did share the concerns of legislators and Commissioner Long about the lack of clear, well-stated procedures and conditions governing a conversion.

Our concerns were heightened when several proposals were presented to us that would cripple the company and severely threaten our ability to meet the health needs of our customers.

For example, one proposal would have stripped away the company's reserves -- premiums paid by our customers and held to cover medical bills. These reserves are required by laws that you have enacted to protect our customers.

To strip those reserves away would have left the company financially vulnerable and endangered the medical coverage of our customers.

Many rushed to claim the company's assets for charity, without understanding or concern for the rights of the policyholders.

Another proposal would have turned over to the Commissioner of Insurance certain day-to-day business decisions -- leaving our health plan at a significant competitive disadvantage.

As the chief executive officer of Blue Cross, those and other proposals were unacceptable because they would have severely hurt our ability to compete and would damage the company.

As an alternative, we worked with legislators, the Commissioner of Insurance, and the Attorney General's office to craft Senate Bill 993.

Its goal is to establish the process and rules under which Blue Cross could convert its status, if and when we ever decide that doing so is important to our company's future.

At Blue Cross, we put the people we serve first.

So the goal of any conversion, should it ever be needed, would be to meet the needs of our customers.

One of the bill's provisions prohibits anyone associated with the company -- trustees, management, employees -- from profiting from a change to an investor-owned company.

We absolutely support this mandate, and did so from the very beginning. Blue Cross wants to do what is best for the public, our customers and the company.

In that spirit, we have arrived at four basic principles that we believe should provide the framework for the conversion issue:

- First, any resolution must protect the assets of Blue Cross so that our customers' medical claims will be paid and our company will remain financially sound.
- Second, any resolution must prohibit anyone associated with the company from profiting from the process of conversion.
- Third, any resolution must provide us with the business flexibility we need to meet the needs of our customers and remain competitive in the health care marketplace.
- And fourth, in the event that we convert to an investor-owned company, we would support the creation of one or more foundations, funded by stock, for the charitable purpose of serving the health needs of North Carolina citizens.

Let me outline our thinking behind these principles.

These four principles are intended to assure that, as part of any conversion, Blue Cross meets our public benefit responsibilities to the people of the state of North Carolina, while preserving a strong company to meet the health care needs of our customers.

Since this issue was raised last year, we have wrestled with the question of who owns Blue Cross.

This is perhaps one of the most complex issues facing the study commission.

State law is unclear.

Our corporate documents, dating back to 1933, are unclear. Does the public have an interest in the value of the company? Do policyholders have an interest in the value of the company?

To underscore the complexity of the issue, I spoke last month to a group of hospital CEOs. During the course of questions from that group, one made the case that they thought health care providers like themselves had an interest in the company!

So we have studied this issue at length and sought extensive review and legal advice from two outside, well-respected law firms. Our understanding and conclusions have evolved through that process.

Frankly, our analysis suggests that no one has a clear claim today.

But by process of elimination, and application of broad equitable principles, we have come to believe that citizens of North Carolina do in fact have an interest in the company upon conversion.

We recommend that the study commission consider a conceptual approach similar to the one implemented in California if and when Blue Cross were to convert its status. Not a carbon copy of California, but one that fairly serves the needs of the people of North Carolina.

Under the California approach, charitable foundations were created to receive the value of the company at the time of conversion in the form of stock. It is impossible to say what the dollar amount of the stock would be worth in a conversion by Blue Cross.

The value of a company is determined by the marketplace. Most financial analysts have trouble predicting what the stock market will do next week, let alone what might happen years from now.

You would be right to question any estimate that you may hear -- other than a purely hypothetical number for illustration only.

The truth is, no one knows what any company will bring on the open marketplace. But if this approach is approved, you can be sure that the people of North Carolina will be direct beneficiaries of the company's market value.

The advantage of the charitable foundation is that this resolution would protect the assets of Blue Cross and benefit the health care needs of North Carolinians for years to come.

These assets include premiums that our customers have paid -- and that we are holding in reserve -- to pay their medical bills. That's why we could never agree to what some have suggested: turn over the assets of Blue Cross. Such actions would be irresponsible and would leave this company and its customers financially vulnerable.

These assets, which are critical to our ability to conduct our core business, must be protected. They will help ensure that the resulting corporation after conversion would be financially strong and viable competitively.

A strong, forward-looking Blue Cross is in everyone's best interests. We have been the only insurer committed to covering North Carolinians living in all 100 counties and committed to providing the health care protection our citizens need regardless of their medical history.

If legislation passed by this General Assembly ties our hands and leaves us unable to compete because of stringent rules or requirements, the people of North Carolina lose.

They lose because they no longer will have the assurance that a major, quality insurer will be there for them in the good times and the bad.

North Carolina's tax base loses, because Blue Cross <sup>pays</sup> approximately \$5.5 million each year in premium insurance tax, local property tax and state income tax . . .

The federal tax coffers lose the approximate \$7.8 million we pay each year in federal income taxes. The state also loses more than 2,600 jobs that provide competitive pay and top benefits to North Carolinians.

We are committed to a win-win solution to this issue.

That is the basis for our four principles:

1. We must retain the assets of our company to pay the medical claims of our customers.
2. We must prohibit anyone associated with the company from receiving any private benefit as a result of conversion.
3. We must have the business flexibility we need, like other insurers, to meet the needs of our customers and remain competitive.
4. We would support the creation, at the time of conversion, of one or more foundations funded by stock whose charitable purpose benefits the health care needs of North Carolinians.

We believe these principles protect the public interest, and also protect the 1.6 million North Carolinians who depend on Blue Cross to provide their medical coverage.

Before closing, I'd like to reflect for one moment on the bill that ultimately got us here, Senate Bill 993.

It is important to say that every principle we've outlined today could have been accomplished within the framework of that bill. Every single one.

It is unfortunate that some members of the General Assembly endured unfair criticism for their support of Senate Bill 993.

We believe that criticism was short-sighted.

But now, it is time to move on and resolve this issue -- fairly and openly and in the public's interest.

What we want to do in the future is what we've done for the past 65 years: put the people we serve first.

Just as in the past 65 years, we want to continue providing affordable health care coverage no matter what county you live in or your medical history.

We are the only insurer willing to do that. Let me repeat: Blue Cross is the only insurer willing to do that.

Blue Cross is committed to being here for our customers in good times and bad.



With the leadership of this commission, we will resolve this complicated issue.

And that resolution will enable Blue Cross to plan its future as this state's hometown insurer for, at least, another 65 years.

Now I'd like to answer your questions.

And Mr. Chairman, with your permission, our general counsel, Brad Wilson is also available to help with any questions.

**Martin Eakes, Co-Chair, Coalition for the Public Trust  
Presentation to Blue Cross Conversion Study Commission  
February 3, 1998**

My name is Martin Eakes. I am the founder and CEO of Self-Help, a nonprofit development lender that has made several thousand economic development loans to small businesses and underserved families throughout North Carolina. With \$150 million in assets, Self-Help is the largest nonprofit community development financial institution in the country. I am a native of North Carolina, born and raised in Greensboro, and now living in Durham. I am a licensed attorney in NC, with a graduate degree in economics and public policy.

I am here today as the Co-Chair of the Coalition for the Public Trust. The Coalition for the Public Trust formed immediately after the 1997 legislative session, and grew out of the letter by 70 prominent North Carolina leaders that supported the creation of this Study Commission to look at the Blue Cross conversion issue. Those leaders and the Coalition strongly believe that assets owned by public or nonprofit entities **must not** be transferred to private interests for less than fair market value. To do otherwise erodes the integrity of public and nonprofit organizations, and the public loses trust in our most valuable institutions.

To date, 81 organizational members have joined the Coalition for the Public Trust, representing 20,000 members in all 100 counties of North Carolina. A number of these groups are interested in health issues: NC Public Health Association, the Covenant with NC's Children, the NC Nurses Association, the NC Psychiatric Association, the NC Health Access Coalition and 13 local health departments. Other statewide groups include: NC Center for Nonprofits, the NC Council of Churches, the League of Women Voters of NC, the NC statewide chapter of the NAACP, the NC Association of County Social Service Directors, the NC Institute for Minority Economic Development, and six different NC foundations.

**Presentation Overview.**

- 1) To describe in detail a win-win conversion solution, and if time permits, to look at the following:
- 2) To diagram the problem of faulty conversions in other states
- 3) To diagram different nonprofit organization types, and
- 4) To examine briefly a charitable conversion foundation.

**The Blue Cross Conversion Issue.**

Blue Cross is a nonprofit public benefit corporation. A nonprofit public benefit corporation is a **private** organization created for **public** benefit. The key characteristic of a nonprofit public benefit organization is that its activities and proceeds cannot be used for private individual gain.

Unlike a for-profit corporation, a nonprofit public benefit organization has no stockholders or owners other than the community. An important feature of nonprofit public benefit corporations is the law that if the nonprofit dissolves or converts to a for-profit entity, private individuals or entities cannot take the assets of the organization away from the community without paying full, fair market value for those assets.

### **The Public Trust Solution.**

Unlike many public controversies, the Blue Cross conversion issue actually has a win-win solution where both "sides" can achieve their goals. From my experience, this is quite rare.

The Coalition for Public Trust believes that there are two key principles to a win-win solution: 1) that 100% of company assets go to Blue Cross and 2) that 100% of the company's stock value goes to a charitable foundation :

**Principle 1: 100% of the cash and other assets of Blue Cross must be retained by Blue Cross to cover the insurance claims of customers.**

This principle insures that the interests of three different parties are protected. First, Blue Cross as a company is just as strong after a conversion as before, which is very important to the citizens of North Carolina. Not one single penny of assets has left the company or been "disgorged" to use Attorney Kolbe's phrase. The company is able to compete forcefully in the world of managed health care because it has not lost any assets, and now it can access new capital from private shareholders.

Second, Blue Cross customers are protected. We do not have to track and distinguish between reserves, surplus, investment securities, etc., because none of them will have been dissipated at all. Conversion with this principle intact will not cause rates to increase because the company's cash and other assets have not been touched.

Third, because this "100% of assets retained by Blue Cross" principle protects Blue Cross the company, and its customers, it also meets the stringent "safety and soundness" test put forth by the Department of Insurance at the last Study Commission meeting.

**Principle 2: 100% of the fair market value of Blue Cross at the time of conversion must be retained in a charitable foundation in the form of stock.**

The stock retained by the new charitable foundation would be sold to private investors over a period of five or more years. The proceeds would be used to create a permanent endowment to promote the health of North Carolina citizens. Hence, the stock value stays in the nonprofit sector. Additionally, a public fight about the valuation of Blue Cross is avoided. The marketplace will determine the value of Blue Cross stock as the stock is sold over time.

Retaining 100% of the new Blue Cross stock in a charitable foundation protects two key parties. First, the citizens of North Carolina are protected because the nonprofit value built up by Blue Cross over 65 years is retained perpetually in a nonprofit foundation for the benefit of all of the citizens of the State. Blue Cross subscribers will not be hurt, and if fact, since they are North Carolina citizens, they will be aided by a charitable foundation along with all other North Carolina citizens.

Second, as outlined by Attorney Hirsch at the last Study Commission meeting, the Attorney General has the duty to protect the public interest, and a charitable trust retaining 100% stock value of Blue Cross would fulfill this duty.

Health care conversion foundations are being created all across the country. At the end of 1996, 81 conversion foundations had been identified totaling \$9.3 billion. When the California Blue Cross converted to for-profit status, two foundations were created totaling \$3.2 billion. Most of these foundations have been created as the result of non-profit hospital conversions, including two in North Carolina, the Cape Fear Memorial Foundation in Wilmington and the Sisters of Mercy of North Carolina in Charlotte.

There is a risk for the charitable foundation to receive its value in the form of stock, since the stock may decline in value before it is sold. And yes, all other things equal, the Coalition for Public Trust would prefer to have had the conversion foundation funded with cash. But cash funding would weaken the position of Blue Cross and its customers, which would violate the Coalition's first principle.

In summary, 100% of the assets go to Blue Cross, which protects the company, its customers, and the safety and soundness requirement of the Insurance Commissioner. 100% of the stock value goes to the charitable foundation, which protects the public trust and integrity, while satisfying the statutory duty of the Attorney General.

**Public Trust Solution Diagram. (See Solution Diagrams)**

Understanding the difference between shares of stock in a company and the assets inside that company is the key to understanding how a win-win conversion solution can be reached. People pay cash to buy shares of stock from a company. The company receives the new cash to use in expanding the business. The recipient of stock gets a piece of paper that entitles the person to a share of the company's profits, if the company makes a profit. The company is selling the right to future profits, not the company's assets. The company's inside assets, such as cash reserves, investments, buildings, corporate name, customer relationships, etc., are still intact inside the company. The stock represents the company's overall value. Once the stock has been issued, that stock can change hands without one penny of change inside the company.

To summarize, the Public Trust Solution essentially takes a single corporation that has both a business purpose and a public benefit purpose and splits it into two corporations. The new for-profit takes 100% of the assets and embodies the business purpose. The new nonprofit foundation takes 100% of the stock value and embodies the public benefit purpose.

### **Faulty Conversion Diagram.**

A conversion plan that simply issues stock from the previously nonprofit corporation to new shareholders is fatally flawed. New shareholders obtain a windfall gain, the public loses the accumulated nonprofit value, for-profit health care competitors face unfair competition, and the public loses trust in nonprofit institutions. (See associated diagram).

Blue Cross has never advocated this faulty conversion plan. To his credit, Blue Cross CEO Ken Otis has repeatedly told me that Blue Cross would not convert in a way that produced a windfall gain for executives or new shareholders.

If a nonprofit converted to for-profit status without creating a charitable trust with 100% of its value, investors would pay for their shares of stock on the open market, but would pay less than fair market value. For example, if a nonprofit is worth \$2 billion, it could sell shares of stock on the open market for \$2 billion. In that case, shareholders would have paid \$2 billion for a company now worth \$4 billion – the original \$2 billion value plus the \$2 billion in new shareholder equity paid for the shares. The investors would double their money instantly by having paid their money into a corporation they fully own, thereby in essence making payments to themselves.

Consider the example of a city selling a fire truck. Suppose a fire truck buyer paid the city \$50,000 for its fire truck, placing the money in the front seat, and driving off with the money. A \$50,000 cash investment immediately doubles and becomes \$100,000 – the value of the truck plus the cash. The buyer has not really parted with his money. He has simply kept the money inside a vehicle that he now fully owns.

### **Types of Nonprofit Organizations.**

The health care conversion debate is confusing because there are several different types of nonprofit organizations. Nonprofits incorporated under Chapter 55A of the North Carolina General Statutes fall into the broadest category. The only common characteristic is that the organizations do not have capital stock. Traditional charities are a subset, but so are chambers of commerce, home-owner associations, and even nonprofit bookstores. (See associated diagram).

The next most restrictive category includes those nonprofits that have a prohibition against private gain to any private shareholder or individual. This group includes traditional charities, private foundations, and “public benefit” corporations, including IRS 501(c)(4) corporations and IRS 833 medical service corporations.

Blue Cross has been a nonprofit for 65 years since one of its predecessor corporations was incorporated in 1933. Blue Cross Blue Shield of North Carolina was an IRS 501(c)(4) corporation until 1987, and thereafter an IRS 833 corporation. The key point is that Blue Cross is currently a nonprofit that is subject to the requirement that “no part of its net earnings inure to the benefit of any private shareholder or individual.” Explicitly prohibited, therefore, is any windfall gain to private shareholders, which is what would result if anything less than 100% of the Blue Cross stock value were retained in a charitable trust. Nor can the accumulated value be distributed to the past or present customers of the nonprofit Blue Cross since a nonprofit has no

private owners. By the process of elimination, there is no place for the conversion value of Blue Cross to go except to a charitable trust.

The next most restrictive nonprofit category is the IRS 501(c)(3) organization. This type includes charities, nonprofit schools and hospitals, and religious organizations. In exchange for tax exemption and the ability to offer a donor a tax deduction, these 501(c)(3) organizations are subject to IRS regulations against self-dealing, conflict of interest, and electioneering, among other things.

Finally, an IRS-defined "private foundation" is a subset of the 501(c)(3) category. A private foundation is even further restricted in its activities and is subject to various excise taxes, including a 2% federal tax on income.

#### **The New Charitable Foundation.**

The new charitable foundation that receives the 100% stock value of Blue Cross at the time of conversion should have an independent board of directors. These directors will need strong skills in grantmaking, as well as in finance and investments. In California, a consortium of professional search firms and a citizen advisory group nominated the initial directors.

The initial assets of the new foundation will be 100% Blue Cross stock. As this stock is sold over a period of five years or more, the assets will be reinvested in a diversified portfolio. These assets will form a permanent endowment. Annual grants will be made out of the annual income earned by the permanent endowment. We estimate that the foundation will increase from no grants initially to more than \$50 million of annual grants when all the Blue Cross stock has been sold.

By IRS regulation and the North Carolina conversion statute, the charitable foundation should be subject to the IRS rules against self-dealing, conflict of interest, electioneering, and commercial activities.

The conversion foundation will be a remarkable legacy for future generations of North Carolinians. It can be created alongside a new for-profit Blue Cross without in any way harming the company or its policyholders. I urge the members of this Commission, as stewards of the interests of the people of North Carolina, to ensure that this legacy is preserved and not lost. I ask that your legislative recommendations include the creation of a new, independent foundation -- to be funded with stock equal to 100% of the fair market value of the company in the event of a Blue Cross conversion.

Thank you.

## Coalition for the Public Trust

- Martin Eakes, CEO of Self-Help
- Co-chair of CPT - 80+ organizations with over 20,000 members
- 919-956-4615

## Today's Goal

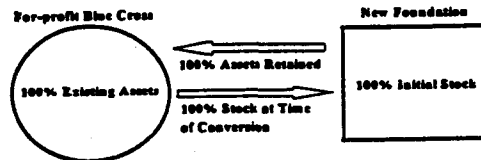
- Describe "win-win" conversion solution
- Diagram faulty conversion problem
- Diagram types of nonprofits
- Outline conversion foundation concepts

## Public Trust Solution

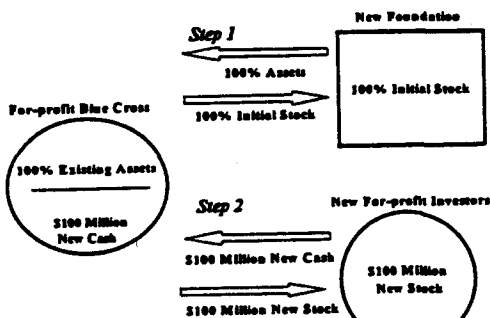
- A "win-win" solution does exist.
- 100% of internal cash and other assets retained by Blue Cross to cover claims.
- 100% of fair market value as stock retained by the public trust.
- Preserves subscriber protection and public integrity.

## Public Trust Solution

Step 1



## Public Trust Solution



## Solution Summary

Blue Cross keeps 100% of company assets

Assets: cash, reserves, investments, buildings, corporate name, customers

Protects company, customers, policyholders

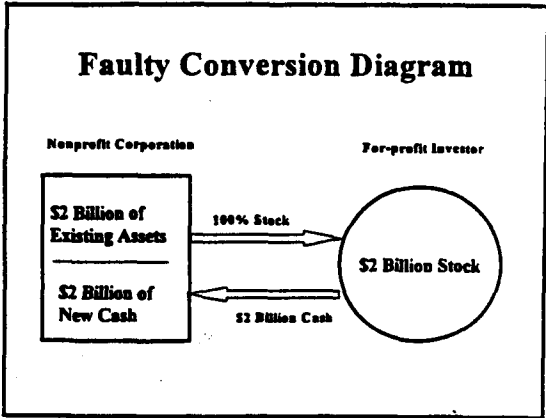
Meets DOI requirements

Public Trust keeps 100% of fair market value

Value: 100% of initial stock at market price

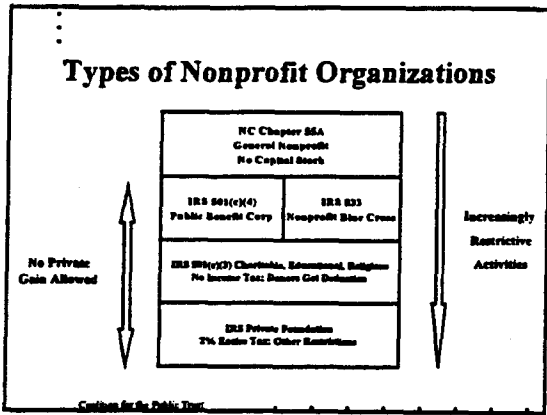
Protects NC citizens

Meets AG requirements



### Nonprofit Conversion Dilemma

- Nonprofit conversion must not be shareholder payments to themselves.
- Loss of nonprofit assets to private shareholders erodes public trust.
- Windfall gain to shareholders gives unfair advantage over competitors.



