

Findings



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The Blue Cross Conversion

How it Could Affect North Carolina Families

By Erik S. Root



Medical coverage has been a consuming topic for decades, due in part to a growing aging population and the expense associated with health care in general.

The current debate over

the conversion of Blue Cross/Blue Shield (hereafter “Blue,” “Blues,” or “BCBS”) from a non-profit to a for-profit company is no different. The proposed conversion of BCBS of North Carolina (BCBSNC) is important to North Carolinians because many families are enrolled in Blue plans. Should the Blues convert to a for-profit company, it could have a detrimental impact on those families who have come to trust BCBS for medical coverage. Not only could the benefit packages change dramatically, but also premiums may increase and the quality of service decrease. In addition, the conversion process could be a financial boon to some BCBS employees, officers, and other company officials. State government representatives could also benefit at the expense of the policyholders because the government will control millions, if not billions, of dollars in a state run non-profit entity that would be established as a result of conversion.

Before we explore some of the uncertainty surrounding the issue of BCBSNC conversion, however, it is important to recall why BCBS began in the first place. This will aid in fully understanding the role of the Blues in the development of medical insurance.

A Short History of BCBS

In the early 1930s, hospital service organizations created associations that later became known as Blue Cross plans. According to historical information in the *Journal of Insurance*:

Insurance companies had little or no desire to enter the field of medical care coverage. Executives of many insurance companies considered hospital and medical-surgical expenses to be insurable hazards, with the result that associations stood almost alone as providers of such coverage.¹

Because many states considered the coverage provided by service organizations as insurance in nature, state legislatures passed special statutes (called “enabling acts”) to exempt BCBS “from some of the

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provisions of the insurance codes which they otherwise would have had to comply.”² Some of these benefits granted to the Blues were income tax exemptions, low capital and surplus stipulations, and the elimination of reserve requirements. In essence, BCBS received generous tax breaks and did not have to hold in reserve the amount of capital that other insurance companies were required to possess.

Though the characteristics of the Blues have changed over time, there are certain attributes that have not changed: (1) their non-profit status, (2) the contractual relationship they have with doctors and hospitals, and (3) their close tie to the community compared to the more removed larger insurance companies.

The non-profit status of the Blues meant that any net “profit” could be returned to the participants and realized in lower subscrip-

tion rates or more liberal benefits packages. The non-profit status also meant that no board member, officer, or trustee could legally receive any of the net earnings of the association.³ Initially, the enabling acts required that any increase in earnings by employees of BCBS needed approval by the American Hospital Association. The intent of these regulations was to ensure that the net earnings would not go to monetarily benefit any one individual or individuals employed by BCBS at the expense of the policyholders. Still, “this was not meant to prevent the use of such earnings to reduce subscription payments or liberalize benefits. Neither does it apply to salaries received by officers and employees, since such expenses would be paid before the figure for ‘net earnings’ is obtained.”⁴ In other words, the enabling acts limited the ability of officers and employees of the Blues from reaping the benefits of profit-sharing and/or bonus plans in which for-profit corporations usually engage.

Another characteristic of the Blues was their contractual relationship with local hospitals. In any given city or region, the local BCBS signed contracts with local hospitals. In return, policyholders received medical services depending on the benefits package they carried. The hospitals and doctors agreed to provide the service for Blues policyholders at a “pre-arranged cost.”⁵

That the Blues had a distinct community presence made it easier for hospitals to enter into a contractual agreement. Though the Blues brand name had a nationwide recognition, the service associations were geographic, or local. They had a closer connection to the community than larger, more removed, insurance companies. This relationship made it easier for patients in the admittance process. In the past, before insurance was widely available, many hospitals required that patients deposit

money before admittance in order to ensure payment of the medical service they received. However, because the Blues were local, they had a close relationship with the hospitals in the area. Therefore, it was relatively easy for hospitals to determine a patient's ability to pay and the type of plan that covered them. By the 1960s, even as for-profit insurance companies grew in number, hospitals continued to require a deposit even from those protected by other insurance companies because it was difficult to determine the extent of a patient's plan with a non-Blues provider. The close community contact of the Blues and the requirement that they contract with hospitals and doctors made the determination of benefits a much simpler task for hospital administrators.

In addition, the origin of the Blues provided a service for people who might otherwise become wards of the state. State legislatures encouraged the growth of the Blues, because it relieved a whole host of problems that they thought they would need to address should significant numbers of citizens have no healthcare plan and become ill. The development of BCBS relieved the government from providing many citizens with a form of state medical insurance. Therefore, the Blues have historically provided coverage to those who otherwise would have no coverage, and they have done so "at reasonable rates."⁶

Why Conversion in N.C.?

In an interview with the North Carolina Political Review, Brad Adcock — BCBSNC Vice-President for Government Affairs — argued that many BCBS plans across the United States have been converting, or are seeking to convert, in order to "compete with other companies to meet customer needs."⁷ Many Blues organizations believe that they need to convert in order to gain freer access to "capital markets."⁸ Adcock asserts that such access will level the playing field and allow BCBSNC to compete with for-profit companies who can leverage vast resources in order to invest in health care technologies. Blues organizations assert that regulatory constraints would diminish their ability to invest their capital and reap even greater profits. These profits can be used to invest in technological advances that otherwise would be cost prohibitive if they remained non-profit. Furthermore, BCBSNC claims that they need to have liberal access to capital markets to keep up with rising medical costs and increased usage of the medical system.

