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Anticipating The Magic Moment: The Public Interest In Health Plan Conversions In California

by Daniel M. Fox and Phillip Isenberg

In California, as in an increasing number of states, billions of dollars in charitable assets are being redirected as a result of the transformation of health plans and hospitals from being nonprofit to being for profit. As the stakes in these transformations grow, so does conflict between public and private interests. On one side are a handful of legislators, regulators, and their allies. On the other are entrepreneurs anticipating large profits from what one of them described as a “magic moment” in the reorganization of the U.S. health care industry.

For more than a decade nonprofit health maintenance organizations (HMOs) and hospitals have been converting to or venturing jointly with for-profit corporations. Easier access to capital for expansion was a major reason for these activities; selling stock yielded more money with fewer constraints than issuing tax-exempt bonds. The financial incentives for top managers were another reason. In the hospital sector, overcapacity, incentives to merge institutions, and attractive offers from well-financed national corporations fueled the abandonment of charitable purposes.

The transformation of HMOs to for-profit status has attracted the most attention because of the size of the charitable assets involved and because there are so many HMOs in California, the nation's leader in managed care. As enrollment in HMOs increased, so did the market share of for-profit organizations. In 1980 nonprofit HMOs had 84 percent of enrollees; by 1994 they had only 35 percent.1

The nonprofit sector in health care is dissolving across the country, most rapidly in California. Journalist Ann Lowrey Bailey reported in mid-November 1995 that since 1994 “at least 64 nonprofit hospitals have been sold to business for an estimated total of $3.3 billion.”2 Columbia/HCA

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alone had acquired about forty nonprofit hospitals in the first three quarters of 1995. In a recent conversation Bailey cited an informed confidential source who estimated that as much as $450 billion of charitable assets now in nonprofit hospitals could be the object of conversions in coming years.

In California the number of conversions is rising, as is the level of public attention. As a result of aggressive state action, the conversion of most of Blue Cross of California to for-profit status led to the creation of two multibillion-dollar charitable foundations, approved by the California Department of Corporations (DOC) in March 1996.

The First Conversions Of California Plans

The law in California, as in most other states, requires that nonprofit corporations “irrevocably dedicate” their assets to charitable purposes.\(^3\) When a nonprofit corporation becomes or merges with a for-profit corporation, the law requires that those assets dedicated to charity be treated as if the nonprofit corporation were dissolved. Every dissolved health plan, therefore, is required to place its assets in a nonprofit organization, usually a newly established foundation. Under California law the DOC has jurisdiction for regulating the process of HMO dissolution and rededication of assets; in other states it is usually some combination of the attorney general and the insurance commissioner.

Investors benefited considerably more than the public did from conversions of health plans in California during the 1980s. Investigators, notably Bailey, found that investors, who were often the former managers of the nonprofit plans, persuaded state regulators to accept wildly low estimates of the value of the dissolving corporations. The evidence of underestimation is that only a year or two after conversion, the new for-profit health plans were worth considerably more than the foundations they left behind. Our arithmetic on data that Bailey published in 1994 reveals that the market value of FHP was 3.5 times higher in 1986 than the assets it gave to charity in 1984; Inland Health Care had a value in 1985 that was 56.6 times its contribution in 1984; and the value of PacifiCare grew 125.8 times between 1984 and 1985.\(^4\) The total market value of these corporations in mid-1995 was, we estimate, around $7 billion.

By 1991 these numbers dismayed leaders of several advocacy groups, particularly Consumers Union, who protested when the managers and directors of Health Net proposed to buy that plan for a $108 million contribution to charity. As a result, the DOC withheld approval of the conversion to for-profit status until the purchasers agreed to create a new charitable trust, now The California Wellness Foundation, and endow it with both cash and an ownership interest in the new for-profit health plan.
Blue Cross/WellPoint Raises The Stakes