### Nonprofit + No Private Gain

- Nonprofit status + No private gain allowed = charitable trust requirement.
- For 65 years, BC has paid reduced taxes and filed tax returns as a nonprofit.
- Fed: "No part of its net earnings inure to the benefit of any private shareholder or individual." Internal Revenue Code: Section 533 & 501(c)(4).
- State: Chapter 58-65-1 corporations are nonprofit.

### Charitable Foundation

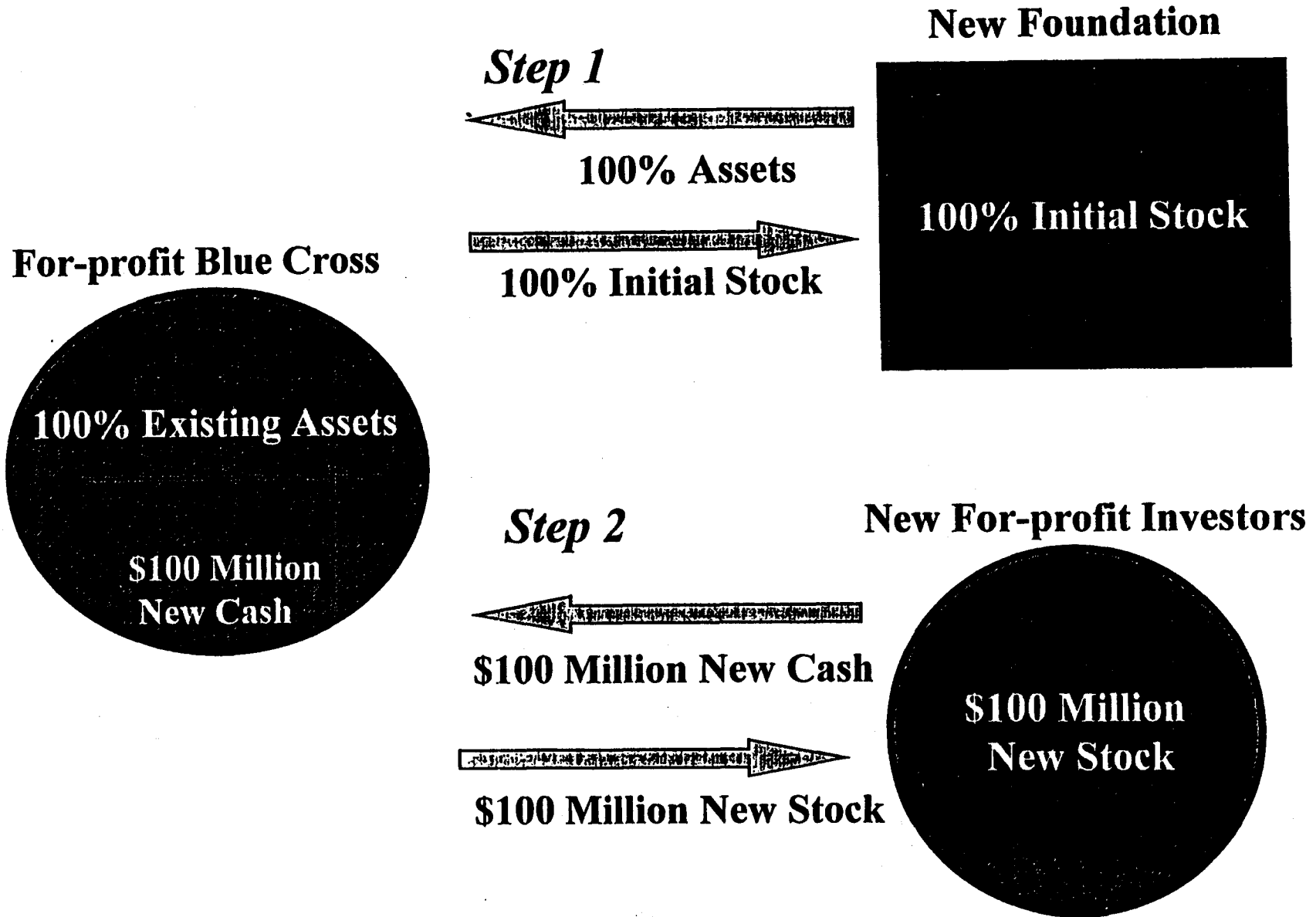
- Independent Board of Directors.
- Assets are a permanent endowment.
- \$50 million of annual grants from income.
- Goal is "to promote the health of the citizens of North Carolina."
- Existing IRS rules against self-dealing, conflict of interest, private gain.

### Summary

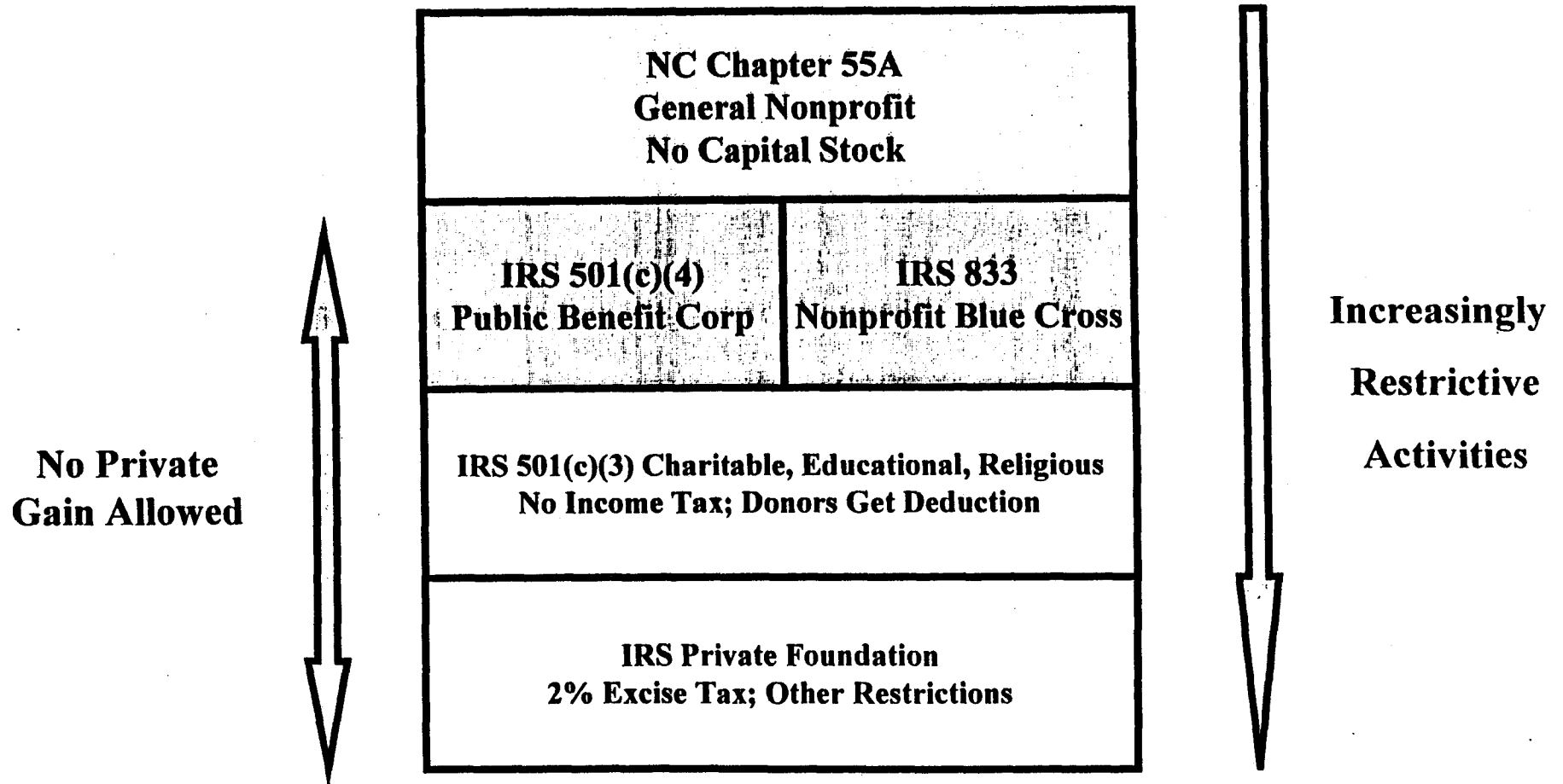
- Blue Cross is valuable asset to NC and must be allowed to compete in health arena.
- Blue Cross is a public benefit nonprofit with a legal prohibition against private gain.
- Blue Cross retains 100% of cash and other assets for covering claims.
- Public trust retains 100% of fair market value in the form of stock.

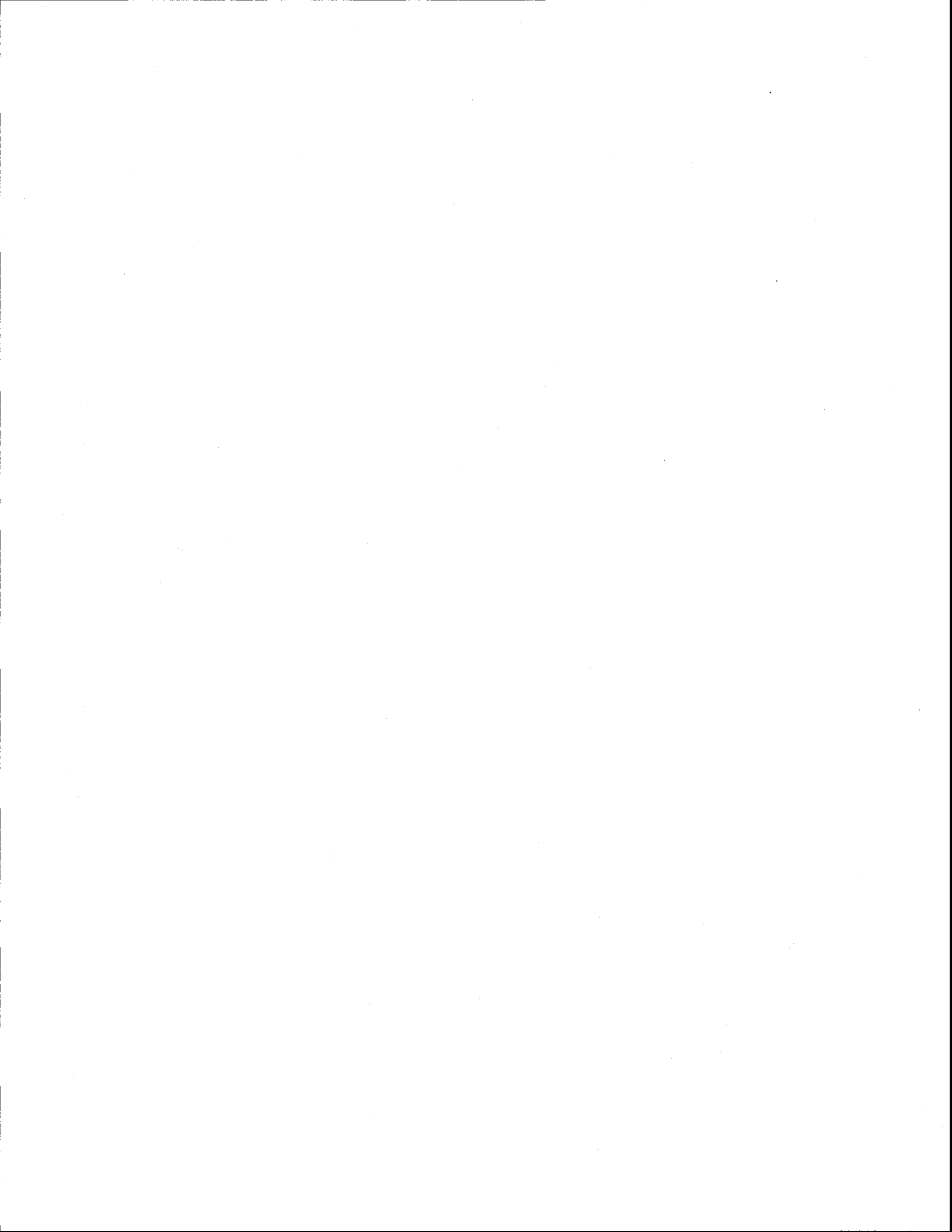


# Public Trust Solution



# Types of Nonprofit Organizations





## **Summary of Comments**

March 3, 1998  
Raleigh, North Carolina

**Judith Bell**  
Director  
West Coast Regional Office  
Consumers Union of U.S., Inc.

## Key Issues

- \* **Threshold question:** Is the transaction in the public interest?
- \* **Public Access to Conversion Information:** Conversion transactions should be subject to full public disclosure and discussion, equal to that of other dramatic policy shifts in the health care system.
- \* **Public oversight and accountability:** Public officials (insurance commissioners, attorneys general) should provide aggressive public oversight of proposed conversion transactions to protect community interests.
- \* **Public Participation:** Public hearings should be held, before a decision is made about a proposed conversion, with adequate public notice, in an accessible location.
- \* **Independent Valuation:** An independent valuation should be conducted for the regulator responsible for reviewing and approving the proposed conversion. "If, at this time of conversion, one hundred percent of the shares of the then-outstanding stock of the corporation is distributed to a foundation, it shall be regarded as having acquired the fair market value of the corporation."
- \* **Protection and Set Aside of 100% of the Charitable Assets:** All (100%) of the charitable assets should remain in the charitable health care sector. The assets should be set aside from the new for-profit.
- \* **Governance and Structure of Foundations Receiving Charitable Assets:** When a foundation receives the assets, it should be fully independent from the new for-profit company and have a new Board of Directors. When a new foundation is formed, it should be established under Internal Revenue Code 501(c)(3) or 501(c)(4) with appropriate 501(c)(3) protections.
- \* **Voting Agreements and Demand Registration Rights:** When the new foundation receives any stock, voting agreements and demand registration rights should protect the foundation's interests, particularly the value of its endowment and its ability to sell stock, as needed.

# The Attorney General is Responsible for Enforcing Charitable Obligations

The protection of charitable assets grows out of the parens patriae powers of the state and is designed to protect the public's interest in assets dedicated to serving the public benefit.

It has been long settled that the Attorney General is the protector and guardian of charitable assets, charged with the duty of enforcing charitable trusts. Across the country, the historic right and ability of the Attorney General to enforce charitable trusts and protect charitable assets dates back at least to the 1800s.

For example:

- **North Carolina:** Courts find that it is the Attorney General's common law right and power to "protect the beneficiaries of charitable trusts and the property to which they are or may be entitled."
- **New Jersey:** The courts have been explicit in defining the function of the Attorney General to enforce charitable trusts: "[the] function resides in the Attorney General; it is his duty to see that the public interests are protected in the administration of a public charity."
- **Kentucky:** Where property is devised for charitable uses, it is the Attorney General who represents the public.
- **Ohio:** The Charitable Trust Act specifically references and includes the Attorney General's common law powers to protect charitable assets and enforce the fiduciary duties of those charged with control of charitable assets. Ohio courts have held that the proper party to prosecute for enforcement of a charitable trust is the Attorney General, the "public officer that lawfully represents the entire community."
- **Missouri:** A trial court held, in an interlocutory order, that the Department of Insurance and its Director lacked standing to argue that Blue Cross was a public benefit corporation. The court determined that the Attorney General was the appropriate regulatory agency to assert that Blue Cross is a public benefit corporation.
- **Kansas:** A trial court ruled in favor of the Attorney General after BCBS challenged her right to assert charitable trust violations. The court held that the Attorney General has a right to enforce charitable obligations and has a right to seek damages against BCBS if she prevails on the merits of the case.

## Blue Cross of California

- \* **1993:** Proposed “restructuring” — transfer 90% of assets to for-profit Wellpoint subsidiary. Eighty percent of Wellpoint stock was transferred to the nonprofit parent, twenty percent was sold on the stock market.
- \* Department of Corporations (DOC) accepted the argument that the transaction was a “restructuring,” not a conversion. Community groups disagreed, however, arguing that the transaction was a conversion.
- \* **Mar 1993:** BCC agrees to contribute \$5 million per year for 20 years to health care charities
- \* **May 1994:** DOC asks for plan to show how proceeds from the restructuring are being used for public benefit. Public called the “stockholder”--- return on investment demanded
- \* **Dec 1994:** DOC holds public hearings across the state to discuss conversion and use of the charitable assets
- \* **1994-6:** Coalition of 170 community organizations demands full market value, independent board to administer endowment
- \* **1996:** Two new foundations, with a combined endowment of \$3.3 billion, established as part of the final approval of the transaction
- \* Lengthy public search for new independent board members

## **California HealthCare Foundation**

- \* Endowed with \$2 billion in Wellpoint stock, will monetize stock and pass 80% through to the California Endowment
- \* 501(c)(4) organization, prohibited from participating in political or lobbying activities, strict conflict of interest rule
- \* Board composed of a majority of old BCC Board members, per BCBSA requirements to retain trademarks

## **California Endowment**

- \* Endowed with \$800 million in cash, will receive proceeds of stock sales from California HealthCare Foundation
- \* Controlled by a majority of new, independent board members (13 of 20 had no history with BCC)
- \* 501(c)(3) private foundation



**Blue Cross of California**

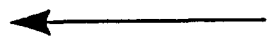
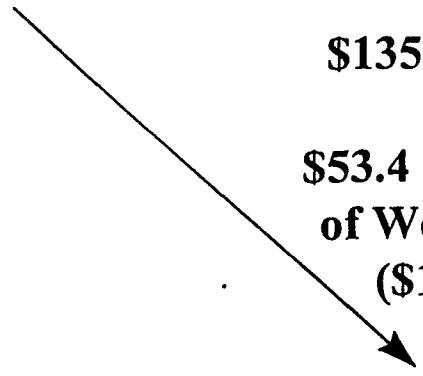
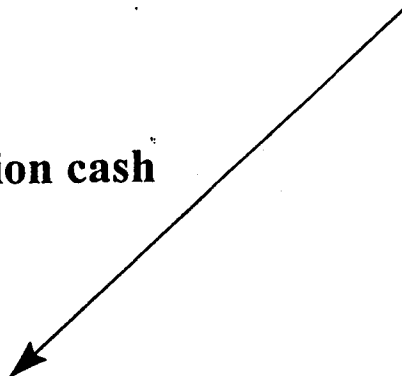
**\$900 million cash**

**\$135 million cash  
+  
\$53.4 million shares  
of Wellpoint stock  
(\$1.9 Billion)**

**The California  
Endowment  
501(c)(3)**

**80% of proceeds  
from sale of  
Wellpoint stock**

**California  
HealthCare  
Foundation  
501(c)(4)**



## CA HealthCare Foundation/CA Endowment

- \* In 1994, the nonprofit California Blue Cross was required to make \$100 million in grants
- \* In 1996, the two foundations began making grants
- \* In future years, the annual payout requirement is a minimum of 5% of consolidated assets, approximately \$160 million, depending on the value of the assets
- \* Both foundations focus on supporting projects and programs that target uninsured, underinsured, and medically underserved populations in California
- \* Both foundations engaged in a statewide needs assessment process to help determine grantmaking priorities

**Mission of The California Endowment  
and The California HealthCare Foundation**

To expand access to affordable, quality health care for underserved individuals and communities and to promote fundamental improvements in the health status of the people of California.

## The California HealthCare Foundation

### **Program Areas:**

- ◆ Managed Care and Special Populations
- ◆ California's Uninsured
- ◆ California Health Policy
- ◆ Consumer Health Information and Education
- ◆ Public Health

### **Sample Grants Awarded:**

**\$1,200,000** to Pacific Business Group on Health and the National IPA Coalition to create an advanced data communications infrastructure for health care in California.

**\$1,500,000** to the Center for Biomedical Research at CSU Bakersfield to administer efforts to find a vaccine for valley fever.

**\$15,000,000** to improve care for elderly Californians enrolled in managed care. Awards will be granted through a Request for Proposal process.

**\$250,000** to support a partnership with the Alliance Healthcare Foundation in San Diego to design, implement, and evaluate a low-cost individual insurance product to be marketed to the working poor.

