Center for Insurance Research

2298 Massachusetts Ave. • Cambridge, MA 02140

October 23, 2012

The Honorable Representative Pete Lund
Chairman, House Insurance Committee
P.O. Box 30014
Lansing, MI 48909-7514

RE: The Proposed Reorganization of Blue Cross Blue Shield of Michigan

Dear Chairman Lund:

We are writing to you and your committee to oppose the proposal to permit Blue Cross Blue Shield of Michigan (BCBSMI or Blue Cross) to convert from a public charitable organization into a mutual insurer owned by its policyholders under the terms outlined in SB 1293 and SB 1294.[1] Now that those final bills have been made public, we address the specific language that is most problematic.[2]

Michigan Consumers for Healthcare, which is comprised of 160 healthcare advocacy groups, has requested that we provide an analysis and best practices guidance on the pending legislation. Given the enormous complexity of the proposed conversion and importance of Blue Cross to Michigan, we urge your committee to slow down the consideration process to allow for a full airing of the issues and deliberation by your Committee, including on the issues addressed below.

We address six critical shortcomings of the bills that, as proposed, endanger the interests of Michigan and its taxpayers and consumers. These are:

1) The language in SB1294 is extremely weak and likely unenforceable when it provides that, upon conversion to a mutual, the new company need only make a "good faith effort" to come up with "up to" $1.5 billion over the next 18 years in tax-deductible "contributions" to a charitable foundation (to fund health care wellness activities in Michigan). If that contribution is all paid in year 18, then it is worth only $500 million in present dollars (even less after the tax deduction).

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[1] The Center for Insurance Research (CIR) is a nonprofit, public policy and advocacy organization founded in 1991 that represents consumers on insurance matters nationally. CIR has extensive experience with mutual insurers, including in analyzing and policing complex transactions such as mergers, reorganizations and conversions. CIR has also analyzed and commented on other proposed Blue Cross/Blue Shield conversions in the past.

[2] On October 12, 2012, CIR commented on the arguments and rationales made by proponents of the Blue Cross conversion in a letter to Chairman Hune of the Senate Insurance Committee. Because the final bills had not yet been made public, we addressed proponents' public claims, most of which are still applicable. The October 12, 2012 letter is attached as Exhibit A.

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Because Blue Cross is not being required to make a fixed payment for its fair market value of at least $6.4 Billion (at twice its capital of $3.2 Billion), the new Blue Cross mutual will be getting billions of dollars in capital *for free*. This amounts to an extraordinary privatization and give away of taxpayers money. It also undermines an important claim by proponents – that they want to level the paying field with other health insurers – because *none* of those competitor companies will be receiving free capital from the state.

2) The bills fail to require Blue Cross to compensate Michigan and its taxpayers *even though* funding mechanisms used to capitalize mutual insurers for 150 years exist that would satisfy all reasonable objectives: to provide Blue Cross with the capital it needs to continue operating; to compensate and protect Michigan and its taxpayers' interests in Blue Cross' charitable assets; and to fund ongoing health wellness activities.

3) Senate Bill No. 1293 fails to restrict the converted Blue Cross mutual from engaging in for-profit business and, even worse, anticipates such practices occurring through stock subsidiaries. In fact, it fails to provide *any* limits on the amount of business it can place in for-profit subsidiaries or on lucrative stock options for management. The only prohibition in the bill is on the sale of 50% or more of Blue Cross itself – which really just applies to the full conversion or sale of the mutual since a mutual cannot be sold piecemeal. Even if the current language were modified – to force a valuation and recapture of the charitable assets when 50% or some lower percentage of the *overall* business of Blue Cross were sold (*e.g.*, through a down stream stock subsidiary) – such language would still enable Blue Cross to provide most or all of its health insurance through a for-profit stock subsidiary. And, if such a subsidiary issued stock to outside investors in *any* amount, then Blue Cross would assume a fiduciary duty to operate to subsidiary (even if it had 99% voting control) for the benefit of the minority stockholders, as a matter of black letter corporate law. Irreconcilable conflicts of interest between policyholders interested in lower premiums and the minority stockholders interests in higher profits would result. Michigan would be ill-served by such a structure.