The story of Blue Cross of California and WellPoint, which began in mid-1991 and resulted in the creation of two foundations, together with billions of dollars, made more precise the need for new policy to protect the public interest in a dissolving nonprofit sector. In July 1991 Blue Cross applied to the DOC to transfer 90 percent of its assets and all of its managed care business to WellPoint, a for-profit subsidiary. Blue Cross argued that the purpose of the reorganization was to obtain access to capital markets, in order to compete with for-profit companies. According to the Dow Jones News Service, "By keeping a majority stake in its managed care unit, Blue Cross side-stepped the state law requiring charities to accord the public a payback,' of its charitable assets.' The DOC approved the restructuring on 7 January 1993, agreeing that it did not constitute a for-profit conversion. But it required Blue Cross to withdraw a stock option plan for its senior executives that resembled the generous arrangements in previous conversions of California health plans. WellPoint stock began trading on the New York Stock Exchange. Its chief executive officer (CEO), Leonard D. Schaeffer, announced to the press on 4 February 1993 that "a total of 19.5 million shares were sold and $517 million in net proceeds were realized by the Company." The value of the stock was approximately $2.7 billion.

In March 1993 Phillip Isenberg introduced a bill in the California Assembly that required individual members of the board of a restructured nonprofit organization to preserve the charitable assets and maintain the same level of corporate charitable expenditures as before the restructuring. A Merrill Lynch "buy recommendation" of May 1993 made what seems in retrospect to be a shrewder point: "[I]n the unlikely worst case scenario if money was to be paid to charity, Blue Cross would be responsible, not WellPoint. This would have no impact on WellPoint's earning growth prospects." Attended by considerable publicity and behind-the-scenes pressure, the Isenberg bill passed the assembly but died in the senate. In concurrent negotiations, however, Blue Cross/WellPoint agreed to give $5 million a year in charitable contributions for twenty years. The company declared its "intent, as part of its restructuring, to expand its nonprofit and charitable activities."

In August 1993 a new commissioner of corporations, Gary S. Mendoza, asked Blue Cross to submit a plan for meeting its obligations to the public as a result of its restructuring. For most of the next year, with escalating irritation, employees of Blue Cross and of the DOC argued about the size of the charitable trust, who should run it, and how the funds should be distributed. The protracted discussion of Blue Cross's charitable obligation gave interest groups and the press an opportunity to revisit the underlying
issue of the public-benefit commitment of nonprofit organizations. The result was costly for Blue Cross/WellPoint, both in completing its restructuring and in its obligations to charity. By late April 1994 Blue Cross had increased its proposed level of public-benefit expenditures for that year to between $25 million and $35 million.

In May 1994 Mendoza wrote to Blue Cross that he was dissatisfied with the amount it had proposed to spend to benefit the public, which he believed was “wide of the mark by an order of magnitude.” Mendoza said that he considered the public to be the shareholder of Blue Cross and himself the representative of the public. The proposed payment to charity of $100 million over twenty years was, he complained, less than 0.2 percent of the present value of Blue Cross/WellPoint. Consumers Union obtained and made public a copy of this letter and in August 1994 joined other advocacy groups in petitioning the DOC to issue regulations on the conversion and restructuring of nonprofit health plans.

A month later, on 15 September 1994, Blue Cross proposed to create a new philanthropic foundation that would receive the assets of WellPoint, then about $2.5 billion. The board of Blue Cross would become the board of the new foundation, to be organized under a provision of the Internal Revenue Code that, among other things, would permit the foundation to avoid the 5 percent minimum annual spending requirement that applied to private foundations. In December 1994 the DOC held public hearings on this plan in Los Angeles and San Francisco. Testimony focused on the size of Blue Cross's public-benefit commitment, the amount of independence of the new foundation’s board of directors, crossover directors from the Blue Cross and WellPoint boards, and prior decisions that committed foundation money far into the future.

A notable side affair was the creation by Blue Cross of a corporation under section 501 (c) (4) of the federal tax code to manage a portion of the public assets. Charitable organizations created under this section of the code are exempt from both the 5 percent payout and the antilobbying regulations that apply to private and operating foundations. Under pressure from legislators and public advocacy groups, however, the commissioner required Blue Cross to prohibit lobbying and campaign contributions by this entity.