Part of the reason many BCBS organizations wish to convert is because the Tax Reform Act of 1986 significantly altered the amount of capital the Blues could access. This act limited the ability of non-profits to access money by restricting the amount of capital they could borrow via debt-financing. Furthermore, BCBS found themselves in a financial bind when Medicare reform resulted in decreased levels of reimbursements.⁹ The decrease in capital led to cash flow problems in the 1990s. With these avenues to capital abated, BCBS organizations decided to look for other ways to raise money.

The initial step of BCBSNC in converting the non-profit status to a for-profit entity began in 1997 when the North Carolina General Assembly convened a bi-partisan

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commission chaired by Senator Tony Rand (D-Cumberland) and Representative Leo Daughtry (R-Johnston) to inquire into conversion. According to the ensuing General Assembly statute:

*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.*¹⁰

This statute echoes BCBSNC's public rationale for conversion. It is also similar to statutes in other states. However, there are some problems with pursuing conversion at this time, and the legal process of conversion may indeed not be in the interest of the current policyholders.

Potential Problems

BCBS conversions have become political and the BCBSNC proposal is no different. If other state examples are any indication, the conversion of BCBSNC from a public non-profit entity could be used not for purposes in the interest of the policyholders, but for partisan, political

purposes. For example, the state of Connecticut received stock valued close to \$81 million after conversion of their BCBS to a publicly traded company. According to the New York Times, Connecticut Governor John Rowland announced he would use some of that money to close their state's \$100 million deficit.¹¹ Given the fiscal problems facing North Carolina, such a scenario is not out of the question. State Representative David Redwine (D-Brunswick and former co-chairman of the House Appropriations Committee) floated the idea that conversion monies could be applied to the general fund in order to provide the state with a source of revenue.¹² As a part of conversion, BCBSNC would incorporate as a for-profit business, but the state of North Carolina would create a non-profit foundation out of the BCBSNC stock issued at the time of conversion.¹³ One-hundred percent of this stock would go to form the new foundation.

The statutes claim the foundation will operate as a "tax-exempt charitable social welfare organization" to promote "the health of the people of North Carolina."¹⁴ The creation of this non-profit agency would give the state government access to billions of dollars, which may be used for purposes not strictly limited to public health. The vague wording that the foundation promote the health and welfare of North Carolinians could be interpreted broadly in order to fund a plethora of new government spending programs and/or supplement existing programs. Former Governor Jim Hunt advocated just that in a public hearing on conversion:

*Just imagine what our state would be like if every single child had the medical attention, the dental and eye care and mental health services and the early intervention that they need. We can create opportunities and resources to do just that, and I think that's the potential of the health foundation of North Carolina.*¹⁵

Perhaps even more revealing is that Hunt seemed to suggest that the foundation should also use some of its cash resources to infuse a health element into the "Smart Start" program. Hunt's desire to put the foundation's money to questionable use is not without precedent in other states. One foundation decided that the well being of a certain community would be best served by funding a sports complex, arts center, and a foreign language program, while others have funded flying lessons for high school students and ethnic festivals.¹⁶

Vague statutory language has not prevented BCBS executives in other states from receiving a windfall of compensation or stock option plans resulting from conversion, or at some time after conversion.¹⁷ In Maryland, the president and chief executive officer of that state's Blues, William Jews, stood to gain \$9.1 million in bonuses if that state's Blues converted and then were bought out by a for-profit company.¹⁸ In Connecticut, the Blues converted again (after the initial conversion)—from a mutual insurer to a stock corporation thus causing some controversy over how, or if, to distribute profits from the subsequent sale. Similarly, in North Carolina the statutes do not prohibit BCBSNC employees from profiting from a subsequent conversion. While it is true that the director, officers, and employees are prohibited from receiving any fee, commission, or additional compensation as a direct result of the initial conversion, they may be able to reap millions in a subsequent conversion.¹⁹

Conversion also does not mean that access to capital markets will improve money flow. The California HealthCare Foundation (created by the conversion of Blue Cross of California in 1996) came under scrutiny for their aggressive investment strategies. The California foundation "lost twenty-five percent of its total assets in the past two years because of ongoing declines in the stock market."²⁰ Despite BCBSNC's assurance, there is no guarantee that they will be able to successfully access capital markets and compete with for-profit companies. BCBSNC could lose money and/or be less successful than a non-profit BCBSNC. Yet, there are also signs that conversion should not proceed because the money flow problems that plagued BCBS organizations in the 1990s have dissipated.