4) The "security" provisions of SB 1293 (that purport to protect the charitable assets in the event of a sale to outside entity) are insufficient and are not an appropriate substitute for the proper course of action – an independent valuation and guarantee stock/surplus note funding arrangement with the new foundation to *ensure* that Michigan taxpayers' interests are protected.

5) The provisions of SB 1293 that seek to strip the legal rights of mutual policyholders are misguided (because they unduly empower and insulate management) and unfair (because they deny policyholders of an interest in a mutual that they will own and to which they will have contributed capital in future

years) and, thus, may be unenforceable and lead to years of protracted policyholder litigation.

6) There are a myriad of issues regarding the reduction in rate review, to file and use, and changes to MediGap, which portend substantial rate increases for consumers, particularly seniors.

These critical flaws are discussed further below.

Points 1 and 2: A fundamental flaw in SB 1294 imperils the newly proposed foundation and could well result in none of Blue Cross's charitable assets being preserved for Michigan and its taxpayers. The amended SB 1294, Section 220(2)(A), provides in relevant part:

> The health care corporation shall include in the plan of merger that beginning in April 2014 the surviving entity of a merger described in subsection (1) shall use its **best efforts** to make annual social mission **contributions** in an aggregate amount of **up to** [$1.5 billion] over a period of up to 18 years beginning in April 2014 to the Michigan Health and Wellness Foundation created under Part 6A of this Act. (Bold added.)

Because this provision is so vague and superficial ("up to", "best efforts" and "contributions") there is no enforceable obligation on Blue Cross to pay $1.5 billion, and thus the bill provides no protection to Michigan taxpayers that any of these charitable assets will be paid to the foundation to carry on the important healthcare mission now borne by Blue Cross.

The bill should strike the terms that include "best efforts", "contributions" and "up to $1.5 billion over a period of up to18 years," and replace with "Blue Cross shall pay to the foundation the value of the disability mutual in the form of guarantee stock (or other like financial instrument that will pay a return on investment) in an amount that reflects the fair market value of Blue Cross's charitable assets upon its reorganization."

Even if the converted mutual's management ultimately paid the $1.5 billion, under the bill it could pay it all at the end, in 2032. The present value of such a contribution would be a mere $500 million, less after it takes a tax deduction for it. This is one third of what proponents had claimed in advocating for the bill and a tiny fraction of Blue Cross's market value of over $6.4 billion. It is unconscionable for the Legislature to even consider privatizing billions of dollars in charitable assets without compensation. Clearly, an unenforceable option for obtaining a small fraction of its value over 18 years does not suffice.

Funding Mechanisms to Capitalize Blue Cross

The pink elephant in the room is guarantee stock, which is the funding mechanism that mutual insurers have used for over a hundred and fifty years to provide their start-up

capital. Here's how it would work: the converted Blue Cross would retain its capital to continue operating, and its new "guarantee stock" in the amount of Blue Cross's fair market value would be issued to the new foundation. No money would exchange hands and Blue Cross would retain its capital. However, the foundation could seek to have its guaranteed stock redeemed over time (as profits afforded), which would gradually retire the guarantee stock. Moreover, an annual income stream could be incorporated into the arrangement to fund the charitable activities of the foundation. A similar option includes surplus notes, which is subordinated debt that is treated as surplus (or a combination of the two mechanisms). In fact, Michigan law contemplates such funding arrangements for mutuals under Insurance Code Section 500.5430 (entitled "Capital funds; borrowing; repayment.")[3]

There is no reason this funding mechanism should not be instituted, and certainly no reason why Blue Cross and its proponents should not be required to address this proposal.

Finally, it is inconceivable that by privatizing billions of dollars without payment back to Michigan, that the health insurance playing field will be leveled – a primary goal of proponents. Blue Cross controls 70% of the market, and other private insurers will have to compete against it without the benefit of *free* capital. Because the cost of capital is a real cost of doing business, this provides an unfair advantage to Blue Cross and will undermine the establishment of a competitive marketplace to the disadvantage of consumers.

Points 3 and 4: The purported restrictions in SB 1293 are not sufficient to prevent the converted Blue Cross from operating in service to a for-profit mission. Section 5801(2) provides, in relevant part:

> A non-profit mutual disability insurer that has merged with a nonprofit mutual health care corporation as provided in Section 5805(1) shall not convert its status to a stock insurer under Chapter 59 or reorganize under Chapter 60.