## The California Endowment

### Grant Making Program Areas

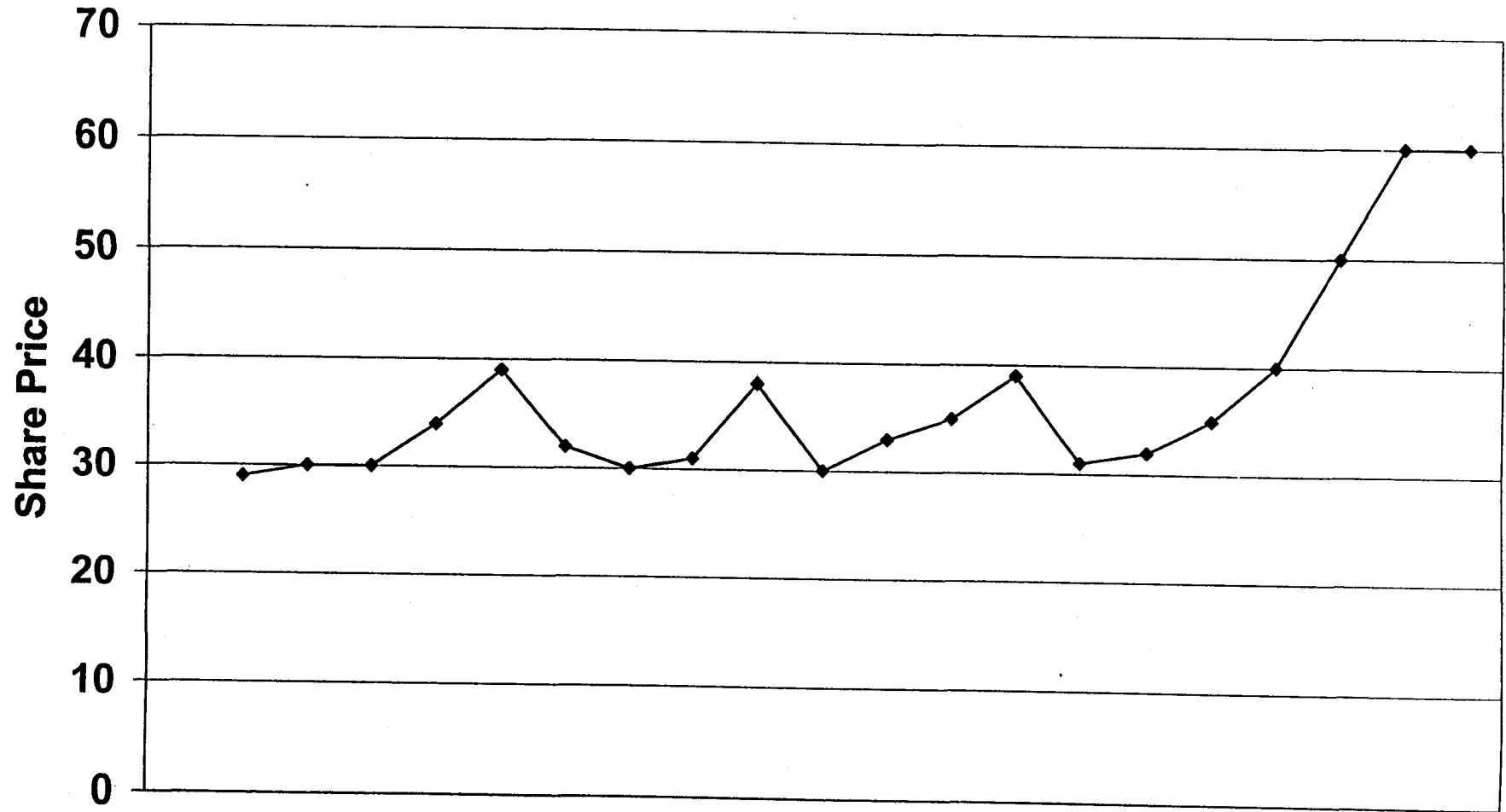
- ◆ The Community Health Investment Program
- ◆ The Children's Health Initiative

### Sample Grants:

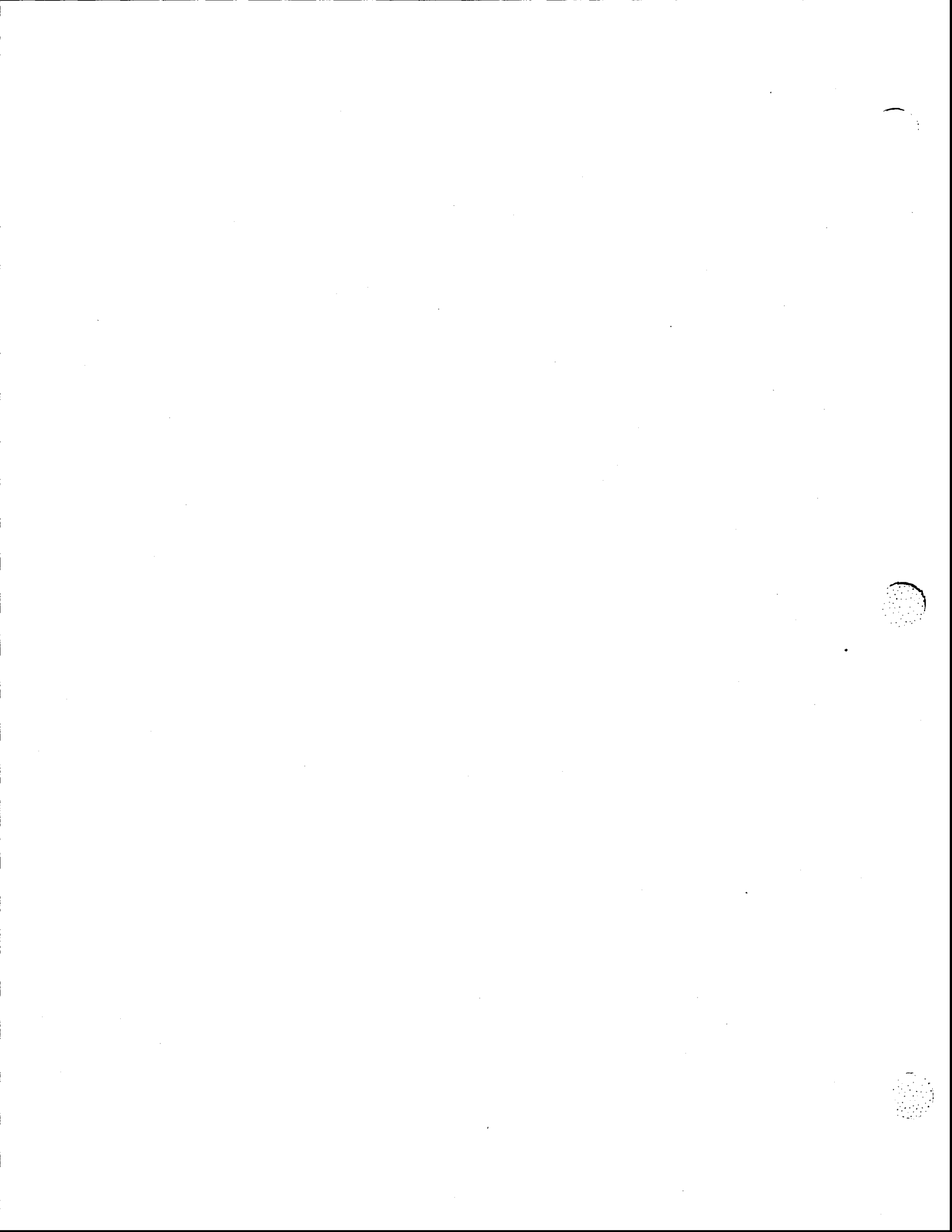
**\$300,000** to the California Department of Health Services for their project to conduct an assessment in 34 California counties of the impact of welfare reform on County Medical Services and to develop local and system wide plans to ensure access to care for medically indigent populations in rural and semi-rural areas.

**\$650,286** to the California Primary Care Association to support expansion of perinatal care access and utilization and to improve pregnancy outcomes and raise awareness of perinatal care for medically indigent women.

# Wellpoint Health Networks



Mar 93 through Feb 98



**Richard A. Daugherty**  
**Testimony to Hospital, Medical, and Dental Service**  
**Corporation Charter Conversion Study Commission**  
**March 3, 1998**

Good morning, Mr. Chairman and members of the study commission. I'm Dick Daugherty. I wear several different hats.

I'm executive director of the NC State University Research Corporation, which means I spend a lot of time promoting the Centennial Campus. And I'm also director of the Kenan Institute of Engineering, Technology and Science at NC State.

I'm the retired Vice President of Worldwide Manufacturing for IBM PC Company. For 22 years, I was responsible for the IBM operation in Research Triangle Park.

Through the years I have been a major supporter of the nonprofit community. In fact, in 1991, I received the North Carolina Public Service Award for volunteer service.

I'm currently chairman of the board of trustees of Rex Healthcare, a leading nonprofit community hospital.

Until three years ago, I was a member of the Board of Trustees for Blue Cross and Blue Shield of North Carolina. And today, I am a member of its Community Advisory Council.

And I guess I should mention that I'm past chairman of North Carolina Citizens for Business and Industry.

I tell you that only because you've invited me here to talk about the business implications of a possible conversion by Blue Cross from a nonprofit medical service corporation to an investor-owned company.

From a business standpoint, let me say that it's important to North Carolina businesses and citizens to have a financially healthy, robust, Blue Cross.

There are about 1.6 million North Carolinians -- some of whom work for large companies, others who are self-employed -- who rely on Blue Cross for coverage.

At Rex Healthcare, Blue Cross is the payor for 10% of the patients hospitalized at Rex. So, in a volatile health insurance market, the stability of Blue Cross is a good thing for people buying coverage and a good thing for providers of health services, such as Rex.

Blue Cross must be doing something right. The company has about 25% market share. That's a strong endorsement for what the company is doing in the marketplace.

As you consider legislation, bear in mind that needless government regulation should not come between Blue Cross and its customers.

A motto for conversion legislation, it seems to me, should be: "*all* the regulation necessary, but *only* the regulation necessary."

It's been three years since I was on the Blue Cross board of trustees.

Frankly, when I began reading about Blue Cross and Blue Shield of North Carolina converting to investor-owned, it was news to me.

During my years of service on the Blue Cross board of trustees, we never met to plan a conversion from a non-profit corporation to an investor-owned company.



From my now arms-length vantage point, there is no compelling business reason to convert.

Blue Cross is well-capitalized. It has no need for heavy investments in technology. There is no need that I am aware of for capital to expand or to develop new product lines.

Now, having said that, let's think back to where we were 10 years ago, in 1988. Ronald Reagan was president. Not many consumers had heard about the Internet. And managed health care was something they were doing out in California, but hardly anywhere else in the country.

Well, a lot has changed since 1988. The world of health care has been revolutionized in that decade -- several times.

We're seeing it every day at Rex. In health care -- especially in the *business* of health care -- if you aren't constantly refining and improving your business approach, you're going to be left in the dust.

Since I left IBM 3 ½ years ago, the pace of change has accelerated even more. We're more productive and more competitive in the global economy than we've ever been.

Our ability to embrace business change has contributed to a record-breaking economic expansion for this country. Just look at the stock market for the past three years.

So, as you consider the rules under which Blue Cross and Blue Shield of North Carolina can change its non-profit status, I hope you'll consider a structure that provides the business flexibility to react to a marketplace that changes literally every day.

This General Assembly should not require Blue Cross to get approval from the Department of Insurance for any business decision unless that approval is necessary to ensure the protection of policyholders and the financial stability of the company.

In other words, the state Department of Insurance should have no oversight of a Blue Cross business decision unless that same approval is required of every other insurance carrier that competes with Blue Cross.

Some people have suggested that the state has an interest in restricting compensation paid to Blue Cross employees if the company converts to investor-owned status. I want to be as diplomatic as I can in addressing that issue.

Once Blue Cross becomes an investor-owned company -- and once Blue Cross repays any obligation it might have to the citizens -- then its obligation is fulfilled.

Nobody has any business dictating whether a Blue Cross employee receives stock options, an extra day of vacation or a parking space.

That's fundamental.

Another fundamental principle is that Blue Cross and Blue Shield's assets should remain with the company, whether it's a non-profit or investor-owned insurance company.

State law and North Carolina Department of Insurance regulations require Blue Cross to maintain those reserves.

Those assets must remain with the company so that its customers are protected and the company remains financially strong.

I've heard some people say that Blue Cross and Blue Shield is what it is today because of tax breaks. Saying Blue Cross is what it is because of tax incentives is like saying a company is successful because the state built an access road to its manufacturing plant.

Blue Cross is successful because:

- it was first to the marketplace some 65 years ago.
- it has offered a good product at an affordable price.
- and because the company has met the needs of its customers.

And, let me point out that it is the only health insurance company in the state to provide coverage in all 100 counties. It is the only insurer that will cover North Carolinians regardless of medical history.

In fact, these public benefits may have placed Blue Cross at a competitive disadvantage against out-of-state insurers who came in and cherry-picked customers in North Carolina's cities, while ignoring the rural areas.

Now, there seems to be no debate about whether Blue Cross and Blue Shield of North Carolina owes some obligation to the citizens of the state if it converts to investor-owned status.

So I'll direct my comments to how that obligation might be viewed from a business standpoint.

As I understand it, Blue Cross has recommended the creation of a foundation, funded by stock, that would be issued if and when the company ever converts.

The business questions revolve mostly around governance and the eventual divestiture of stock.

On governance, it is important that the Foundation be independent of the control of an investor-owned Blue Cross. And it's equally important for an investor-owned Blue Cross to be independent of Foundation control.

In other words, the Foundation should have no business control of Blue Cross. I'm told that that has been the case in California, and that it has worked well.

Blue Cross management must be able to assemble a board of directors that will provide savvy oversight and expert counsel to a company in the complex, rapidly changing health care industry.

Some folks have suggested that there is no place on the board of the new foundation for anyone connected with Blue Cross.

I don't know if that immediately disqualifies all 1.6 million North Carolinians who are covered by Blue Cross, but for the sake of the people that the foundation should help the most, it ought not.

If a conversion ever occurs, this foundation will find itself possibly holding hundreds of millions of dollars of stock in a health insurance company.

From a business standpoint, it makes sense for that foundation to have someone on the board who carries an institutional memory of Blue Cross.

That insight is important so that as the foundation divests itself of the Blue Cross stock, it will do so in a way that maximizes the value of the shares.

This is not about power or control of a foundation board. This is about a smart, business-like approach to making the most of a wonderful opportunity to provide more health care for North Carolinians.

So, to recap:

- Don't take any steps that would weaken Blue Cross and Blue Shield post-conversion.
- "All the regulation necessary, but *only* the regulation necessary."
- Business flexibility equal to that of other insurance company competitors so that the company can adapt in a fast-changing industry.
- Protect the assets of Blue Cross so that the company can cover the medical bills of its customers and remain financially strong and within state law and Insurance Department regulations.
- Create a foundation that would receive the value of the new company in stock upon conversion.
- Make the foundation independent of Blue Cross control and the new, investor-owned Blue Cross independent of foundation control.
- Consider foundation rules and board make-up that will maximize the benefit to the North Carolinians who need it most.

Mr. Chairman and members of the study commission, thank you for inviting me to speak to you today. Now I'll be happy to answer your questions.

Blue Cross Conversion Legislative Study Commission  
Presentation by Ray Cope

Comments by

E. Ray Cope

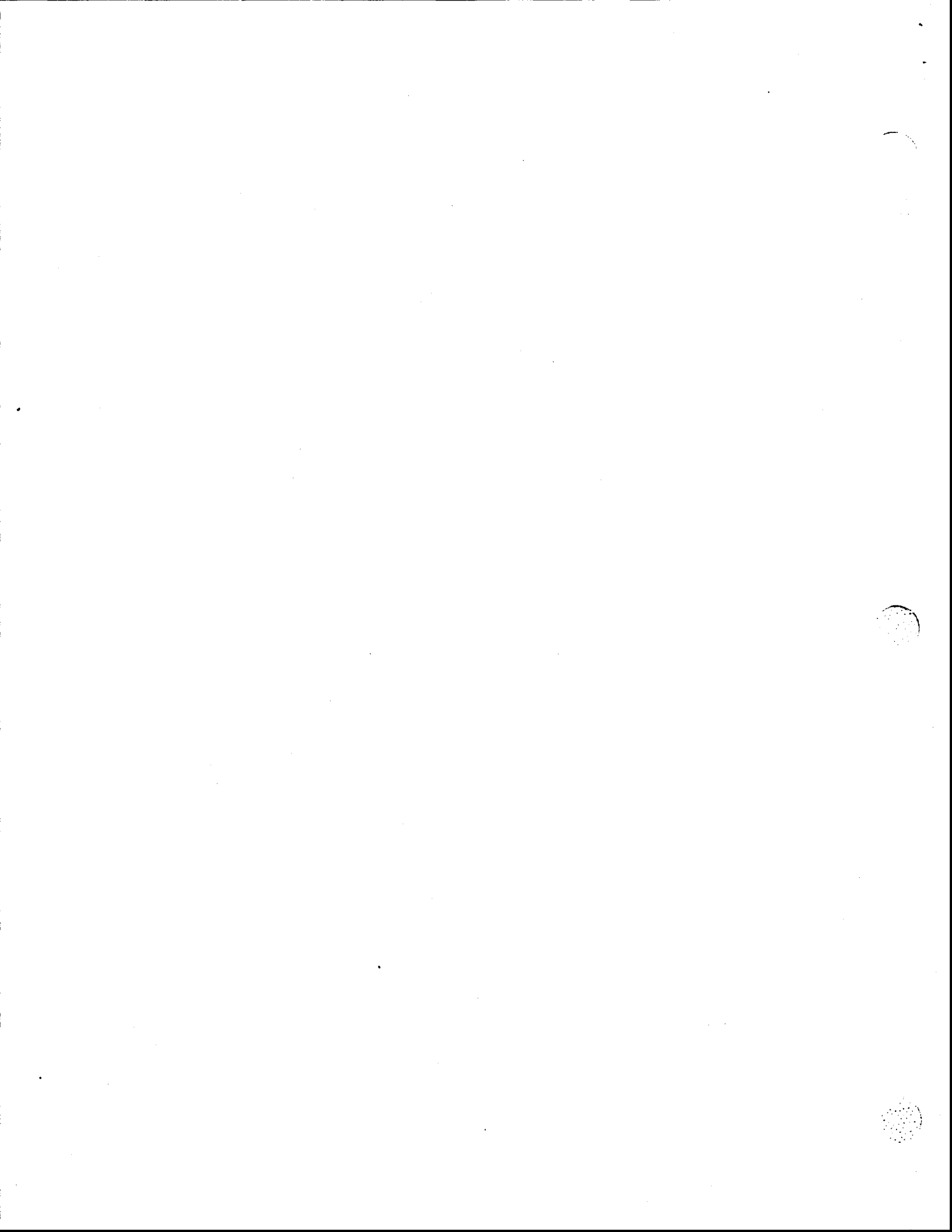
Executive Director

Kate B. Reynolds Charitable Trust

Legislative Study Commission

Raleigh, North Carolina

March 3, 1998



Good morning, Mr. Chairman and members of the commission. I'm Ray Cope, executive director of the Kate B. Reynolds Charitable Trust in Winston-Salem. Thank you for the opportunity to meet with you today.

I have served as executive director of the Trust since 1991. Prior to that I worked for Wachovia Bank serving as manager of the Charitable Funds Management Department. The department was established in 1975 to serve the needs of foundations and other charitable entities. In that capacity, I worked with hundreds of charitable trusts and private foundations.

The Kate B. Reynolds Charitable Trust is one of more than 850 private foundations in our state. Private foundations are classified as such because their funding comes from a single source. The Kate B. Reynolds trust was funded through the will of Mrs. Kate B. Reynolds. The proposed charitable foundation would be funded with Blue Cross and Blue Shield of North Carolina stock, a single source. I will address the implications of administering a private foundation later in my remarks.

Before I go further into my comments, you should know that Blue Cross Blue Shield of North Carolina has been represented on our Health Care Division advisory board for more than 25 years. Ken Otis, president of Blue Cross, has been a valued member of our board for the last four years.

My role here today is to share with you information that I hope will be helpful in structuring a charitable foundation which may result from the proceeds of the sale of stock if Blue Cross converts to a for-profit institution.

Foundations are private and independent nonprofit organizations. I'll say that again because it's important. Foundations are private and independent organizations. They have flexibility to act quickly, an ability often lacking in governmental programs or large corporate enterprises.

Funds used to create foundations are endowments that function in two ways: first, to generate income to provide grants to charitable organizations for current needs; and second, to generate growth to provide for greater grant needs in the future. As such, the funds placed in a foundation are a legacy for future generations. Foundations are supported by boards of trustees who are knowledgeable about the community and have expertise about the particular interests or purposes of the foundation. It's important that these individuals understand and support the foundation's mission and that they represent our diverse population, a population impacted by the same health problems from the far west to the eastern-most parts of our state.

It's also important at the outset to establish a broad mission for a health care foundation. Our Trust is a good example. Ten years ago the Kate B. Reynolds Charitable Trust was a \$129 million foundation. All of our assets were in RJR Nabisco common stock. As you may remember that was before the leveraged buyout of the company for around \$25 billion. Almost overnight our grant resources tripled. We have been able to start new initiatives and make additional grants that were not possible before.

However, our original charter would not have provided us with this flexibility. When the Kate B. Reynolds Charitable Trust was established in 1947, three-fourths of its income was to be distributed to hospitals for the care of patients in their charity wards. That was a time when a few dollars a day could cover a big portion of a hospital stay. By the late 1960s, our grants averaged \$3.16 per patient per day. But conditions were changing significantly. The federal government had begun pouring enormous amounts of money into hospitals through Medicare and Medicaid payments, and the Trust charter no longer served Mrs. Reynolds' wishes.