Legislative pressure on Blue Cross/WellPoint increased. Bills introduced in the California Assembly and Senate early in 1995 proposed rules that applied to nonprofit health plans that converted or restructured to achieve the benefits of for-profit status. One bill, for example, would create a statewide foundation to administer funds returned to the public as a result of conversions, prohibit members of the boards and officers of converted or restructured corporations from receiving benefits from the transaction, and
establish a method of valuing the assets of the nonprofit entity to determine an appropriate return to the public.\textsuperscript{13}

In April 1995 Blue Cross/WellPoint and Health Systems International (HSI) agreed to a merger that included a resolution of the public benefit issue acceptable to Mendoza. Cash in the amount of $1.2 billion and 23 percent of the stock of the merged corporation was to be placed in a new private foundation; $233 million and 44 percent of the stock was to be held by a foundation organized under the less restrictive section of the Revenue and Taxation Code. The total value of the newly created charitable assets would be $3 billion, making the two foundations among the largest in the country. A few months later, the new foundations advertised widely for candidates for their boards and engaged a consortium of search firms to conduct interviews.

On 14 December 1995 Blue Cross and HSI canceled their plan to merge, leaving confusion about the ability of Blue Cross to fully fund its obligation to these foundations. A new legal question has been brought to the DOC and the state's attorney general: Do the people of California have a right to recoup any loss of charitable benefits that would have accrued to the foundations if the merger had gone through? Moreover, what is the public's claim on any part of the loss that is a result of both personal inurement and the clash of egos between the CEOs of WellPoint and HSI?\textsuperscript{14}

The failure of the merger had practical significance beyond the borders of California. According to press accounts, the “core of the dispute” between Schaeffer and Malik Hasan, the CEO of HSI, “was a struggle over who would oversee the new firm's merger activities.”\textsuperscript{15} In a confidential memorandum to Hasan in September 1995, Schaeffer had demanded leadership for Blue Cross/WellPoint in what he called “sensitive discussions” about “strategic alliances” with Blues plans elsewhere-alliances that, his memo said, included acquiring other plans.\textsuperscript{16} According to recent press reports, the end of the merger may have diminished WellPoint's cash assets, but it is still using its ownership of Blue Cross's name and trademark to expand into other parts of the country.\textsuperscript{17}

While the controversy over Blue Cross was occupying the attention of the press, the California legislature passed and Governor Pete Wilson signed Senate Bill 445, by Sen. Herschel Rosenthal. The bill further refined the authority of the commissioner of corporations in dealing with HMO conversions. Most interesting was the expansion of the definition of “restructuring,” to prohibit such creative lawyering as Blue Cross's attempt to avoid paying a public benefit by leaving the majority of its stock in the hands of the former nonprofit entity.
Protecting The Public Interest In Conversions

The history we have summarized has important lessons for public policy. The general lesson is that the assets of California's and the nation's nonprofit health care institutions belong to the public. They are irrevocable charitable assets. More importantly, they were dedicated to health care as a result of public policy that implemented the principle that health care is a public good rather than a commodity that can be traded in the market. As the current privatization of nonprofit health care accelerates, the public has a claim on the assets created for nonprofit entities by public subsidies.

Several more specific lessons emerge from this history. First, legislators, regulators, and leaders of nonprofits need to discuss what public purposes are served by existing nonprofits and to consider the implications of the increasing commercialization of health care. Second, as the wave of nonprofit conversions, restructuring, and joint ventures with for-profit companies sweeps the nation, new policies are necessary to protect the public interest.