While BCBS saw a decrease in enrollment between 1980 and 1994, they have since seen an increase. BCBS margins also increased greatly by 2000, and their margins were exceeded only by the top three companies in the Fortune 500 (General Motors, Wal-Mart, and Exxon).²¹ Part of the reason for this financial success was that many Blues organizations consolidated instead of converting. Several BCBS organizations have merged into a larger non-profit organization. The benefits of merging are stark: "non-profit Blues that merged had an advantage over competitors that ran up huge debts acquiring market share, because these deals did not require cash."²² Therefore, BCBS organizations seem to be financially more secure because

they are not operating like other for-profit entities. They did not have the enormous debt obligation that other for-profit companies assumed. These data suggest that consolidation might be a better path for BCBSNC. More recently, The News and Observer reported that BCBSNC is enjoying record profits.²³ Their \$61.7 million net gain in the first quarter of 2003 may mean that even the consolidation option should be reconsidered. Nevertheless, whether they consolidate or remain a non-profit, conversion at this time will most likely adversely affect policyholders, because conversion will guarantee a premium increase for current the policyholders.

When the North Carolina Policy Review posed this question to BCBSNC directly, Adcock said, "rising medical costs, government mandates and the cost of building and maintaining a successful company will

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continue to drive premium increases."²⁴ In other words, without denying there will be an increase, Adcock claims that future increases will be partly at the hands of regulators. This is not a wholly dismissive argument: The more the government regulates, the more costs imposed on businesses. Businesses will pass these costs to the consumer. Nevertheless, Adcock admits that the market and the ordinary costs of building a successful business will increase premiums. Furthermore, the conversions in states like Maryland, Connecticut, California, and Kentucky all report a general decline in the level of service from the converted Blues. Payment levels, the handling of disputed claims, and contract negotiations all declined or became far worse than under a non-profit Blues.²⁵

What Happens Next?

According to statutory law, North Carolina Department of Insurance (NCDOI) Commissioner Jim Long must approve the conversion plan for it to proceed. Among the conditions necessary for approval are that no employee, director, or officer may

benefit directly from conversion, that the plan must be in the public interest and fair to current policyholders, and that BCBSNC must not have any disciplinary actions pending against them. Blue must also meet other more detailed requirements listed in the general statutes. The Commissioner has some discretion in determining whether BCBSNC has met conversion requirements. For example, it is not defined what is the "public interest." In other instances, however, the Commissioner does not have unlimited discretion. If there is pending action against BCBSNC, then the statute makes Long's decision for him: he cannot approve conversion. Finally, as a part of the process of conversion, the North Carolina Attorney General (NCAG) must sign-off on some elements of the plan.

Recent developments have given the Commissioner broader discretion, or more power, over the conversion process. NCDOI hired a legal consulting firm to advise them on the conversion proposal—LeBouf, Lamb, Greene, and MacRae. The firm crafted a 29-page report for the state agency. Lawyer Peter Kolbe told the Triangle Business Journal that Long may impose conditions not specifically stated in the statutes. Some of these stipulations could include capping premium rate increases.²⁶ Kolbe believes that state regulators have this authority, because recent Supreme Court decisions have allowed it. Virginia, Vermont, Connecticut, New York, Maine, Wisconsin, Missouri, and New Hampshire have legally imposed similar restrictions. Therefore, Kolbe argues that Long does not have to render a simple yes or no decision on conversion.

BCBSNC officials oppose Kolbe's understanding of the law. They would prefer NCDOI not have this wide latitude and argue that they should be allowed to operate like other for-profit insurers after conversion. Further restrictions, they say, will impair their ability to compete with for-profit companies. However, when NCDOI asked for a second opinion, the NCAG's office concurred with LeBouf, Lamb, Greene, and MacRae. Three deputy NCAGs concluded that the General Assembly conferred "on the Commissioner broad powers to fulfill his obligations, including the power...to approve a conversion plan with conditions."²⁷ With NCDOI and NCAG united on this matter, it appears likely that a conversion would come conditionally.

To complicate matters further, BCBSNC underpaid emergency room claims by \$15 million between 1998-2002.

While BCBSNC claims a computer error caused the underpayments, some believe that the Commissioner will not approve conversion while BCBSNC is not in compliance with existing insurance laws.²⁸ In addition, NCDI could fine the non-profit insurer for these underpayments. Thus, conversion will likely be delayed until BCBSNC clears up this problem. Still, if Long approves conversion with stipulations, BCBSNC has three options. The health insurer could accept the offer, reject the offer, or opt to litigate the matter in Wake County Superior Court.²⁹

Conclusion

There are many who believe that BCBSNC conversion is not wise because there is something inherently wrong with the free-market and the concept of profit.³⁰ This paper rejects that notion. Yet, there is something suspicious in that many BCBSNC employees and their spouses have written letters to the Department of Insurance asking Jim Long to approve the conversion, and they have done so without identifying their interest in BCBSNC.³¹ In addition, BCBSNC conversion does not appear to be a wise decision because of the overly vague statutes and because of the fact that the newly created government directed non-profit foundation which may use monies generated from conversion for many questionable health related programs. These facts do not serve current BCBSNC policyholders well, nor the citizens of North Carolina in general who wish that the state government would practice fiscal self-restraint.

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Endnotes

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