The Trustees of the Kate B. Reynolds Charitable Trust were put in the position of continuing to follow the letter of Mrs. Reynolds' will and failing to fulfill her desire, or taking an action to change the will to meet the conditions that existed in the 1970s. The Trustees chose to do the latter, petitioning the courts for permission to take a broader approach in serving the health needs of the state's poor citizens. This proved to be a time consuming process and the operations of the Trust were interrupted over a two-year period as this action was approved in Superior Court and the North Carolina Supreme Court. It all could have been

avoided if the original charter had allowed the Trustees greater flexibility in making grants. The resulting direction from the courts provided the Trust with the flexibility to be progressive and resourceful and to adopt methods, and indeed to change them, to react to the fast developing field of health care for our citizens.

The grantmaking process we use at Kate B. Reynolds is typical of most foundations. Our broad mission permits us to consider a wide range of specific grant requests from charitable organizations. Our Health Care Division board meets twice a year to consider those requests. When we receive a grant request, our staff reviews it to ensure that it meets our legal, tax, and program criteria, and that it is properly documented. We often make site visits prior to the board meeting to gain first hand knowledge about the applicant organization. Once a grant is awarded, the Trust requires expenditure reports on the use of the funds and qualitative and quantitative reports on the effectiveness of the program or project. This follow up reporting is vital both for the accountability on the use of the funds and to learn from the program or project.

North Carolina is fortunate to have many well-endowed foundations. Some of them cover territories much wider than North Carolina, while others serve smaller, hometown constituencies. Most of you have foundations in your hometowns or in the districts you represent. They do wonderful work, but if you were to multiply their resources many times over, they still could not adequately meet the health care needs of people in North Carolina.

It is estimated that over 2 million people in our state are either uninsured or underinsured. North Carolina is largely a rural state with at least 24 counties and parts of 35 other counties that have too few primary care providers to meet the needs of the communities. There are major changes occurring in the demographics of the state that will challenge our health care system; for example, the aging of the population. It is estimated that by the year 2010, the number of adults ages 65 and older will increase by almost 30%. The number of those 85 and older will increase by 60%. Another concern is the increase in the number of Hispanics who are less likely than the general population to have health coverage. This population is one of the fastest growing populations in the state. Some estimates place their number at 300,000 and increasing. Major health care issues challenge us in other areas such as



sedentary lifestyles, nutrition, substance abuse (especially among our youth), infant health, diabetes-related deaths, and dental care for our children. Also, there are great disparities in health status among our minority populations.

Health care services are not available and accessible to many individuals who need them. Numerous barriers prevent them from obtaining care including financial constraints, availability and cultural sensitivity of providers, and the availability of transportation or after hours care. Many of our disadvantaged citizens are experiencing problems accessing some providers as the health care system changes from predominantly a fee-for-service insurance system to one dominated by managed care organizations.

A foundation of the size contemplated by the Blue Cross conversion could have the potential to dramatically impact these issues beyond that which has been possible heretofore. Due to the scope of our health care problems and the resulting enormous costs, much planning will be necessary to ensure that these funds are strategically placed to impact directly those who need the services most. Also, it is vitally important that we concentrate on changing attitudes and lifestyles through health promotion and disease prevention and/or intervention efforts.

For example, a couple of years ago, our Trust established a Good Health Program to encourage communities to improve the provision of preventive services to low income populations in 13 communities across the state. The program promotes the development of collaborative linkages with primary care providers to use more effectively the limited resources and personnel in the communities served by these agencies. These various efforts addressed such issues as dental health education and prevention services for children and youth, the improvement of immunization rates among children, the reduction of diabetes-related morbidity and mortality, and breast cancer screening for low-income women.

Health-related needs cover a broad spectrum, and we are learning that many of them are best dealt with through prevention programs. Ironically, we often do a better job of following maintenance schedules on our automobiles than we do our bodies.

North Carolina has many health-related programs and services today that can be traced to the support of a foundation. One that we are proud of at Kate B. Reynolds is the hospice program that serves 99 counties in North Carolina. In 1977, two Episcopal ministers in the Triangle area were trying to start a hospice group here. In doing so it became obvious to them that a number of communities wanted to have hospice programs. They came to us and asked for funding to create a state organization to help create local hospice chapters around the state. We gave them \$37,000. Today, North Carolina has the best hospice program in the country.

There may be a tendency to think of health care as a cradle-to-grave issue. Actually, it's broader than that. Most of you are familiar with the challenge to reduce our infant mortality rates in this state. Infant mortality is as much a prenatal issue as it is a postnatal issue. It's as important to address the problem from an educational perspective as it is from a treatment perspective. In fact, prenatal care and education can often prevent health problems or at least reduce their severity.

A statewide foundation has the responsibility of making its resources available to all the citizens in North Carolina who may be served under its broad mission. About four years ago, we realized that some people across North Carolina did not know about the Kate B. Reynolds Charitable Trust. So, we began hosting week-long satellite offices in three cities around the state to meet individually with nonprofit organizations that serve health care needs of the region's financially needy residents. Senator Rand and Representative Hurley, you may be interested to know that Fayetteville is one of the annual locations. The others are Greenville in the east and Asheville in the west. This year we added Elizabeth City in the northeast and Sylva in the far west.

One of the interesting outcomes of this outreach effort is that we have learned as much about what the people of the state need as they have learned about us. We know that transportation needs have been identified as a common health care problem throughout the state. We have noted the lack of a health care infrastructure in many of our rural areas. We know that many of our citizens are concerned about the health of their neighbors and communities and that sometimes, with minimal support, they can make a difference.

Foundations are subject to many legislative and regulatory controls on what we can and cannot do. The Internal Revenue Service has very strict rules on how much money we must distribute each year and on any activities that might be interpreted as conflicts of interest by Trustees or staff. There are stiff penalties for any foundation that fails to follow the rules. We are required to file reports with the Internal Revenue Service and with the State of North Carolina each year and to make these reports available to the public.

In addition to the required reporting, many foundations publish annual reports describing their financial and programmatic activities. I have given copies of our 1997 annual report to the Sergeant at Arms. This report demonstrates what our foundation is doing in the state to address some of the health care needs. The Z. Smith Reynolds Foundation, directed by Tom Lambeth who is on this Study Commission, has been making grants to communities across North Carolina since 1936. They also publish an annual report. Many of you know about the good work of the Z. Smith Reynolds Foundation.

As I'm sure you can see, the operation of a private, independent foundation requires a broad range of skills and knowledge. The staff and trustees need to have expertise in the types of programs being funded as well as in the technical and fiduciary issues of governance for nonprofit organizations and foundations.

It's often very humbling, but it is always satisfying to see how our work helps build better lives for people around the state. I know that it will continue long after I'm gone, because our foundation--like most foundations--provides a legacy for future generations.

Thank you for allowing me to testify before you today. I'll be glad to try to answer any questions you may have.

**TESTIMONY OF GARY S. MENDOZA©  
BEFORE THE NORTH CAROLINA CONVERSION STUDY COMMISSION  
MARCH 3, 1998**

Mr. Chairman and Members of the Committee:

I appreciate the opportunity to be with you this morning to discuss the conversion of Blue Cross of California. My name is Gary Mendoza. Currently, I am a principal with the Los Angeles-based law firm of Riordan & McKinzie. Since January 1, I have been working with BlueCross BlueShield of North Carolina in connection with their consideration of the conversion issue. From July 1993 to March 1996, I was the Commissioner of Corporations for the State of California. In that capacity, I headed up the California Department of Corporations.

The Commissioner of Corporations' Authority. The Department of Corporations is a regulatory department with jurisdiction over a range of business activities within the State. The managed care/HMO industry is one of the industries regulated by the Department of Corporations. Managed care is the predominant form of health care delivery in the State, and approximately 80% of the insured population in California receive their health care from health care plans regulated by the Department of Corporations. Less than 20% of the insured population receive their health care from insurance companies regulated by the California Department of Insurance.

In California, as in North Carolina, the Attorney General has primary jurisdiction over the activities of nonprofit corporations. A specific statutory provision of California law, however, grants the Commissioner of Corporations exclusive jurisdiction to monitor compliance by nonprofit health plans with the provisions of California law governing nonprofit corporations. This authority is the same authority that the Attorney General has with respect to other nonprofit corporations in the State.

As a result of the scope of the Commissioner of Corporations' jurisdiction, during my involvement with the Blue Cross of California conversion, I exercised the equivalent authority of both your Commissioner of Insurance and Attorney General.

The BCC Conversion. During my tenure at the Department of Corporations, perhaps the most significant and controversial issue that I dealt with was the conversion of Blue Cross of California from a nonprofit health care service plan to a for-profit health care service plan. This matter was first brought to my attention within weeks of my arrival at the Department, and the DOC approved the final form of the conversion on my last day in office. During this period of review, I sought a solution that both assured that BCC's public benefit responsibilities were fully met and that the company's viability as a significant health care provider in the State was not undermined in the process. I would like to summarize the history behind the Blue Cross of California conversion, set out the principles that guided the DOC's review of the conversion and respond to whatever questions any member of the Commission or the Commission's staff might have.

History. I have attached as Appendix A to my written testimony a chronology of the BCC conversion. I would like to briefly summarize that history.

In July 1991, Blue Cross of California filed an application with the DOC to become licensed as a health care service plan and to restructure its operations. As part of this restructuring, BCC transferred substantially all of its operating assets to a newly formed for-profit company, Wellpoint Health Networks, in exchange for all of Wellpoint's stock. Since the stock of Wellpoint remained in the hands of a nonprofit corporation, the DOC concluded that BCC's restructuring was not a conversion. The Department approved the application in January 1993, and Wellpoint completed an initial public offering in February 1993. In its IPO, Wellpoint sold 19.5 million shares of newly-issued stock for approximately \$510 million.

The restructuring changed the nature of the assets that BCC held to meet its public benefit responsibilities. Before the restructuring, BCC met its public benefit responsibilities by using its operating assets to run a nonprofit health care plan. After the restructuring, that operation was conducted substantially by Wellpoint, a for-profit plan, and BCC held 80.5% of Wellpoint's stock, a very valuable financial asset.

Beginning in January 1993, the Department worked with BCC to complete the process begun by the restructuring and to assure that BCC met its public benefit responsibilities by utilizing the assets available to BCC as a result of the restructuring. That process was completed when the conversion of BCC was consummated in May 1996. During that process, significant public input into the terms of BCC's conversion was solicited, BCC/Wellpoint entered into an agreement to merge with another for-profit health plan (an agreement that was ultimately abandoned) and the Department and BCC negotiated the definitive terms of BCC's conversion/public benefit plan.

The completion of the BCC conversion resulted in the creation of two independent foundations. These two foundations initially held a combined total of more than \$3 billion in assets, and each is dedicated to programs that increase access to health care for underserved populations within the State or improve the overall health status of the people of California. Since Wellpoint has been successfully run, the value of the Wellpoint stock has increased. As a result, the two foundations now hold resources totaling, in the aggregate, approximately \$4 billion.

Certain aspects of the BCC conversion, particularly those relating to the restructuring, may not be relevant to the situation here in North Carolina. I do believe, however, that the BCC conversion establishes a successful model for a Blue Cross conversion that the Study Commission may want to consider within the context of its important deliberations.

The California Model. During our review, the Department of Corporations felt it was important that the following core principles be incorporated into any resolution of the Blue Cross of California conversion issue:

- (1) 100% of the value of Blue Cross of California should be made available to one or more health care foundations as part of the conversion.

- (2) The foundations that held these assets should be managed by independent boards of directors.
- (3) The corporate structure chosen for the foundations should be sufficiently flexible to enhance the benefits made available to the public through the foundations' activities. That desired flexibility should not, however, undermine those public benefits.
- (4) The foundations should be dedicated to serve broadly-stated health care needs of the people of the State of California.
- (5) The process of the conversion review and the resolution reached should not adversely impact BCC/Wellpoint's ability to successfully manage its operations and provide health care coverage to the people of California.

Capturing BCC's Value. From the outset, it was important to the Department that, as part of any resolution of the BCC issue, 100% of the value of BCC's assets be made available to serve the public benefit. The BCC conversion, as finally approved, did result in the capture of 100% of the value of BCC's assets for the benefit of the public. Substantially all of that value was represented by the transfer by BCC of its Wellpoint stock to one of the foundations as part of the conversion. The balance of that value was established through a market-assessment process, a process made necessary by the restructuring that preceded the conversion.

In my opinion, any conversion that results in the transfer of 100% of the stock of the newly-converted for-profit company to one or more foundations would, by definition, capture 100% of the value of the assets being converted for the benefit of the public.

Independent Governance. In the initial public benefit plan, Blue Cross of California proposed that its board, including its CEO, comprise the initial board of the newly-established foundation that would discharge public benefit mission. This was not acceptable for two principal reasons. First, to assure that the foundation(s) operated independently of the for-profit company, it was important to the Department that there not be any overlap between the board of the charitable foundation(s) and the board of the for-profit company. In addition, while the Department concluded that some involvement by former BCC board members on the board(s) of any newly established foundations was appropriate, the Department felt it was important that the initial board(s) include a number of newly-named individuals who could bring a different and valuable perspective to the foundation(s)' operations.

To assure the Department that the newly-established foundations had boards that were independent and broadly representative of the interests of the people of California, BCC agreed to undertake a comprehensive statewide search for new board members. While BCC retained the right to name initial board members, the DOC did retain the right to veto up to six of the prospective board nominees that were identified during that search effort. The

DOC monitored that statewide search effort and reviewed the qualifications of the prospective board nominees. We did not exercise any of our veto rights. BCC and the Department also agreed that there would be no overlap between the boards of the for-profit company and either of the foundations and that the former BCC members who comprised a portion of the boards of the newly-established foundations would leave those boards according to an agreed-upon schedule.

In my view, the process that we followed did assure that the boards of the newly-established foundations were independent of the for-profit company and comprised of members with an appropriate and broad range of skills, backgrounds and perspectives.

Structural Flexibility; Structural Safeguards. To assure that the benefits to the public were maximized, the Department was sensitive to the tax complications associated with the conversion and the activities of the charitable foundation(s) following conversion. Initially, the Department was of the view that the charitable mission should be discharged by a 501(c)(3) private foundation, a well-understood form of charitable organization. This view was echoed by number of consumer groups and members of the State legislature.

Beginning with its initial May 26, 1994 submission, however, BCC argued that, for a number of tax reasons, a 501(c)(4) social welfare organization was a more appropriate vehicle to discharge the charitable mission. BCC explained that, unlike a 501(c)(3) private foundation, a 501(c)(4) social welfare organization (i) is not required to divest itself of "excess holdings" over a five-year period or subject to a 2% excise tax on investment income and (ii) could engage in redemption-type transactions that might be advantageous to both the foundation(s) and the company but would be prohibited self-dealing transactions for a 501(c)(3) private foundation.

After a significant period of review, the Department concluded that a 501(c)(4) organization could play an important role within the context of BCC's conversion, particularly with respect to the monetization or sale of the Wellpoint stock that was transferred to the foundation as part of the conversion. As a result, the Department agreed to authorize the 501(c)(4) to hold the Wellpoint stock, provided it transferred not less than 80% of the proceeds it received from any sale of the stock to the 501(c)(3). The Department wanted to make certain, however, that the legitimate tax planning goals served by the use of a 501(c)(4) did not undermine the benefits to the public associated with the conversion.

While the Department agreed that a 501(c)(3) private foundation was not the best type of entity to hold and monetize the Wellpoint stock, the Department did recognize that there were important safeguards that 501(c)(3)s are subject to that are not applicable to 501(c)(4)s. These safeguards include (i) prohibitions against lobbying and other political activities, (ii) prohibitions against conflicts of interest and (iii) the requirement that 501(c)(3) private foundations expend 5% of their assets each year for public purposes. To assure that these safeguards were preserved, the DOC negotiated with BCC undertakings to incorporate these safeguards into the 501(c)(4)'s charter documents.

Although there are a number of features to the California Model that make it a useful precedent, I do not believe that it is necessary to establish both a 501(c)(4) and a 501(c)(3) to fully serve the public's interest within the context of a Blue Cross conversion. Unless the entities have fundamentally different missions, there is no compelling reason to establish two separate entities. Having two foundations can complicate the implementation of the public mission and increase the related administrative costs. Upon additional reflection, I believe that the best foundation vehicle is a 501(c)(4) social welfare organization that is subject to many of the safeguards applicable to 501(c)(3) private foundations. As explained below, this is the path that Empire Blue Cross Blue Shield of New York is now proposing.

Public Benefit Mission. Under the *cy pres* doctrine, when the value of the assets held by the nonprofit BCC was transferred to the newly-established foundations, it was important that foundations remained committed to serving the health care needs of the people of the State. At the same time, the Department recognized that these foundations could serve the public's interest in perpetuity and resisted any effort to too narrowly circumscribe the foundations' mission. As part of the negotiated undertakings, each of the foundations adopted mission statements that called for each to support programs that increased access to health care for underserved populations or improved the health status of the people of California. The undertakings also obligated the foundations to file with the Attorney General whatever reports he or she thought was appropriate to assure that they were meeting their public benefit missions.

Maintaining BCC's Ability to Compete. In the Department's view, the people of the State of California, through the 501(c)(4) became, in effect, BCC's indirect shareholders upon completion of the conversion. As a result, the success of Wellpoint, the for-profit company, inures directly to the benefit of the people of California through an increased value of the stock. The Department also recognized that, both before and after the conversion, over two million Californians would depend upon BCC to provide their health care coverage. As a result, the Department wanted to make certain that neither the process of the conversion nor the conversion itself compromised BCC's ability to compete in the managed care marketplace.

This concern manifested itself in several ways. During the conversion process, the Department made it clear that it would not force a fire-sale liquidation of BCC's Wellpoint holdings or require BCC to take other actions that would adversely impact the value of the Wellpoint stock. Before we approved the conversion, we also confirmed that the conversion would not compromise BCC/Wellpoint's solvency or otherwise adversely impact its ability to provide health care coverage. The Department also carefully considered the views of the BlueCross BlueShield Association. The Department recognized that the Blue Cross trademark was very valuable, and the Association made it clear that it was prepared to revoke BCC's right to use the trademark if the Association's requirements were ignored. Accordingly, the Department did modify certain of its proposals to accommodate the Association's views. For example, the Department ultimately acceded to the Association's requirement that a majority of the directors of the 501(c)(4) be former BCC board members.



Corporate Governance. The Department also recognized and accepted the Association's interest in assuring that Wellpoint, the for-profit entity, did retain adequate control of its activities to effectively pursue its business interests. These controls were memorialized in a voting agreement and a voting trust agreement that the 501(c)(4) entered into in connection with its receipt of the Wellpoint stock. Under the terms of the voting agreement, the 501(c)(4) agreed that, so long as it held 5% or more of the Wellpoint voting stock, it would vote its shares (i) in favor of the board nominees selected by Wellpoint's nominating committee or the members of the Wellpoint board who had been members of BCC's board prior to the conversion and (ii) in opposition to any action to remove a Wellpoint board member (except in cases of gross misconduct) or to amend Wellpoint's articles or bylaws unless the Wellpoint board supported the amendment. Under the terms of the voting trust agreement, the 501(c)(4) agreed to vote certain of its shares in a manner that was consistent with the vote cast by the other Wellpoint shareholders.

Empire Blue Cross and Blue Shield. Although I am not involved in the potential conversion of Empire Blue Cross and Blue Shield in New York, I have reviewed certain of the filings that have been made by Empire and am generally familiar with what is currently being proposed.

As currently proposed, as part of the Empire conversion, all of the stock of the converted for-profit company would be contributed to a newly-established 501(c)(4) social welfare organization whose purpose will be to address the health care needs of the poor and uninsured in the state of New York and promote and maintain the health of all New Yorkers. The 501(c)(4) would be subject to many of the limitations ordinarily applicable to 501(c)(3) private foundations, including prohibitions against lobbying or participation in political campaigns. Based upon the materials I have reviewed, however, the 501(c)(4) would not be subject to the 5% distribution requirement. Empire has proposed using a 501(c)(4) organization for precisely the same reasons that lead the Department to authorize the use of a 501(c)(4) within the context of the BCC conversion.

Consistent with the approach in California, the initial board members are proposed to be identified through a statewide search effort. Empire will appoint substantially all of the initial board members. While it is not currently proposed that the Attorney General retain the right to veto proposed board members, the Attorney General does have the right to appoint two of the initial board members. In contrast with California, in New York it is proposed that no member of Empire's current board can be appointed to the initial board of the foundation. As part of the conversion, the foundation will enter into a Stock Voting and Sale Agreement in compliance with the requirements of the Blue Cross and Blue Shield Association. Among other things, this Agreement will require the foundation to vote its shares in support of directors to the board of the for-profit company nominated by the for-profit company and otherwise in a manner that is consistent with the vote casts by the other holders of the for-profit company's stock.