State legislatures should amend existing statutes regulating nonprofit corporations to include the following policies. (1) Public notice should be required from corporations that are contemplating conversion or restructuring. (2) A detailed but not excessively bureaucratic public hearing and comment process should be adopted. Hearings should be held by both the board of the nonprofit proposing to change its governance and by an appropriate state regulator. (3) Each state should designate a public official to determine the fair market value of the converting or restructuring corporation, including the value of its potential for growth and future earnings. This official should hire experts to assist in determining the amount of the assets of the corporation and conduct public hearings before approving or denying any request to convert or restructure or to create a foundation to receive and spend funds being returned to the public. The cost of independent, expert valuation of assets should be borne by the corporation seeking to convert or restructure. (4) An independent board of directors should manage the assets of a converted nonprofit corporation that are transferred to a new private or community foundation. The compensation of the members of the board should be minimal, comparable to that received by their counterparts on the boards of foundations with similar assets and purposes. An independent board is crucial in a situation, like that of WellPoint and HSI, in which the size of the charitable assets is dependent on the business judgments (and misjudgments) of for-profit executives. (5) A plan for a new foundation, including specific purposes relating to the health of the public, should be proposed by the board, reviewed at a public hearing, and approved by an appointed state regulator.
(6) Staff, executives, and officers of converting or restructuring corporations should be prohibited from serving on the board of or being employed by a foundation created as a result of a conversion or restructuring of a nonprofit health plan or provider. (7) The directors and staff of the converting corporation and the resulting foundation should be prohibited from receiving preferential stock options or similar benefits. (8) Consideration should be given to the creation of a statewide or regional foundation to combine the assets created by all future conversions or restructuring. The alternative is a multiplicity of smaller foundations, each of them arguably doing good but without any coordination or planning for improving the health care of the citizenry.  

That Magic Moment

The dissolving nonprofit sector has left a vast legacy of law and social experience as well as assets that can be either plundered or redirected in the public interest. Institutions that have been important to the life of many communities are being dismantled without prolonged and informed public debate. If, however, nonprofits are not engaging in much charitable activity, as some experts argue, there is an even more compelling need for public oversight of the benefits they offer in exchange for tax exemption.

Schaeffer himself disparaged the charitable activities of nonprofits in a recent interview in *Health Affairs* (Winter 1995). “[S]ome hospitals, too,” he said, “hide behind the claim that they are driven by a social ethic.” Moreover, “if you are [only] accountable to your membership,” as he describes Kaiser Permanente, “the rest of the system [must] bear the burden of caring for all of the people who are uninsured.” Schaeffer went on to interpret the conversion of nonprofit organizations in a broad historical context. Conversion, he said, is an inevitable stage in the process by which excess capacity “is really squeezed out” of the health care system. Only the most efficient for-profit corporations will survive this convulsion. When this historically ordained process is complete, Schaeffer said, a “magic moment” will occur, when the surviving corporations will be able to decide whether to own rather than to continue purchasing services from the organizations that deliver health care.

Schaeffer’s metaphor recalls a fictional “magic moment” in Kurt Vonnegut Jr.'s 1965 novel, *God Bless You, Mr. Rosewater (or Pearls before Swine)*. Vonnegut’s narrator, though a lawyer recalling a professor of law, describes a sensibility that seems to be shared by entrepreneurs from a variety of disciplines who are converting “a once charitable enterprise” into our largest industry.

‘In every big transaction,’ [he] said, ‘there is a magic moment during which a man has
surrendered a treasure, and during which the man who is due to receive it has not yet done so. An alert lawyer will make that moment his own, possessing the treasure for a magic microsecond, taking a little of it, passing it on. If the man who is to receive the treasure is unused to wealth, has an inferiority complex and shapeless feelings of guilt, as most people do, the lawyer can often take as much as half the bundle, and still receive the recipient's blubbering thanks.19

A magic moment, indeed.

NOTES

3. California Revenue and Taxation Code, Sec. 23701 (d).
10. Mendoza to Anderson, personal communication.
11. Ibid.
17. Confidential sources.
18. Others have made similar recommendations for policy. See, for example, L. Miller et al., State Attorneys General’s Authority to Police the Sale and Conversion of Not-for-Profit Hospitals and HMOs (Washington: Volunteer Trustees Foundation for Research and Education, September 1995); and Hamburger et al., “The Pot of Gold,” 489-502.