Based upon my review, I believe that the proposal currently under consideration in New York is substantially consistent with the model that we followed in California in connection with the BCC conversion.

This ends my prepared testimony. I would now like to respond to any questions that the Commission has.



**Conversion of Blue Cross of California  
A Chronology**

Gary S. Mendoza  
February 18, 1998

The following is a chronology of the critical events that led to the conversion of Blue Cross of California (BCC).

- July 1991**            BCC files an application with the Department of Corporations (DOC) to become a licensed health care service plan and to restructure its operations. Pursuant to the restructuring, BCC proposed to contribute substantially all of its operating assets to Wellpoint Health Networks in exchange for 80 million shares of stock, representing 100% of Wellpoint's initially issued stock.
- January 1993**        DOC approves BCC's license application and restructuring plan.
- February 1993** Wellpoint completes an initial public offering. In this offering, Wellpoint sold 19.5 million newly-issued shares of stock to the public for approximately \$510 million. BCC sold none of its Wellpoint shares in the initial public offering.
- March 1993**        Legislation introduced in California State Assembly to treat the BCC restructuring as a conversion and retroactively impose a charitable trust obligation upon BCC as a result of the restructuring.
- August 1993**        BCC enters into a negotiated settlement with certain members of the California Legislature. Under the terms of this agreement, BCC agreed to provide \$5 million a year of public benefit funding for 20 years, and the members of the Legislature agreed to end consideration of the bill retroactively imposing a charitable trust obligation upon BCC as a result of the restructuring.
- August 1993-  
May 1994**            The DOC works with BCC to determine BCC's plans to meet its public benefit responsibilities.
- May 6, 1994**        The DOC sends a letter to each member of BCC's Board summarizing the DOC's unsuccessful effort to determine BCC's public benefit plans. The DOC also suggests that BCC commit to provide \$100 million in public benefit funding in 1994 and, as part of BCC's plan to meet its public benefit responsibilities, contribute not less than 40% of its Wellpoint stock to a newly-formed foundation.
- May 26, 1994**        BCC files an undertaking with the DOC to provide \$100 million in public benefit funding in 1994 and to file a plan with the DOC by September 15, 1994 to use all of its assets for the benefit of the public.
- September 1994**    BCC files its public benefit plan with the DOC. Among other things, the

plan contemplates that BCC will transfer all of its assets to a newly-established 501(c)(4) that is dedicated to health-related public benefit purposes. BCC's proposal also contemplates that BCC's Board would become the board of the 501(c)(4) following that transfer.

October 1994- The DOC expresses its view that the BCC transfer/sale of assets  
March 1995 to Wellpoint is a "related party" transaction under California law and urges BCC and Wellpoint to explore the possibility of merging with, or selling all or substantially all of BCC's assets, including BCC's Wellpoint stock, to another health care company or a financial buyer. BCC and Wellpoint thereafter undertake a market assessment effort.

March 1995 BCC and Wellpoint enter into a merger and recapitalization agreement with Health System International (HSI), another California-based health plan. Among other things, the merger/recapitalization agreement contemplated that (i) BCC would transfer all of its assets, including the Wellpoint stock and BCC's remaining operating assets to a newly-established 501(c)(4) social welfare organization, (ii) Wellpoint would pay a dividend of \$10 per share to all of its shareholders, including the 501(c)(4), (iii) BCC would convert to a for-profit corporation and merge with HSI and (iv) the 501(c)(4) would receive \$235 million in consideration for the transfer of BCC's remaining operating assets to the converted for-profit company.

October 1994- BCC and the DOC negotiate the terms of the final public benefit plan  
1995 and the related conversion.

September 1995 DOC approves BCC's public benefit plan and the related conversion. The public benefit plan, as approved, contemplated that (i) BCC would form two foundations, a 501(c)(4) that would hold the stock of the converted/merged company and a 501(c)(3) private foundation that would initially receive from the 501(c)(4) the \$800 million cash dividend and \$100 million of the \$235 million consideration received by the 501(c)(4) for BCC's remaining operating assets, (ii) the 501(c)(4) would be subject to many of the protections that apply to 501(c)(3) private foundations, including the 5% distribution requirement and restrictions on lobbying and conflicts of interest, (iii) the 501(c)(4) would be obligated to transfer to the 501(c)(3) 80% of the proceeds the 501(c)(4) received from any sale of the stock of the converted/merged company, (iv) both the 501(c)(4) and 501(c)(3) would be dedicated to increasing access to health care for underserved populations and improving the overall health status of the people of California, (v) the board of each of the 501(c)(4) and 501(c)(3) would include newly-appointed members identified through a statewide search effort undertaken by BCC and (vi) there would be no overlap between the members of the boards of the 501(c)(4), the 501(c)(3) and the converted/merged company.

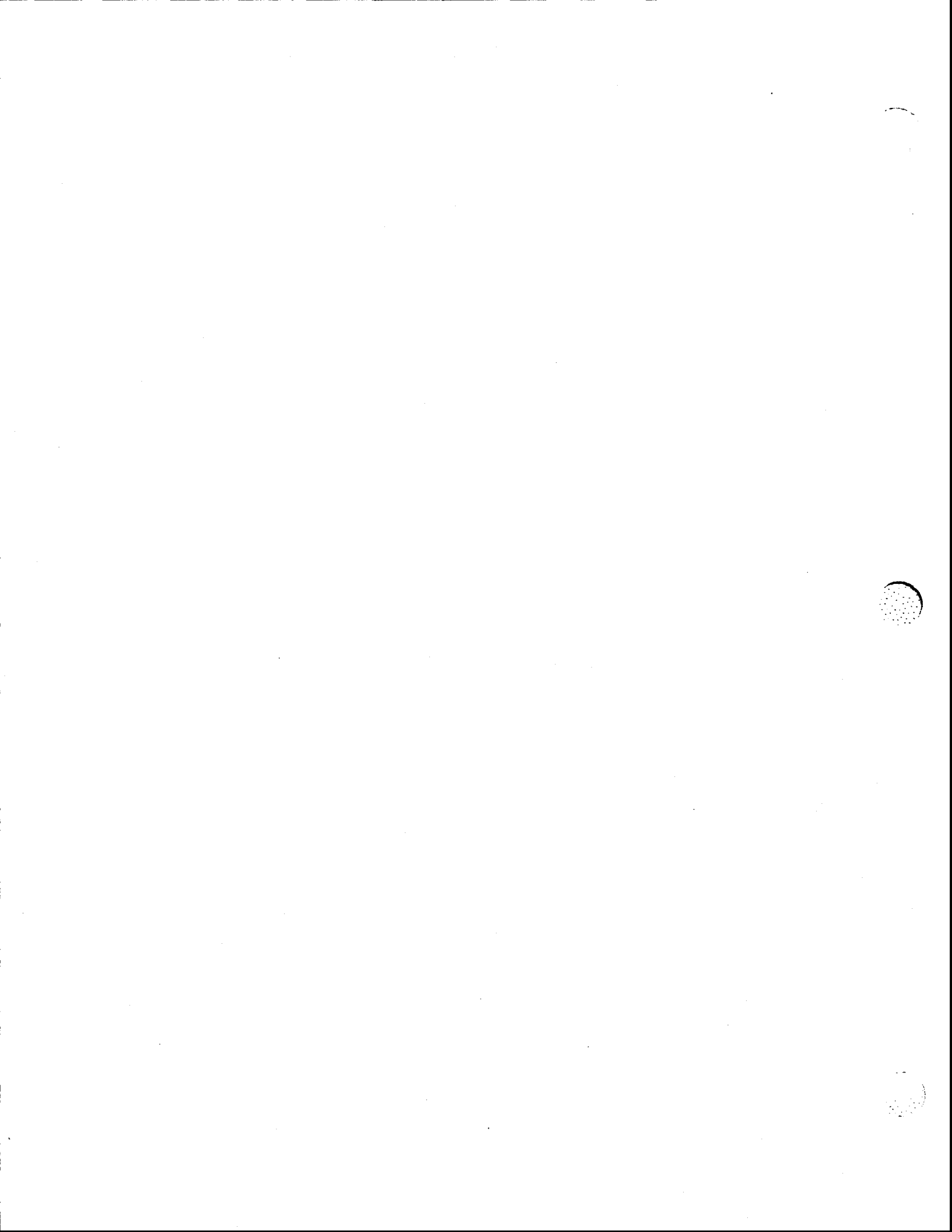
December 1995 HSI and BCC/Wellpoint terminate their merger/recapitalization agreement.

March 1996

The DOC approves BCC's revised public benefit plan and the related conversion. Other than those changes necessary to reflect the termination of the HSI/BCC/Wellpoint merger/recapitalization agreement, the revised plan was essentially the same as the plan approved in September 1995.

May 1996

BCC/Wellpoint merger/recapitalization approved by Wellpoint's shareholders and merger/recapitalization/conversion is consummated.



**BLUE CROSS AND BLUE SHIELD  
JOINT STUDY COMMISSION  
TESTIMONY OF ROBIN L. HINSON  
MARCH 3, 1998**

I am a senior partner in the law firm of Robinson, Bradshaw & Hinson, P.A. in Charlotte. Late last summer our firm was engaged as special counsel to give legal advice to Blue Cross and Blue Shield of North Carolina concerning the ownership of the Company. We were hired because of a class action lawsuit seeking a court ruling that the subscribers, and only the subscribers, have property and contractual rights in all of the Company's reserves. The Attorney General of North Carolina intervened in this lawsuit, contending that all North Carolina citizens have beneficial rights and interests in the assets of Blue Cross. We have been authorized by Blue Cross to discuss our opinions and conclusions publicly, but Blue Cross does not waive its attorney-client privilege.

After a thorough review, we concluded that neither the subscribers of the Company nor the citizens of North Carolina presently have any ownership interest in the reserves or any other assets of Blue Cross. It is our opinion that legal title to the reserves and all other assets of Blue Cross is vested in Blue Cross as a separate corporate entity. We are confident that these opinions are correct.

If Blue Cross should merge with or convert to a for-profit entity, it is not clear under the corporate documents and present law where ownership of the value of Blue Cross would be vested. We believe, however, that the citizens of the State of North



Carolina would have the best claim to ownership of the value of the Company upon conversion to a for-profit status, as I will explain more fully.

### Rights of Subscribers

The question whether subscribers would have any ownership interest in Blue Cross upon conversion has been a difficult one. We learned that Blue Cross has operated over the years as a "de facto" mutual organization. Sorting through the complexities of ownership rights took several months of research and thought, and reasonable persons – and reasonable lawyers – might differ on the conclusions reached. However, we have concluded that subscribers have no ownership rights in the assets and reserves of Blue Cross. Further, it is our opinion that the subscribers would have no claim to ownership of any part of the value of the Company upon a conversion to, or merger with, a for-profit entity. Again, we are confident that these conclusions are correct. The basis of these conclusions is as follows:

1. A review of the charter documents of Blue Cross back to the Company's origins in 1933 confirms that the subscribers have no ownership interest in the reserves or other assets. The articles of consolidation of two separate corporations in 1967 creating the present corporation, Blue Cross and Blue Shield of North Carolina, declared that the rights of certificate holders would be as set forth in the certificates issued by the corporation.

2. A review of the certificates or policies issued to subscribers confirms that these documents confer no ownership rights on subscribers in any reserves or other assets.

3. There are two references in the statute under which Blue Cross is governed referring to subscribers' "rights" in the reserves and capital of Blue Cross. One provision says that the charter of Blue Cross may be amended to convert the corporation into a mutual non-stock or stock accident and health insurance company or life insurance company "provided the rights of the subscribers or certificate holders in the reserves and capital of such corporation are adequately protected" under regulations adopted by the Commissioner of Insurance. The same language appears in another provision permitting a merger of Blue Cross with a mutual non-stock or stock accident and health insurance company or life insurance company. These references do not say what such subscriber rights are, nor are such rights defined in any other statute. This is in sharp contrast to other North Carolina statutes dealing with mutual or cooperative organizations that do specifically define ownership rights of members. We have concluded that the "rights" referred to in the statute are contract rights, and not ownership rights. The contracts Blue Cross has with its subscribers require the Company to pay covered medical expenses of subscribers. If Blue Cross breached a contract with a subscriber, the subscriber might have recourse to the reserves or other assets of Blue Cross to require it to honor the contract or to collect damages for its breach. But subscribers presently have no ownership rights in any assets of Blue Cross.

4. Subscription contracts and North Carolina statutes give subscribers voting rights in certain circumstances. However, it is our opinion that voting rights do not constitute proof of ownership.

5. Finally, practical considerations dictate that subscribers do not now and would not upon conversion own any interest in the reserves or other assets of the Company. For example, if one concludes subscribers own all or part of the Company's reserves, which subscribers are vested with ownership? Subscribers who happen to be covered at any one point in time? Those who had subscription contracts over some period of time, and, if so, what period? And how would ownership among subscribers be divided or computed? Would it be figured in some way to have some relationship to the amount or type of coverage? Would it differ depending upon whether subscribers had made no claims under their coverage or made claims in excess of the premiums paid for the coverage? Lastly, vesting subscribers with ownership of any amount of the reserves or other assets would provide subscribers an ownership windfall. Presumably, each subscriber over the years has gotten that for which he or she contracted - medical insurance coverage in payment of covered medical expenses. We see no justification legally or from the standpoint of fairness for giving to some group of subscribers any of the value of the Company.

#### **Disposition of Value Upon Reorganization**

As a legal matter the disposition of the value of Blue Cross upon some possible future change in status from a nonprofit to a for-profit corporation is simply not clear. As

already stated, however, we concluded that the citizens of North Carolina have the best claim for ownership upon a change in status. We arrived at this conclusion partially by a process of elimination.

It is our view that Blue Cross is not a charitable corporation and that the doctrine of charitable trusts should not apply upon a conversion. There is a clear legal distinction under North Carolina law between a charitable and a nonprofit corporation. Blue Cross is a nonprofit corporation. Beginning in the 1940's and continuing for more than twenty years, the statute under which Blue Cross is governed did refer to the corporation as a charitable corporation. However, this nomenclature disappeared from the statute more than twenty years ago.

Blue Cross enjoyed a favorable tax status over an extended period of time. Some have argued that a portion of the Company's assets attributable to favorable tax treatment should belong to or benefit in some manner the citizens of the State. We believe that this argument proves too much. There are a number of different organizations and entities (for example, farmers cooperatives, country clubs, and the like) that have received favorable tax treatment over the years. Also, business corporations are frequently given significant tax incentives to build plants or locate in an area. We do not believe it could be credibly contended that tax benefits for these companies bestowed on the public any ownership rights in the companies. A state or federal policy of taxing different organizations and entities at different rates should not give rise to ownership by the public in tax savings.

What should not happen to the value of the Company upon conversion is clear. No part of the value of the Company should be distributed to officers, employees, or directors of Blue Cross upon conversion, and no one at Blue Cross has ever contended otherwise. Also, private investors in a new for-profit company upon conversion should not be entitled to claim value formerly held by Blue Cross. Such a transfer would unjustly bestow value upon investors in addition to the capital they invested. If Blue Cross is worth \$100 million and an investor paid Blue Cross that amount for the Company, he would have paid \$100 million for a company then worth \$200 million. This would constitute an inequitable windfall.

For the foregoing reasons, we conclude that the value of Blue Cross upon conversion should inure to the benefit of the citizens of the State. We base our conclusions on an in-depth study of broad and compelling equitable principles. While we find no precedent in North Carolina or elsewhere that would govern in these peculiar circumstances, we believe that the laws most analogous are the doctrine of escheat, which requires that unclaimed property be ceded to the state as sovereign; the doctrine of charitable trusts; and certain provisions of North Carolina law requiring payment to the government or a charity in the cases of mergers of charitable corporations with business corporations. We believe that these principles and compelling public policy dictate that property to which no citizen or group of citizens has a superior claim must inure to the benefit of the whole community.

## **Proposed Conversion Legislation**

We have examined actual or pending Blue Cross plan conversions in a number of states, including California, Colorado, and New York. We have concluded that the California experience is the most appropriate to use as a guide, but we believe that legislation must be modified to make it workable in North Carolina.

It may be useful to summarize critical legal and business considerations concerning the approach to legislation in North Carolina and to comment on the form any such legislation should take.

There are fundamental principles that are essential to Blue Cross in any conversion legislation:

- The assets and reserves of Blue Cross must be maintained for the benefit of subscribers and the financial well being of the Company;
- The Company must have the business flexibility to manage its business and compete in its market;
- The directors, officers, and employees of Blue Cross must not profit from or receive any distribution in connection with a conversion;
- The obligation of Blue Cross to the citizens of North Carolina upon conversion should be funded with newly issued common stock representing 100% of the value of the Company;
- The timing of any initial public offering of Blue Cross common stock must be in the discretion of the board of directors of Blue Cross; and

- The conversion transaction must be a nontaxable event under both state and federal law.

We believe that the essential elements of an acceptable conversion statute would be as follows:

- Blue Cross files an application to convert with the Commissioner of Insurance outlining the conversion plan, financial projections, etc.
- The Commissioner of Insurance publishes a notice that the plan has been filed, establishes a public comment period, and sets a date for a public hearing on the plan.
- Blue Cross establishes a new charitable corporation;

> A charitable social welfare corporation organized under Section 501(c)(4) of the Internal Revenue Code (the "Foundation") that

is the recipient of all of the issued and outstanding common stock of Blue Cross;

is independent of Blue Cross;

has a self-perpetuating board of directors initially appointed by the Commissioner of Insurance based on recommendations of an executive recruiting firm;

is the ultimate recipient of the net proceeds of sale of Blue Cross common stock.

> The Foundation enters into a voting agreement with Blue Cross that is approved by the Commissioner of Insurance

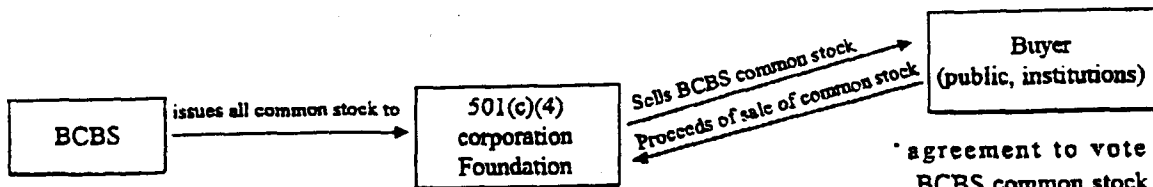
- providing that the board of directors of the Foundation agrees to vote the Blue Cross common stock owned by the Foundation for directors of Blue Cross nominated by the Blue Cross board until the Blue Cross common stock is sold by the Foundation, at which time the voting restriction ceases to exist;

- providing that Blue Cross will determine the timing of any initial public offering of its common stock; and

- providing optional "piggy back" registration rights to the Foundation upon any subsequent offerings of Blue Cross common stock. That is, if Blue Cross makes a public offering of common stock, the Foundation would have the right to sell some or all of its Blue Cross shares in that public offering, all on terms to be agreed.

The transaction can be illustrated as follows:





\* agreement to vote BCBS common stock for directors nominated by BCBS eliminated when stock sold

Foundation

- completely independent of BCBS
- board recommended by executive search firm and selected by Commissioner of Insurance and then self perpetuating
- corporate purpose: promote the health of the people of North Carolina
- voting agreement to vote shares of BCBS for BCBS directors nominated by BCBS
- agrees to reduce ownership of BCBS common stock to less than 5% over a certain period

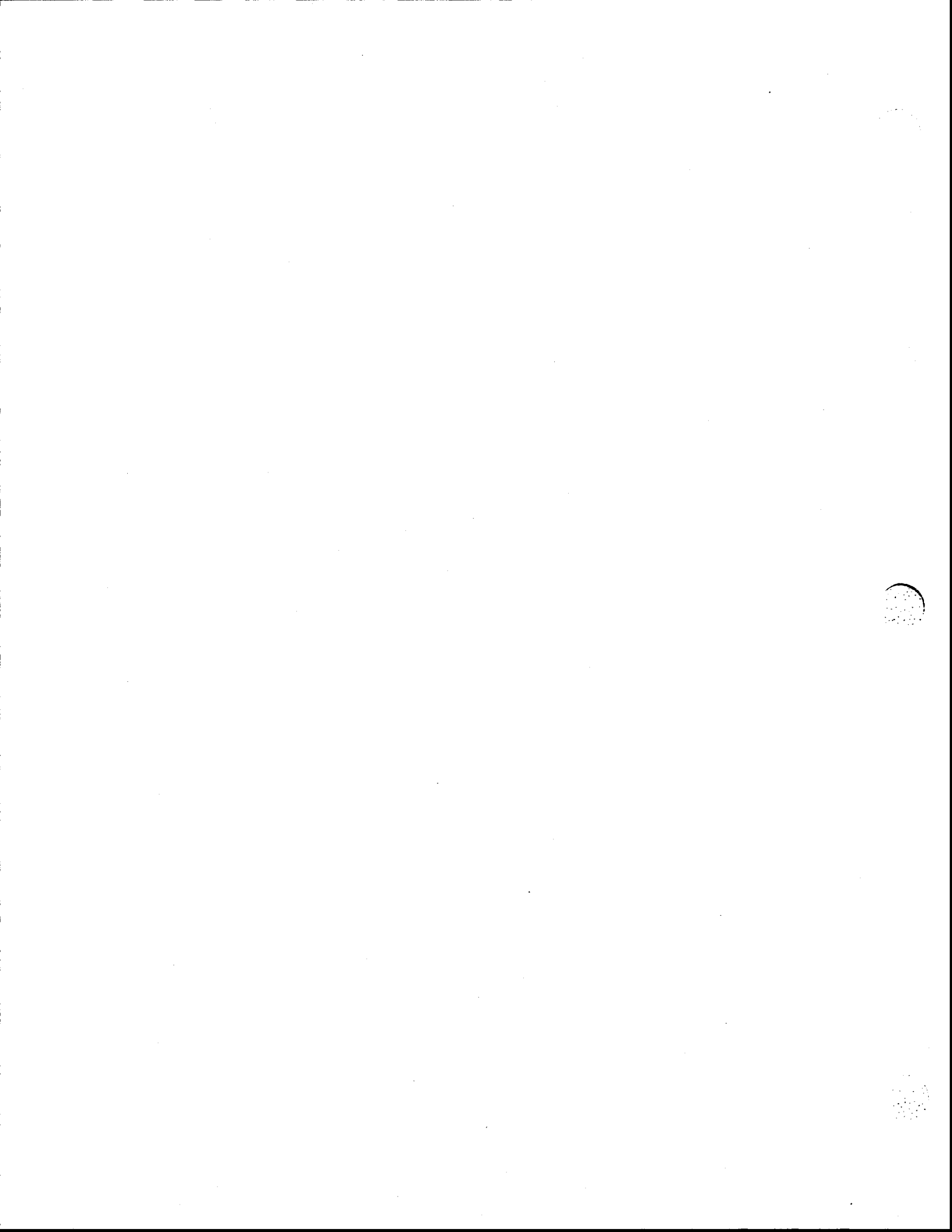
Reasons for 501(c)(4) corporation :

- Foundation as initial holder of BCBS common stock
  - > need not divest stock to diversify within 5 years as required of a 501(c)(3) corporation
  - > does not pay 2% excise tax as would be required of a 501(c)(3) corporation
  - > does not have to distribute 5% of value of corpus annually as required of a 501(c)(3) corporation

We believe that a conversion statute structured along the lines outlined above would protect the Company and preserve its reserves and assets for the benefit and protection of its subscribers and future stockholders. We also believe that this structure will satisfy in full any obligation that Blue Cross has to the citizens of North Carolina. Finally, if and when Blue Cross converts to for-profit status, this structure would provide in perpetuity an important vehicle to serve the health care needs of the people of the State.

There are many issues to be resolved in developing any such legislation that will be satisfactory to the various interested constituencies. We believe, however, that these issues can be resolved and that this proposal could ultimately have enormous benefit for the people of North Carolina.

I will be happy to respond to any questions.





*Bringing lifetimes of experience and leadership to serve all generations.*

NORTH CAROLINA STATE LEGISLATIVE COMMITTEE

CHAIR

Mrs. Evalyn Brendel  
2989 Tillinghast Trl.  
Raleigh, NC 27613-5411  
(919) 676-8752

VICE CHAIR

Mr. R. Lamar Whittle  
505 N. Vance St.  
Red Springs, NC 28377-1376  
(910) 843-1730

SECRETARY

Mrs. Ila McIlwean White  
117 Bernhurst Rd. Apt. 11  
New Bern, NC 28560-5039  
(919) 638-7027

COORDINATOR

Capital City Task Force  
Mr. Richard C. Hatch  
217 Beachers Brook Lane  
Cary, NC 27511-5506  
(919) 481-9449

TESTIMONY OF RICHARD C. HATCH, COORDINATOR OF THE NORTH  
CAROLINA CAPITAL CITY TASK FORCE OF THE AMERICAN ASSOCIATION  
OF RETIRED PERSONS (AARP) STATE LEGISLATIVE COMMITTEE

PUBLIC HEARING OF THE HOSPITAL MEDICAL AND DENTAL SERVICE  
CORPORATION CHARTER CONVERSION STUDY COMMISSION

Raleigh, North Carolina  
March 3, 1998

TESTIMONY OF RICHARD C. HATCH, COORDINATOR OF THE NORTH  
CAROLINA CAPITAL CITY TASK FORCE OF THE AMERICAN ASSOCIATION  
OF RETIRED PERSONS (AARP) STATE LEGISLATIVE COMMITTEE  
BEFORE THE HOSPITAL MEDICAL AND DENTAL SERVICE CORPORATION  
CHARTER CONVERSION STUDY COMMISSION

March 3, 1998

My name is Richard C. Hatch. I am a member of AARP's North Carolina State Legislative Committee and Coordinator of its Capital City Task Force. Thank you for giving me the opportunity to testify today.

Many of AARP's over 849,000 North Carolina members are concerned over what will happen if NC Blue Cross Blue Shield (NCBCBS) should convert from a nonprofit corporation to a stock or mutual corporation as provided in Senate Bill 993. That is why AARP and other concerned citizens opposed that bill last summer in the General Assembly. Indeed, one of our recommendations at that time was the establishment of a study commission to recommend conversion procedures, and we are pleased that the General Assembly agreed with and implemented that recommendation.

We are also pleased that last month Mr. Ken Otis, the President and Chief Executive Officer of NCBCBS, proposed to this Study Commission four principles for such a conversion, which included the creation of one or more foundations, to be funded by NCBCBS stock, for the charitable purpose of serving the health needs of North Carolinians.

We are equally pleased that the Study Commission is looking at the experience of California in developing principles for conversion and in establishing one or more

charitable foundations. We agree that the California example is a good starting point. However, we would hope that tax laws will permit the creation of a single charitable foundation rather than two, as was done in California.

We agree that on conversion 100% of the **assets** of NCBCBS should be retained by the new for-profit corporation to safeguard the company and protect its ability to pay customer claims. But we also agree with those concerned citizens who insist that 100% of the **stock** in the new for-profit corporation must be initially owned and controlled by the charitable foundation. NCBCBS was founded and is a nonprofit public benefit corporation. It has no shareholders or owners other than the public. The activities and proceeds of a public benefit corporation must not be used for private individual gain.

The new for-profit corporation must be able to authorize and issue additional shares to the public; however there should be protection against unfair dilution of the value of the shares held by the charitable foundation. The general principle should be that what is good for the for-profit corporation should also be good for the charitable foundation as long as it holds that corporation's stock.

While some limitation on the voting rights of trustees of the charitable foundation in electing the Board of Directors of the for-profit corporation may be prudent, all

shares of the for-profit corporation following conversion, whether those shares are held in trust or by the general public, must be treated the same and have the same rights in the event of an attempted take-over, hostile or otherwise, by another business organization.

We recommend the following guidelines in creating the charitable foundation to receive the stock of the for-profit corporation following conversion:

1. The trustees of the charitable foundation should be truly independent. Political affiliation shouldn't play a part in the selection process. While they should have high financial acumen, they should also be broadly representative of the diverse population of our state and knowledgeable about the health issues facing our state's population.

2. Many constituent groups have particular health needs but especially since our population is aging dramatically leading to projected increases in long-term care needs, one or more of the trustees selected should be particularly sensitive to the health needs of older North Carolinians.

While NCBCBS may never elect to convert to a for-profit stock corporation, we believe the Study Commission is well on the way to establishing a conversion procedure that will be a great benefit to our state's citizens. I thank you for allowing me to present AARP's views.

# THE NORTH CAROLINA HEALTH ACCESS COALITION

A Project of the North Carolina Justice and Community Development Center  
P.O. Box 28068 / Raleigh, NC, 27611 / 919/856-2568 / fax:919/856-2175 / health@ncjustice.org

*NCHAC, an independent organization, is a member of the Coalition for the Public Trust. However, the views expressed by NCHAC do not necessarily reflect those of the Coalition for the Public Trust.*

## Testimony to the Blue Cross Blue Shield Study Commission

March 3, 1998

Adam Searing

Prominent philanthropists, physicians, and nonprofit hospitals all came together in the 1930s to provide health insurance to North Carolinians unable to purchase it. These men and institutions wanted to address this critical problem and saw nonprofit health insurance plans as the solution. **The hard work and commitment of these dedicated citizens in forming NC Blue Cross should not be forgotten in the current discussions.**

The dream of these dedicated North Carolinians can live on. I am convinced that as the Study Commission continues its deliberations on this important issue legislators will craft a way to preserve these original ideals. From the discussions so far we seem to be moving towards requiring the formation of a charitable foundation at the time of conversion with 100% of the fair market value of the company. I would also encourage broad public input and a broad health mission for the new foundation.

*A note on the early history of Blue Cross: Formed as North Carolina nonprofit corporations in 1933 and 1935 respectively, the Hospital Care Association and the Hospital Saving Association (in 1938 both Associations received permission to display the Blue Cross emblem of approval) merged in 1968 to become today's NC Blue Cross. The Hospital Saving Association was called Blue Cross Blue Shield from 1946. Hospital Care received Blue Shield approval in 1962.*

### SOME OF THE IDEALS OF THE FOUNDERS OF BLUE CROSS THAT WE CAN PRESERVE IN A CHARITABLE FOUNDATION.

1. The first President of one of the early NC Blue Cross companies was **Dr. I.H. Manning**, former dean, UNC School of Medicine, President, Medical Society of North Carolina. Dr. Manning acknowledged philanthropic donations to Blue Cross from the Duke Endowment as "generous support of a program which gives promise of great relief to the hospitals and to the **underprivileged people of this state.**" (Community Health, a newsletter "Published quarterly in the interest of better health for North Carolinians by Hospital Saving Association", page 2 (Winter 1952)).
2. In the history of the Hospital Care Association the motive of the founders of the Association was described: "[A] **community project whose motive was never pecuniary gain for those who promoted it.** This enterprise was designed to make available the proper medical attention needed for persons who could least afford it and to enable the self-respecting person to pay their way without jeopardizing their future welfare by sacrificing other needs equally important." (History of the Hospital Care Association, Inc., Elisha M. Herndon, page 17, (October, 1968)).
3. **Graham Lee Davis** of the Duke Endowment wrote in 1931 of many of these ideals in a paper that urged the creation of NC Blue Cross: "[T]he **cost of adequate medical service is almost**

March 3, 1998

For more information contact Adam Searing, NCHAC Project Director, at (919) 856-2568.



# THE NORTH CAROLINA HEALTH ACCESS COALITION

A Project of the North Carolina Justice and Community Development Center  
P.O. Box 28068 / Raleigh, NC, 27611 / 919/856-2568 / fax:919/856-2175 / health@ncjustice.org

---

*NCHAC, an independent organization, is a member of the Coalition for the Public Trust. However, the views expressed by NCHAC do not necessarily reflect those of the Coalition for the Public Trust.*

prohibitive at times to a very large proportion of the population, the people with limited incomes." Not only is lack of health insurance bad for the health of North Carolinians but it is expensive too: "The consequence is that [a person who can't pay for medical care] puts off going to the hospital when he needs hospital care as long as he can. The hospital stay is about twice as long....[and] the cost to the hospital of this care is doubled." ("Hospital Insurance - Why Not?", Graham Lee Davis, Hospital Management, Feb. 1931.)

## HOW TO PRESERVE THE IDEALS OF THESE FOUNDERS?

**Graham Lee Davis**, The Duke Endowment.

**Dr. W.C. Davison**, Dean, Duke University School of Medicine.

**Dr. I.H. Manning**, Dean, UNC School of Medicine, President, Medical Society of North Carolina

**George Watts Hill**, Philanthropist, Board Chairman, Watts Hospital.

**Dr. Watson S. Rankin**, Director of the Hospital Section, The Duke Endowment.

From the health advocacy perspective I would respectfully say that the Commission should consider the following three key points:

1. **Requiring the establishment of a charitable health foundation upon conversion to a for profit funded with 100% of the assets of Blue Cross [We seem to be here already].**
2. **Require significant public input into the board selection and operation of the foundation. It is a foundation established for the people of North Carolina through the investment of the people of North Carolina. The people of our state should therefore have significant say in how the foundation is run.**
3. **Ensure the foundation has a broad mission to improve the health of all North Carolinians for generations to come.**

Thank you. I appreciate the opportunity to testify before the Commission.

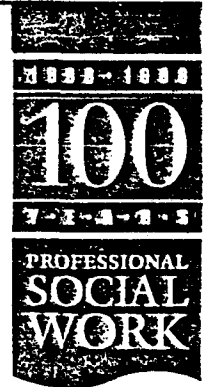


N A S W

NORTH CAROLINA CHAPTER

National Association of Social Workers

**National Association of Social Workers-NC Chapter  
 Public Comment on BlueCross BlueShield Conversion  
 March 3, 1998  
 Presented by: Myrna Miller, MSW, JD**



The North Carolina Chapter of the National Association of Social Workers (NASW-NC) strongly supports the creation of a *meaningful* charitable trust upon the conversion of non-profit BlueCross BlueShield (BCBS) to a for-profit corporation.

NASW-NC represents more than 3,500 professional social workers and their clients. NASW is the largest professional social work organization in the country, as well as in North Carolina. Every day we work with the citizens of North Carolina that would most directly benefit from programs likely to be funded by this charitable trust.

Social workers from across the state have called to let us know that they support the creation of a charitable trust. These social workers are employed in a variety of settings, including mental health centers, county DSS agencies, private practice, and hospitals.

NASW-NC believes the creation of a charitable trust in this situation is sound public policy, which will benefit all the citizens of this State. However, we would like to emphasize that we speak in a representative capacity, rather than expecting a direct benefit for ourselves. Like every elected official in North Carolina, we have constituents that will most directly benefit from the creation of a charitable trust.

Programs that might be funded by the charitable trust vary widely, and of course will not be determined until a later date. However, we can look to programs funded in other states to get an idea of who might benefit directly from the charitable trust. Each of the members of this study commission should think about their constituents that would benefit from programs addressing such needs as:

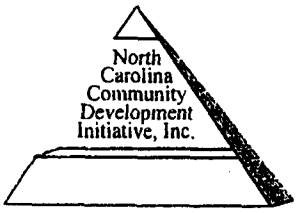
- Primary health care in rural communities
- Health access for the low-income elderly
- Women's health access
- School-based health clinics
- Identification of children with mental health care needs
- And many more!

We are glad that BCBS has stated their commitment to the creation of one or more public foundations. In order for the charitable trust to be *meaningful* to the citizens of North Carolina, we advocate for the following:

1. 100% of BCBS value at the time of conversion should be retained in the form of stock in a single, newly created charitable foundation that will operate as a permanent endowment for the people of NC.
2. The foundation must have a broad mission to promote the health of the people of North Carolina and be entirely independent of the for-profit BCBS.
3. That the trustees of the foundation be selected by a broad, professional, nonpolitical process, with substantial public input.



P.H. #4



316 W. Edenton St., Suite 200A  
Raleigh, NC 27603

P.O. Box 98148  
Raleigh, NC 27624  
(919) 828-5655  
(919) 834-8018 (fax)

**President and CEO**

*Abdul Sm Rasheed*

**Board of Directors**

*George Esser, Chairman  
Chapel Hill, NC*

*P.E. Bazemore  
Monroe, NC*

*Fannie Corbett  
Wilson, NC*

*Gregory A. Cummings  
Concord, NC*

*Joyce Dickens  
Rocky Mount, NC*

*Martin Eakes  
Durham, NC*

*James Grace  
Winston-Salem, NC*

*Andrea Harris  
Henderson, NC*

*Rep. Howard Hunter, Jr.  
Conway, NC*

*Joseph Kilpatrick  
Winston-Salem, NC*

*Ronald J. Leeper  
Charlotte, NC*

*William Moun  
Winston-Salem, NC*

*Susan Perry-Cole  
Rocky Mount, NC*

*Rhonda Raney  
Raleigh, NC*

*Ed Stewart  
Durham, NC*

*Alan Thompson  
Greensboro, NC*

*Stanley Watkins  
Charlotte, NC*

*Herbert M. Wayne, Jr.  
Winston-Salem, NC*

*Henry Williamson  
Winston-Salem, NC*

*Winnie Wood  
Camden, NC*

---

## MEMORANDUM

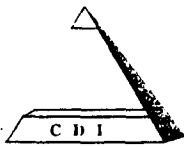
---

**DATE:** March 3, 1998  
**TO:** Blue Cross Blue Shield Study Commission  
**FROM:** Abdul Sm Rasheed *ASR*  
**RE:** **Conversion to a Foundation to Support and Promote the Health of the People of North Carolina**

Thank you for this opportunity to make brief comments on the issue of the Blue Cross Blue Shield conversion. I work in low wealth communities with individuals and families of very limited means who deserve every opportunity to enjoy both physical health and a healthy community environment. There are many factors that have lead to the circumstances that produce the poor health conditions that individuals and families suffer from in North Carolina which could be partly addressed based on the decisions that this commission makes regarding the assets of Blue Cross and Blue Shield. While health and healthy communities are not issues of race, there are clear disproportionate indicators of the negative effect of poverty on the physical, and mental health of persons of color. This resource if created will have major impact on correcting this disproportionate effect.

I stand before you today to seek your consideration of the following recommendations:

- **Have a broad mission "to promote the health of the people of North Carolina**
- **100% of stock value to a single foundation**
- **100% of assets to Blue Cross**
- **Be entirely independent of the for-profit Blue Cross**



- **Have a highly qualified board of directors that is independent of Blue Cross**

The newly created foundation should be a free standing institution and not an affiliate of any existing charity. It should operate as a permanent endowment for the people of North Carolina. As an endowment only, the interest would be spent on an annual basis to support the health of North Carolinians. The foundation should build in a process to insure public input into the ongoing operations of the trust.

Thank you for the opportunity to give this brief input to your deliberations.

## Remarks from the N.C. Center for Nonprofits to the Blue Cross Study Commission

(Hospital, Medical, and Dental Service Corporation Charter Conversion Study Commission)

by Jane Kendall, President  
N.C. Center for Nonprofits

March 3, 1998

To the Co-Chairs and Commission members, thank you for the opportunity to meet with you today.

I represent the North Carolina Center for Nonprofits, which is a network of the nonprofit organizations serving all 100 counties across the state. Besides serving as a statewide network, the Center is an information center on effective nonprofit practices – in areas such as management and governance – and an advocate for North Carolina's nonprofit sector as a whole.

The Center's Members range from the Cumberland Community Foundation in Senator Rand's and Representative Hurley's county ... to the Council on Aging in Representative Daughtry's hometown of Smithfield ... to the Neuse Rive Foundation in Senator Perdue's district ... to Habitat for Humanity and the Crisis Control Ministry in Representative Gray's city of Winston-Salem ... to the Davie County Arts Council in Senator Cochrane's county ... to the Baptist Children's Homes based in Representative Dockham's county ... to the United Way and the Partnership for Children in Senator Lee's district.

Many of you serve on nonprofit boards of directors, and more than half of North Carolina's citizens volunteer through nonprofit organizations each year.

The Center is one of many organizational members of the Coalition for the Public Trust, but I am here to speak for the Center, not the Coalition.

The Center cares about this issue of the potential conversion of Blue Cross and Blue Shield from a nonprofit to a for-profit company because of the fundamental issue of the public trust of all nonprofit organizations.

We believe strongly in the principle that public and nonprofit assets cannot be taken for private gain for less than their full fair market value. This is why it is vitally important that

(Continued on next page)

if Blue Cross converts, 100 percent of its value must be retained in a charitable foundation for the people of North Carolina. I applaud the Study Commission and Blue Cross for recognizing this fundamental principle.

There could be other conversions of nonprofits to for-profit companies in North Carolina, so the process you define for Blue Cross will be important in other conversions in our state as well. In other states, conversions are occurring particularly with nonprofits such as hospitals and hospices.

As you lay the framework for the creation of a charitable foundation with 100 percent of the stock of Blue Cross if it converts to a for-profit company, I urge you to follow these five basic principles:

1. One hundred percent of the stock should go for *one, newly-created* foundation.
2. This foundation should be entirely independent of the for-profit Blue Cross.
3. The statute should require the conduction of a broad search to select highly-qualified, independent trustees through a professional, non-partisan process with substantial public input.
4. The foundation should have a broad mission "to promote the health of the people of North Carolina."
5. The foundation should have minimal, but sufficient authority to protect the public in matters related to the foundation's value.

Thank you for your service to the people of North Carolina through this Study Commission and for protecting the public's interest in nonprofit assets.

Summary Comments by Watts Hill, Jr.  
March 3, 1998 to the  
Hospital, Medical and Dental Service Corporation  
Charter Conversion Study Commission

I come before you as one with 40 years experience in the insurance industry, as the son of the co-founder of what today is BC/BS, and as a former member of the General Assembly. I know your time is valuable, hence I will cover only the key points here. I hope you can find time to read the entire paper as it contains important background which leads to the key points.

The heart of the presentation begins with a discussion of the options which would exist if BC/BS places 100% of its stock in a charitable foundation. The Foundation would then control Blue Cross – in theory. In theory, the Foundation could then offer Blue Cross for sale to the highest bidder, presumably another for-profit health insurer.

There much to recommend an outright sale for cash. The Foundation could then re-invest the proceeds, diversify its investment risk, and be assured of income to spend on health improvements. Given the turmoil in the health industry today, this could prove to be the most prudent approach.

Clearly this is not what Blue Cross desires nor what the Coalition currently is considering. But it is an option which you should provide for in any recommended legislation. It could become the best option.

There are many complications with the second option – the Foundation retaining the stock of BC/BS and selling it off over a period of years.

Gary Mendoza will have discussed the California experience (I will comment on his observations, if needed).

The Coalition and Blue Cross apparently call for completely separate Boards of Directors. My comments begin on the top of page 5 in the full presentation. I refer to them in the interest of brevity and accuracy.

If 100% of the stock in Blue Cross is put into a foundation as the Coalition suggests, and if, in turn, the stock is immediately sold to an acquiring corporation such as Trigon, Virginia's Blue Cross, then the relationship of the Foundation with the Blue Cross/Blue Shield of North Carolina's Board of Directors will be a non issue. The Foundation would then have cash to invest and any relationship between Blue Cross and the Foundation will be at an end. I assume that Blue Cross does not want to be an acquisition target, but the possibility of such a merger must be considered and provision made in any legislation to deal with this possibility should it take place in the future.



If, on the other hand, the capital stock of Blue Cross stock is to continue to be held in the Foundation, and gradually sold to investors over the years, as appears to be the choice of both Blue Cross and the Coalition, a new set of issues remain to be dealt with. Under that scenario, the Foundation trustees would control Blue Cross/Blue Shield. Presumably, it was this possible outcome which was concerning Ken Otis when he stated his third principle that "any resolution must provide (Blue Cross) with the business flexibility we need to meet the needs of our customers and remain competitive in the health care market place." Otis is correct. Whatever you adopt must let Blue Cross continue to be run as a business. This is in the Foundation's best interest. The Coalition agrees. The question is what relationship should exist between the Foundation board and the Blue Cross board when the Foundation owns a majority of Blue Cross' stock.

The Coalition suggests that the Blue Cross and Foundation boards should be completely separate, that a voting trust be established which would preclude the Foundation voting Blue Cross stock except in special circumstances. The Coalition further suggests that limits be set on what either board may do without the concurrence of the other. A voting trust is suggested to get around the provision by the national Blue Cross Association that no single entity may vote more than 5% of a regional Blue Cross' stock. The penalty for non-compliance is loss of use of the Blue Cross name, a valuable asset to Blue Cross.

If the complex voting trust procedures can be worked out to the satisfaction of both parties, and to your satisfaction, fine. What I will suggest here is a fall-back approach in case concurrence is not achieved. Moreover, I believe there are benefits to accrue as well as costs associated with representation on each other's boards.

We need to look to California for insights into what to do – and what to avoid. California faced the same problem when the California Blue Cross transferred capital stock, worth roughly \$3.2 billion to two foundations. According to a recent article in the News and Observer, 3 of 21 board members of one foundation and 5 of 9 board members of the other, are former Blue Cross board members. To quote the chief administrative officer of one of the foundations: "because we own such a significant share, the Blue Cross/Blue Shield Association has an interest in seeing the company do well. They (Blue Cross/Blue Shield) didn't want to see some other outside group take control." The article goes on to say that Gary Mendoza, the lawyer who brokered the conversion agreement, said having Blue Cross board members on the foundation boards makes sense because they have "an institutional memory with respect to the company's operations and understanding of the environment in which it operated." As the former chief executive of an insurance company, I know first hand the importance of having competent board members with institutional memory on one's board of directors. But I hasten to say that this does not mean that former Blue Cross Board members should control the board. At an absolute minimum, the overwhelming majority of Foundation board members should be independent of Blue Cross/Blue Shield.

What I suggest be considered - is the following:

***(1) At conversion to for-profit status, the Blue Cross board would remain as it is then constituted but two persons representing the Foundation would be added. The Foundation representatives would be chosen by the Foundation's board. They would not have to be Foundation Board members, and more likely, would be senior Foundation staff.***

***(2) The Foundation Board, in turn, would have two members chosen by the Blue Cross board with the same provisions for choice as pertain to Foundation representation on the Blue Cross board.***

***(3) At the time when Foundation ownership of Blue Cross stock is less than 50% of the outstanding stock, each board would be relieved of the requirement for representation selected by the other board.***

This approach would go a long way toward assuring each board of access to the thinking of the other board during the planning process, i.e., before any board action is finalized. It would greatly reduce the need to put into law which conflicts between Blue Cross and the Foundation would trigger a given action.

I suggest that is impossible to write laws which provide for all the situations which will arise. I suggest further that giving each board access to the "inside" information of the other usually leads to the resolution of conflicts before they become public. As a final resort, in the case of irreconcilable differences, you could specify in the law the following:

***(4) Differences between the boards of a former non-profit corporation and a Foundation which results from conversion to a for-profit status, if they appear to be irreconcilable, shall be moderated and, if necessary, resolved by the office of the Attorney General acting in its supervisory capacity.***

There is another issue which, to my knowledge has not been given public consideration by Blue Cross or the Coalition. It is how to make sure that the Foundation has income to distribute. I suggest a fifth provision needs to be in the law as follows:

***(5) The newly created for-profit corporation shall pay an annual dividend of not less than 30% of its earnings so long as more than 50% of its stock is held by the associated Foundation.***

Such a requirement is necessary to assure the Foundation of having income to distribute. This is because many corporations pay no dividends. They justify this by saying they can show higher returns on earnings retained in the corporation and invested in new business than through a combination of dividends and lower retained earnings. They claim that the result will be increased value of the stock so that the "total" return from appreciation will exceed what one would have gained from the combination of less appreciation plus dividends. Supporting this concept is the lower tax rate on capital gains

than on dividends for many taxpayers. This approach may pay off for a Microsoft, but it is much less likely to pay off for a Blue Cross.

The health insurance field is changing rapidly driven by the gains and losses in different segments. Losses stem from efforts to build a larger HMO base and from consolidations taking place as the industry reconfigures for the future. Every for-profit health insurer will be faced with the choice of paying dividends versus retaining earnings for reinvestment in growth.

I suggest a payment of a 30% dividend as a minimum as it assures the Foundation of income as long as Blue Cross remains financially successful while, at the same time, permits Blue Cross to retain 70% of its earnings to meet anticipated future needs.

There is no magic in 30%. A lower percentage seemed inadequate given Foundation needs. Requiring a higher percent seemed unfair to Blue Cross. A 30% minimum pay-out is consistent with health insurance practice among for-profit companies and would be a fair minimum for other non-profits which will seek to convert in the future.

There is a remaining concern.

The membership of both boards must be based on competence, not politics. Blue Cross, both now and in the event of a change to for-profit status, will continue to have a board of seasoned, competent business and health oriented membership. The Board is now and will remain essentially self perpetuating. Comparable provision is needed for the Foundation board. The Coalition has suggestions to that end. I strongly recommend them to you.

A final comment. What you are considering is bigger than Blue Cross/Blue Shield and the Coalition. You appreciate that fact but I am not sure the public does. By its very charge, what your Commission is now considering could well set a precedent for how all non-profit corporations which wish to become for-profit in the future will make that conversion.

You have an extraordinarily important and ground-breaking challenge. I suggest that you seek to lay out basic concepts, broadly applicable, such as the five I have listed and not try to "dot every 'i'" and cross every "t". Each situation, as with Blue Cross, will have its unique aspects. Provide for a mediating, resolving authority should this be needed – I have suggested the Attorney General – but leave it to those involved in each conversion to work out the details so that what is done will make sense given the circumstance which then exist.

Thank you.

Watts Hill, Jr. ,610 Greenwood Road, Chapel Hill, NC 27514; TEL: (919) 967-5696

Presentation by Watts Hill, Jr.  
to the  
HOSPITAL, MEDICAL AND DENTAL SERVICE CORPORATION  
THE CHARTER CONVERSION STUDY COMMISSION  
March 3, 1998

One of the advantages of being over 70 is that I was present when key events transpired and thus have first hand knowledge of what actually took place and why. This includes the origins of Blue Cross Blue Shield of North Carolina and its subsequent history.

From the 1920's my father, George Watts Hill, served in various health care related capacities. These included Board Chairman of the hospital founded by his grandfather, George W. Watts, the hospital which today we know as Durham Regional. In the 1930's, Dr. W. C. Davison was Dean of the newly formed Duke Medical School and Hospital. Together they organized the Hospital Care Association in 1933. Hospital Care ultimately became Blue Cross/Blue Shield.

My father served as a trustee of Hospital Care and then Blue Cross for 41 years and, for an additional 19 years, as honorary trustee, a total of 60 years. Were he alive, he would be here today. I would never speak for him. I speak from my own experience, 40 years in the life and health insurance industry, and first hand knowledge of the origins and history of Blue Cross from its founding.

Let me remind you of the situation which existed in 1933 and which led to the "first public pre-paid hospitalization plan in North Carolina". I believe it was only the second such plan in the United States. As you know, in 1933 this country was in the depths of a depression. Persons requiring medical care were unable to pay their hospital and doctor's bills. One way to mitigate that problem was to create a corporation which would permit a person to prepay for future care while they were well. In theory, this should have been available from the existing life and health insurance industry. In practice, protection was not available to most persons due to high premiums and/or an inability to obtain coverage due to one's previous health history.

To cope with this unmet need, a non-profit was called for, one which would minimize the cost to the policy holder and, uniquely, be accessible to everyone regardless of their prior medical history. To make these two goals financially possible, special legislation was enacted eliminating and/or reducing taxes which other companies providing health insurance were required to pay. Once the enabling legislation was in place, the Hospital Care Association was formed followed by Hospital Savings. In 1968, they merged to form today's Blue Cross and Blue Shield of North Carolina.

You should know that the insurance industry reluctantly went along with favored tax treatment for these not-for-profit companies because they feared the alternative – legislation which would force them to provide coverage for all who applied regardless of prior health history.

Since 1950 when I returned to North Carolina, I have been familiar with Blue Cross Blue Shield's operation. Over the years, I have enjoyed friendships among senior management and Board members. Today, at least four members of senior management are former associates in other companies in the insurance industry. Blue Cross/Blue Shield has been well managed. The fact that it provides health protection to more North Carolinians than any other company validates the concepts of its founders and testifies to the quality of its management over the years.

In recent years, there have been changes in the special tax treatment which Blue Cross Blue Shield formerly enjoyed. These changes have made its tax bill more nearly comparable with other health insurers. At the same time, but especially over the past five years, there have been fundamental changes in health care financing, most notably the trend to "managed care". These trends are forcing all segments of the health industry to accommodate to the new realities. Blue Cross Blue Shield is subject to these same pressures. Its management is doing what any prudent management should do – preparing for the future. Like other companies, this must include consideration of merger and acquisition and, unique to Blue Cross Blue Shield, conversion from non-profit to for-profit status.

I say this for we need to acknowledge the contribution Blue Cross Blue Shield has made – and continues to make. We need to accept the fact that change is both inevitable and appropriate. And we can not say too often that it is imperative that Blue Cross/Blue Shield remain financially healthy. Indeed that is why the Coalition for the Public Trust has always insisted that Blue Cross' assets must remain untouched so that policy holder protection is preserved. Blue Cross must be left healthy so that it can continue to serve the public no matter what form of corporate restructuring may take place in the future.

What is at issue is not the continuance of a healthy Blue Cross Blue Shield. The issue is what happens to the market value of Blue Cross Blue Shield when as, and if it converts from non-profit to for-profit status.

It has been the Coalition's contention from the onset that Blue Cross' market value is substantially in excess of the book value of its assets – as much as a billion dollars or more. The existing book assets should be left undisturbed. It is the "going corporation" value, the additional market value of the company's stock generated by going from non-profit to for-profit, which should be preserved for the people of North Carolina. This is a critical distinction which has not been given adequate emphasis in prior presentations.

Fortunately, Blue Cross apparently has come to the same conclusion; i.e., that a foundation should be established which represents the public's interest in the non-profit corporation.

In his presentation to the Legislative Study Commission on February 3, 1998, Ken Otis, President and Chief Executive Officer of Blue Cross laid out "four basic principles that we (Blue Cross/Blue Shield) believe should provide the framework for the conversion issue. First: Any resolution must protect the assets of the company so that our customer's medical claims will be paid and our company will remain financially sound." The Coalition for the Public Trust agrees and has always supported that position.

Second, Otis said "any resolution must prohibit anyone associated with the company from profiting from the process of conversion." Again, the Coalition has supported this principle from the outset.

"Third, any resolution must provide us with the business flexibility we need to meet the needs of our customers and remain competitive in the health care marketplace." No one, the Coalition included, would want Blue Cross to remain anything but "competitive in the health care market place," nor would anyone suggest depriving them of necessary "business flexibility."

Otis concludes by saying, "And fourth, at the time of conversion we would support the creation of one or more foundations, funded by stock, for the charitable purpose of serving the health needs of North Carolina citizens." We understand that "stock" in this case, is 100% of the capital stock of Blue Cross/Blue Shield which would result from conversion to for-profit status. This, of course, is exactly what the Coalition has been calling for from the outset. It is important to be sure that what Otis meant by "stock" is 100% of the stock of the for-profit Blue Cross, and not a lesser percent, or some other meaning of "stock".

The Coalition's viewpoint is clear:

1. 100% of the assets of Blue Cross at the time of conversion must be retained by the new for-profit Blue Cross to safeguard the company's ability to pay policyholder claims. (This also is the Blue Cross position.)
2. 100% of the Blue Cross stock which would be generated by conversion to a for-profit corporation should be placed in a single foundation. (We are told that this position is acceptable to Blue Cross.)
3. The Board of the foundation must be independent of Blue Cross/Blue Shield. (Blue Cross has not spoken on this issue.)

As noted, the first two of the three principles enunciated by the Coalition are completely consistent with two of the four principles enunciated by Blue Cross/Blue Shield. It is our belief that the Coalition's third principle is consistent with the other points made by Otis – but I am not aware that anyone representing Blue Cross has made specific, written comment on their acceptability. May I suggest that you seek clarification from Blue Cross.

Given agreement on the basic principles, the remaining issues requiring resolution relate to how best to establish a managing board for the Foundation and the Foundation's relationship with Blue Cross - and what overlap, if any, should exist between the two.

To understand the importance of these issues, it is necessary to first state some basic concepts relative to insurance companies.

For any well-run company such as Blue Cross, the book value of its assets is always significantly less than the market value of the company to a prospective purchaser. Moreover, without getting into the technicalities, the book value of assets of insurance companies generally are carried on financial statements at less than market value. This is a result of the conservative accounting requirements established by the National Association of Insurance Commissioners to protect policyholders. The big difference between "book" value and "market" or "acquisition" value is what is known as the "going business" value of the company. A company acquiring another company expects to pay a substantial premium over book value. This premium reflects the fact that it is usually less expensive to buy a "book of business" than to create a comparable "book of business" where none now exists. This is particularly true when a company such as Blue Cross holds a dominant position in the market. The reality to keep in mind, in the case at hand, is that a buyer of Blue Cross would expect to pay a significant multiple of the company's book value just because the company is so dominant in the market.

All of the stated book assets of the company should be left alone and committed to the protection of policy holders. Even when this is done, a company acquiring Blue Cross would expect to pay a premium of as much as a billion dollars above the book value of Blue Cross' assets. It is this "extra" billion which belongs to the people of this State. This is what should be captured "for the charitable purpose of serving the health needs of North Carolina citizens", to use Ken Otis' words.

Hopefully, your Study Commission will recognize and endorse what both Blue Cross and the Coalition have said and leave the book assets of the company alone. Hopefully, you will direct your attention to the two key issues remaining – the purposes of the Foundation and how it will be managed, and the relationship between the Foundation and a for-profit Blue Cross.

Let us consider first how Blue Cross is to be managed.

If 100% of the stock in Blue Cross is put into a foundation as the Coalition suggests, and if, in turn, the stock is immediately sold to an acquiring corporation such as Trigon, Virginia's Blue Cross, then the relationship of the Foundation with the Blue Cross/Blue Shield of North Carolina's Board of Directors will be a non issue. The Foundation would then have cash to invest and any relationship between Blue Cross and the Foundation will be at an end. I assume that Blue Cross does not want to be an acquisition target, but the possibility of such a merger must be considered and provision made in any legislation to deal with this possibility should it take place in the future.

If, on the other hand, the capital stock of Blue Cross stock is to continue to be held in the Foundation, and gradually sold to investors over the years, as appears to be the choice of both Blue Cross and the Coalition, a new set of issues remain to be dealt with. Under that scenario, the Foundation trustees would control Blue Cross/Blue Shield. Presumably, it was this possible outcome which was concerning Ken Otis when he stated his third principle that "any resolution must provide (Blue Cross) with the business flexibility we need to meet the needs of our customers and remain competitive in the health care market place." Otis is correct. Whatever you adopt must let Blue Cross continue to be run as a business. This is in the Foundation's best interest. The Coalition agrees. The question is what relationship should exist between the Foundation board and the Blue Cross board when the Foundation owns a majority of Blue Cross' stock.

The Coalition suggests that the Blue Cross and Foundation boards should be completely separate, that a voting trust be established which would preclude the Foundation voting Blue Cross stock except in special circumstances. The Coalition further suggests that limits be set on what either board may do without the concurrence of the other. A voting trust is suggested to get around the provision by the national Blue Cross Association that no single entity may vote more than 5% of a regional Blue Cross' stock. The penalty for non-compliance is loss of use of the Blue Cross name, a valuable asset to Blue Cross.

If the complex voting trust procedures can be worked out to the satisfaction of both parties, and to your satisfaction, fine. What I will suggest here is a fall-back approach in case concurrence is not achieved. Moreover, I believe there are benefits to accrue as well as costs associated with representation on each other's boards.

We need to look to California for insights into what to do – and what to avoid. California faced the same problem when the California Blue Cross transferred capital stock, worth roughly \$3.2 billion to two foundations. According to a recent article in the News and Observer, 3 of 21 board members of one foundation and 5 of 9 board members of the other, are former Blue Cross board members. To quote the chief administrative officer of one of the foundations: "because we own such a significant share, the Blue Cross/Blue Shield Association has an interest in seeing the company do well. They (Blue Cross/Blue Shield) didn't want to see some other outside group take control." The article goes on to say that Gary Mendoza, the lawyer who brokered the conversion agreement, said having Blue Cross board members on the foundation boards makes sense because



they have "an institutional memory with respect to the company's operations and understanding of the environment in which it operated. " As the former chief executive of an insurance company, I know first hand the importance of having competent board members with institutional memory on one's board of directors. But I hasten to say that this does not mean that former Blue Cross Board members should control the board. At an absolute minimum, the overwhelming majority of Foundation board members should be independent of Blue Cross/Blue Shield.

The same News and Observer article notes that "Gary Mendoza, a lawyer who was then the state (of California's) corporation commissioner, (who) brokered the agreement under which Blue Cross transferred 100% of its assets, roughly \$3.2 billion to two grant making foundations," is the same Gary Mendoza " who "has been working since January 1 as a paid consultant to Blue Cross/Blue Shield of North Carolina on the conversion issue." His presence would lead one to expect that Blue Cross of North Carolina may seek to control the Foundation. That must not happen.

What I suggest be considered - is the following:

*(1) At conversion to for-profit status, the Blue Cross board would remain as it is then constituted but two persons representing the Foundation would be added. The Foundation representatives would be chosen by the Foundation's board. They would not have to be Foundation Board members, and more likely, would be senior Foundation staff.*

*(2) The Foundation Board, in turn, would have two members chosen by the Blue Cross board with the same provisions for choice as pertain to Foundation representation on the Blue Cross board.*

*(3) At the time when Foundation ownership of Blue Cross stock is less than 50% of the outstanding stock, each board would be relieved of the requirement for representation selected by the other board.*

This approach would go a long way toward assuring each board of access to the thinking of the other board during the planning process, i.e., before any board action is finalized. It would greatly reduce the need to put into law which conflicts between Blue Cross and the Foundation would trigger a given action.

I suggest that is impossible to write laws which provide for all the situations which will arise. I suggest further that giving each board access to the "inside" information of the other usually leads to the resolution of conflicts before they become public. As a final resort, in the case of irreconcilable differences, you could specify in the law the following:

*(4) Differences between the boards of a former non-profit corporation and a Foundation which results from conversion to a for-profit status, if they appear to be irreconcilable, shall be moderated and , if necessary, resolved by the office of the Attorney General acting in its supervisory capacity.*

There is another issue which, to my knowledge has not been given public consideration by Blue Cross or the Coalition. It is how to make sure that the Foundation has income to distribute. I suggest a fifth provision needs to be in the law as follows:

*(5) The newly created for-profit corporation shall pay an annual dividend of not less than 30% of its earnings so long as more than 50% of its stock is held by the associated Foundation.*

Such a requirement is necessary to assure the Foundation of having income to distribute. This is because many corporations pay no dividends. They justify this by saying they can show higher returns on earnings retained in the corporation and invested in new business than through a combination of dividends and lower retained earnings. They claim that the result will be increased value of the stock so that the "total" return from appreciation will exceed what one would have gained from the combination of less appreciation plus dividends. Supporting this concept is the lower tax rate on capital gains than on dividends for many taxpayers. This approach may pay off for a Microsoft, but it is much less likely to pay off for a Blue Cross.

The health insurance field is changing rapidly driven by the gains and losses in different segments. Losses stem from efforts to build a larger HMO base and from consolidations taking place as the industry reconfigures for the future. Every for-profit health insurer will be faced with the choice of paying dividends versus retaining earnings for reinvestment in growth.

I suggest a payment of a 30% dividend as a minimum as it assures the Foundation of income as long as Blue Cross remains financially successful while, at the same time, permits Blue Cross to retain 70% of its earnings to meet anticipated future needs.

There is no magic in 30%. A lower percentage seemed inadequate given Foundation needs. Requiring a higher percent seemed unfair to Blue Cross. A 30% minimum pay-out is consistent with health insurance practice among for-profit companies and would be a fair minimum for other non-profits which will seek to convert in the future.

There is a remaining concern which I share with you as a former member of the General Assembly, as one who was appointed to chair a State agency and to serve on appointed boards of State agencies. I urge you to adopt the Coalition recommendations on the process to be used to select Foundation board members. Their recommendation is non-partisan and non-political.

Please do not recommend a process which involves the Governor and the General Assembly. As we all know, though unintended, appointments by political entities inevitably leads to selection based on political influence. And, while knowledgeable, experienced, and competent service may be a result, too often it is not. One does not need

to call the names of individuals or agency boards, to make this point. You know what I mean from press coverage.

The membership of both boards must be based on competence, not politics. Blue Cross, both now and in the event of a change to for-profit status, will continue to have a board of seasoned, competent business and health oriented membership. The Board is now and will remain essentially self perpetuating. Comparable provision is needed for the Foundation board. The Coalition has suggestions to that end. I strongly recommend them to you.

A final comment. What you are considering is bigger than Blue Cross/Blue Shield and the Coalition. You appreciate that fact but I am not sure the public does. By its very charge, what your Commission is now considering could well set a precedent for how all non-profit corporations which wish to become for-profit in the future will make that conversion.

You have an extraordinarily important and ground-breaking challenge. I suggest that you seek to lay out basic concepts, broadly applicable, such as the five I have listed and not try to "dot every "i" and cross every "t". Each situation, as with Blue Cross, will have its unique aspects. Provide for a mediating, resolving authority should this be needed – I have suggested the Attorney General – but leave it to those involved in each conversion to work out the details so that what is done will make sense given the circumstance which then exist.

Thank you.

Watts Hill, Jr.  
610 Greenwood Road  
Chapel Hill, NC 27514  
TEL: (919) 967-5696  
FAX: (919) 967-4125



Remarks

By Rhone Sasser  
Chairman of the Board of Trustees  
Blue Cross and Blue Shield of North Carolina

to the  
Hospital, Medical and Dental Service  
Corporation Charter Conversion  
Study Commission

May 1, 1998

Good morning, Mr. Chairman and members of the commission.

I'm Rhone Sasser, Chairman of the Board of Trustees for Blue Cross and Blue Shield of North Carolina.

I want to talk to you as one person -- one North Carolinian -- who cares very much about this state and about this company.

When I spoke to this commission in February, I shared with you about the commitment of our board to a strong, not-for-profit company that meets the health care needs of the citizens of North Carolina.

But I must tell you today that I am angry that our integrity and our commitment to that mission has been questioned by special-interest groups.

It is outrageous to hear talk of "clandestine" moves, "schemes" and "sneak attacks."

Some of the e-mails that have been circulated in the last couple of days are an insult.

You know the character and the integrity of the individuals who serve on our Board of Directors.

I've made a special effort to be here today because I care about what happens to this state and this company. And I, for one, cannot stand by while the character of Blue Cross is assassinated.

For 65 years, North Carolinians on the board of Blue Cross have run the company for the purpose of serving fellow North Carolinians. And this company has a record of service for which I am proud.

Blue Cross serves North Carolinians in all 100 counties. We offer coverage to any citizen, regardless of medical history. In short, we've gone and we've served where others wouldn't.

We want to continue that mission for another 65 years.

So the fundamental, rock-bottom question you must answer today is this: Are you going to have Blue Cross shackled by of unfair and unnecessary statutes and restrictions?

Or are you going to allow Blue Cross -- this "treasure," as Governor Holshouser called it -- to compete on a fair, level playing field.

During months of discussions, Blue Cross has supported every conversion proposal that did not conflict with the four principles we have consistently advocated. We have compromised over and over, whenever it didn't violate our principles.

Our four principles are straightforward:

1. protect the assets of the company for our policyholders.
2. allow no one associated with the company to profit from the process of conversion.
3. maintain business flexibility to run the company.
4. establish a public trust, funded by stock, if and when the company needs to convert its status to an investor-owned company.

We agreed that a public trust should be created, funded by 100 percent of the value of the company in stock at the time of conversion.

We agreed that the board of the charitable trust should be independent of Blue Cross.

We agreed not to convert to a mutual company.

We agreed to all of these issues because we concluded that they were the right decisions for our company, our policyholders and the people of North Carolina.

But today we find that all that isn't enough for the Coalition for Public Trust.

Those are the same folks who a year ago were demanding that we not be allowed to convert.

But now, they want legislation that forces Blue Cross to convert at the earliest possible date. I think we all know why that's so. And, in my opinion, that is indefensible and irresponsible.

Ladies and gentlemen of the commission, what you should know is that if they succeed, they...and you...and 1.6 million North Carolina Blue Cross customers...may very likely see Blue Cross and Blue Shield disappear.

If we are forced to convert from a position of weakness, rather than from a position of strength, the possibility that we'll be gobbled up by a larger, national company becomes very real.

And if that happens, it's doubtful that the acquiring company will have any special allegiance to North Carolina.

It's doubtful that that company will have 65 years of history, or families, or roots that tie it to the people of this state.

It's doubtful that that company will see the importance of donating nearly \$1 million a year to the Caring Program for Children to cover uninsured kids -- which Blue Cross did before it became politically correct.

In that event, instead of having your friends, neighbors and fellow citizens running Blue Cross and Blue Shield of North Carolina, you'll have people from out of state running Blue Cross by long distance.

As a lifelong North Carolinian, and speaking for the other North Carolinians on the board, I hope this morning that the commission will make the right decision for our company, our policyholders and the people of North Carolina.

I say again, and with all due respect, the real question is: Are you going to have Blue Cross shackled by of unfair and unnecessary statutes and restrictions that our competitors don't have to follow?

Or are you going to ensure that Blue Cross can continue a 65-year tradition of providing high-quality, affordable health care to North Carolinians, many of whom could not secure health insurance otherwise?

If you restrict our ability to grow the company, to purchase policies, lines of business or even other health insurance companies -- then you could dramatically cut the length of time that we can remain an independent, hometown insurer.

Your recommendations will help decide if that is possible.

There is a lot at stake in this decision.

I appreciate your dedication and hard work on studying this issue, and I trust you'll do the right thing for the people of North Carolina.



## Future In Jeopardy

For Blue Cross and Blue Shield of North Carolina to meet the health care needs of North Carolinians, the company must be healthy, strong and able to operate under laws that provide business flexibility. That includes having the ability to purchase policies, lines of business and health insurance companies without restrictions.

Proposals from the Coalition for the Public Trust would seriously damage the company's ability to serve the interests of North Carolinians. The Coalition would like to limit BCBSNC's business flexibility at a time when the health care industry in North Carolina is rapidly changing and consolidating.

Restricting North Carolina's Blue plan from adapting and expanding will weaken the company and force it to convert to a for-profit company, leaving it ripe for takeover by a national conglomerate that doesn't have North Carolina's interests at heart.

BCBSNC occupies a unique role in the state – providing high-quality, affordable health care coverage for North Carolinians in all 100 counties. Competitors have no such mission. The future of Blue Cross and Blue Shield of North Carolina is in jeopardy.

- 1. Other companies – including North Carolina non-profits and Blue plans in other states – face no restrictions in purchasing North Carolina for-profit companies. Forcing Blue Cross to sit on the sidelines as other companies expand their presence here would be a death sentence for the company.**
  - State law today permits BCBSNC to purchase for-profit companies and lines of business. Other non-profits – such as Kaiser Permanente, Novant Health Inc., and hospitals – can buy for-profit companies.
  - Blue plans in other states frequently buy for-profits of all types – HMOs, physician groups, technology companies, life insurance companies, and others.
  - Independence Blue Cross in Pennsylvania, Blue Cross Blue Shield of Michigan, Blue Shield of California, Blue Cross Blue Shield of New Jersey and others all have recently bought companies to expand and strengthen their service.
  - Consider this scenario: A North Carolina HMO is put up for sale. Under the Coalition's proposal, North Carolina's Blue plan would be prohibited from buying it and expanding its service. Yet any of BCBSNC's competitors – even non-profit Kaiser Permanente – could buy it. In fact, Blue plans from other states could come into North Carolina and buy this North Carolina business out from under BCBSNC.



**2. National insurance conglomerates will take control in North Carolina if the hometown insurer is handcuffed and weakened by excessive regulation.**

- Virtually all of the largest health insurance companies in North Carolina are owned by regional or national companies.
- North Carolina will continue to have fewer insurance carriers, and more out-of-state carriers. Healthsource and PHP (now United Healthcare) already have been bought by out-of-state conglomerates.
- Consider this scenario: BCBSNC sits on the sidelines while competitors buy up health plans and expand their presence. A seriously weakened BCBSNC converts to for-profit in an attempt to survive and be competitive. But the company, made vulnerable by state restrictions placed only on BCBSNC, is bought out by a national conglomerate. Now North Carolinians call the 1-800 number in Hartford, Connecticut, not Chapel Hill/Durham, North Carolina.

**3. Restricting Blue Cross's ability to grow as a non-profit carrier will hasten a conversion to a for-profit company from a position of weakness.**

- North Carolina is well served by a non-profit Blue Cross and Blue Shield of North Carolina.
- BCBSNC wants to remain a non-profit company for as long as possible to serve the people of North Carolina.
- The company should not be pushed into a conversion by limiting the very actions it would take to preserve its not-for-profit heritage.
- Such a conversion would result in less value to a foundation, and probably ownership and control of BCBSNC by an out-of-state company.



**Remarks**

**By Ken Otis  
President & Chief Executive Officer  
Blue Cross and Blue Shield of North Carolina**

**to the  
Hospital, Medical and Dental Service  
Corporation Charter Conversion  
Study Commission**

**May 1, 1998**

Good morning, Mr. Chairman and members of the commission.

I'm Ken Otis, president and chief executive officer of Blue Cross and Blue Shield of North Carolina.

On Tuesday, I had the opportunity to attend the legislative study commission meeting and hear arguments for restricting Blue Cross's business flexibility.

Today, I am here to urge you to do what is right for the 1.6 million customers of Blue Cross and the people of North Carolina.

While market conditions and strategy have changed and will continue to do so, Blue Cross and Blue Shield of North Carolina remains committed to its long standing mission of serving North Carolina as a not-for-profit corporation.

We are concerned that some of the proposals regarding the trigger provision would severely limit our ability to manage our business in the best interests of our policyholders and the people of this state.

They would create such an unlevel playing field and impede our ability to compete that it would force us to convert when we would not want to, nor be well prepared to do so.

Under the rules you are considering, we would be the most restricted Blue plan in the country in terms of what we can do.

Blue Cross plans across the country are routinely making acquisitions, getting involved in joint ventures and buying blocks of business.

Let me give you just a few examples to illustrate this point.

- Blue Cross of New Jersey bought physician groups;
- Independence Blue Cross in Pennsylvania bought HMOs, a home health agency and a minority interest in a for-profit medical company;
- Blue Cross of New Hampshire bought an HMO;
- Blue Cross of Michigan bought a physician network management company last year;
- Blue Cross and Blue Shield of Texas announced it would buy a HMO health plan in Texas last month;
- Blue Shield of California bought a for-profit health plan and a for-profit life insurance company in 1997.

Purchasing these types of special capabilities is often far preferable to a new start up.

These Blue plans have the flexibility to run their business in the best interest of their customers.

If you adopt the Coalition's proposal, we would not.

To our knowledge, there is no other Blue Plan – not one – that is subject to the restrictions proposed by this trigger language.

Moreover, other non-profits in this state – Kaiser, Duke, Novant – routinely do the exact same thing in order to compete and meet the needs of their customers.

No other non-profit in this state is now precluded from buying a for-profit company, even including the non-profits involved in the Coalition.

Several years ago, the Commissioner of Insurance asked Blue Cross to acquire the North Carolina policies from a for-profit health insurer that was leaving the state.

We did that, and served this state well as a result. But under these new rules, we would be substantially at risk in a case like that.

This kind of restrictive legislation also fails to recognize the huge explosion of competition taking place in North Carolina.

Blue Cross clearly will be at a competitive disadvantage to acquire small to medium size health care companies or respond to other opportunities in the marketplace.

A \$100 million acquisition, even in North Carolina, is not a large one.

The restrictive trigger would effectively make us a non-player in the industry at the same time competitors are making acquisitions in this state.

It would create the ironic situation where Trigon – Virginia's Blue Cross – or South Carolina Blue Cross Blue Shield or any number of others could freely come in and take market share when we are constrained from doing so without heavy consequence.

In fact, those folks are already here.

We then very likely would find Martin Eakes' prophecy a self-fulfilling one – Blue Cross would be forced to convert from a position of weakness, not a position of strength, when we were not well prepared and frankly did not want to.

And conversion, particularly an unwanted and unwise one, would inevitably lead to acquisition of Blue Cross and Blue Shield of North Carolina by another, larger organization from outside our state.

Blue Cross and Blue Shield of North Carolina – a strong, non-profit company dedicated to the people of North Carolina – would be replaced by a regional office of a company headquartered in Richmond, Hartford, New York City or whatever city you choose to name.

It's not in the best interest of North Carolina to see that happen.

A year ago, many of the folks in this room were clamoring for us not to be allowed to convert our status.

We did not want to convert then. We don't want to convert now.

Today, they are here because they want to ensure that we will be forced to convert.

They want the golden eggs that would go into a charitable trust and they want them sooner, rather than later.

But under their proposal the best we could hope for is a cooked goose.

That's what's at stake here. Those are the very real risks.

Blue Cross has negotiated on every point.

We have given away the store, and we gave it away because it's the right thing to do if we become a for-profit company.

However, we want to continue to be the company that provides high-quality, affordable health care to North Carolinians in all 100 counties.

I urge you today to pass a legislative report that allows us to meet the health care needs of North Carolinians – both today and in the future – without forcing us to convert before it is appropriate or necessary.

I appreciate all of your hard work on this issue, and trust you will make the right decision for North Carolinians.

# THE NORTH CAROLINA HEALTH ACCESS COALITION

A Project of the North Carolina Justice and Community Development Center  
P.O. Box 28068 / Raleigh, NC, 27611 / 919:856-2568 / fax:919/856-2175 / health@ncjustice.org

---

*NCHAC, an independent organization, is a member of the Coalition for the Public Trust. However, the views expressed by NCHAC do not necessarily reflect those of the Coalition for the Public Trust.*

**THE SOLUTION: A WIN-WIN SITUATION FOR EVERYONE. ALLOW BLUE CROSS TO BUY FOR-PROFIT COMPANIES AND SINK 50%, 75%, EVEN 100% OF ITS ASSETS INTO THESE FOR-PROFITS – JUST MAKE CLEAR THAT THESE ACTIONS ARE FOR-PROFIT CONVERSIONS REQUIRING THE SET-UP OF A FOUNDATION.**

No one is saying that Blue Cross shouldn't be allowed the maximum business flexibility it needs to remain competitive in today's fierce health insurance market. However, if the company decides to move into acquiring other for-profits and move material amounts of its assets into these for-profits then we should recognize the move for what it is. Nothing less than a conversion to a for-profit company – and such a conversion should be subject to the charitable trust requirement.

**THE SETTING UP OF A FOUNDATION DOES NOT REQUIRE ONE PENNY OF BLUE CROSS'S CURRENT ASSETS!**

THAT'S RIGHT – EVERY PENNY THAT BLUE CROSS SAYS IT WANTS AVAILABLE TO COMPETE IN THE FOR-PROFIT MARKETPLACE WOULD BE AVAILABLE TO THE COMPANY WHETHER OR NOT IT SET UP A FOUNDATION. Remember – the foundation gets set up with NEW stock issued when the company decides it wants to convert. Blue Cross gets to keep every penny of hard assets it has currently. When it is a for-profit company it can do whatever it likes with those hard assets – buying other huge for-profit health insurers, etc – it is up to them. However it needs to first meet its public obligation.

## **RECOMMENDED CHANGES TO APRIL 28 BLUE CROSS PROPOSAL**

In light of the above discussion I would recommend the following:

- A. Removal of the second bullet point under paragraph (w) on page 2 starting with "in the case of purchase by the corporation of all the common stock of a company..."
- B. In paragraphs (y) and (z) on page 4, remove the number 50% and replace with the phrase "a material amount of".

Thank you. I appreciate the opportunity to testify before the Commission.

# THE NORTH CAROLINA HEALTH ACCESS COALITION

A Project of the North Carolina Justice and Community Development Center  
P.O. Box 28068 / Raleigh, NC, 27611 / 919/856-2568 / fax:919/856-2175 / health@ncjustice.org

*NCHAC, an independent organization, is a member of the Coalition for the Public Trust. However, the views expressed by NCHAC do not necessarily reflect those of the Coalition for the Public Trust.*

## Testimony to the Blue Cross Blue Shield Study Commission

May 1, 1998

Adam Searing, JD, MPH, Project Director, NCHAC

In the history of the Hospital Care Association [Blue Cross] the motive of the founders of the Association was described: "[A] community project whose motive was never pecuniary gain for those who promoted it. This enterprise was designed to make available the proper medical attention needed for persons who could least afford it and to enable the self-respecting person to pay their way without jeopardizing their future welfare by sacrificing other needs equally important." (History of the Hospital Care Association, Inc. [NC Blue Cross], Elisha M. Herndon, page 17, Published by the Hospital Care Association (October, 1968)).

### **THE KEY ISSUE: WHEN DOES THE NONPROFIT BLUE CROSS CONVERT TO A FOR-PROFIT ORGANIZATION?**

NC Blue Cross is in no way a for-profit company. Its very roots and own proud history show how different it is than any other for-profit health insurer – just look at the above quote from Blue Cross's own account of its beginnings. What should happen when Blue Cross decides that it must change its nature from its original goals as a non-profit community project and go into battle as a for-profit company? Everyone agrees that such a conversion should result in a foundation. However, Blue Cross's proposal of a conversion definition loophole would allow the Blue Cross nonprofit community project to become largely a for-profit company without setting up a foundation.

### **THE LOOPHOLE: BLUE CROSS WANTS TO BE ABLE TO BUY FOR-PROFIT HEALTH INSURERS AND MOVE HALF ITS ASSETS INTO THE NEW FOR-PROFIT COMPANIES.**

The language is simple. Exempted from the fair 10% limitation on transfer of assets to whatever entity Blue Cross chooses (to provide needed business flexibility) is the purchase of for-profit health insurers by Blue Cross. Blue Cross can spend as much money as it wants to buy gigantic for-profit HMOs and other for-profits as long as "only" half of its assets are in the for-profit company. [See pages 1,2,4 of the April 28 BC proposal.]

### **THE RESULT: ONE HALF OF BLUE CROSS IS A FOR-PROFIT -- YET NO FOUNDATION HAS BEEN SET UP. FOR-PROFIT FLEXIBILITY IN A NON-PROFIT SHELL.**

Blue Cross is by its own admission a nonprofit community project. But when one-half of its assets have been used to buy a for-profit company on the open market it is no longer a nonprofit. It is a for-profit company and should have all the rights and responsibilities of such – including, in Blue Cross's case, setting up a foundation upon the conversion.

May 1, 1998

For more information contact Adam Searing, NCHAC Project Director, at (919) 856-2568.