[3] The statute expressly provides that: "A mutual insurer ... may borrow or assume liability for the repayment of a sum of money sufficient to defray the reasonable expenses of its organization ... the sum shall be repaid with interest accrued in a manner and at a rate approved by the commissioner. The agreement under which the sum is obtained shall provide that any claim for its return shall be inferior and subordinate to all claims of and reserves for policyholders and creditors. Interest shall be paid and principal shall be retired only out of the surplus earnings of the insurer and with the approval of the commissioner whenever, in his or her judgment, the financial condition of the insurer warrants it, except that approval shall be withheld if repayment will reduce the surplus to an amount that is less than the amount determined adequate to comply with section 403. Any sum advanced shall not form a part of the legal liabilities of the insurer but until repaid all statements published by the insurer or filed with the commissioner shall show the amount remaining unpaid."

However, neither this provision nor any other part of the SB 1293 prevents a mutual disability insurer from forming a stock subsidiary, and then transferring a significant portion or all of its business to that stock subsidiary.

This is exactly how the Blue Cross Blue Shield plan of California became a for-profit insurer without any regulatory approval or formal action, by transferring the bulk of its business to a stock subsidiary. *See* http://yourhealthdollar.org/pdf/yourhealthdollar.org_blue-cross-history-compilation.pdf. Blue Cross Blue Shield of Missouri acted similarly, transferring 80% of its business to a stock subsidiary. *Id.* Remarkably, Senate Bill No. 1293 does not bar these transfers and lacks sufficient detail to prevent such back-door-for-profit conversions.

The provision that purports to protect Michigan from a for-profit conversion or sale are ineffective. That is, Section 5825(3) provides:

> In the event of a transaction or series of transactions that results in another person or entity acquiring a greater than **50% beneficial ownership interest** in a nonprofit mutual disability insurer described in subsection (1), the nonprofit mutual disability insurer or the acquiring person or entity shall make payment for the benefit of the people of this state to the Michigan Health and Wellness foundation created under Part 6A of the nonprofit health care corporation reform act, 1980 PA 350, MCL 550.1651 to 550.1655, in an amount equal to the greater of the acquisition price or the fair market value of the nonprofit mutual disability insurer and its subsidiaries, considered on a consolidated holding company basis as of the time of the closing of the transaction or series of transactions, as determined by an independent valuation by a person or entity mutually agreed upon by the Attorney General, the Commissioner, and the nonprofit mutual disability insurer. The cost of the independent valuation shall be paid by the nonprofit mutual disability insurer or the acquiring person or entity. The payment for the benefit of the people of this state shall be administered in a manner consistent with the supervision of trustees for charitable purposes act, 1961 PA 101, MCL 14.251 to 14.266, and shall be in satisfaction of any claim or assertion that consideration is due with respect to the charitable assets of the nonprofit mutual disability insurer. (Emphasis added.)

Section 5825(4), defines "beneficial ownership interest" as the

> "actual ownership or the right, directly or indirectly, to control voting power associated with ownership interests in the nonprofit mutual disability insurer."

However, this definition of "beneficial ownership interest" effectively renders subsection (3) applicable only to a sale of control to another mutual or the full conversion of the mutual to stock form (since a mutual cannot be sold in pieces). Even if the definition

were modified to apply to the broader business of the mutual,[4] the bill would still be deficient due to the conflicts of interest created, as discussed further below. Significantly, the current bills authorize Blue Cross to form for-profit subsidiaries into which significant or even most of its business could be transferred (there are no limits in the bills) and the mutual parent could operate on a for profit basis that way without either conducting a valuation or paying compensation to Michigan and its taxpayers under Section 5825(3). Even with the possible modification of the text as discussed above, as long as any outside stockholders own less than 50% of Blue Cross's business, there would be no triggering obligations to the state.

More importantly, as a matter of black letter corporate law, the issuance of stock to outside investors in a stock subsidiary would obligate Blue Cross to run the stock subsidiary in the sole interests of its stockholders. Even if Blue Cross (and thus its policyholder-owners) maintained ownership of 51% to 99% of the stock, Blue Cross will have a fiduciary duty to operate the stock subsidiary in the interests of the minority stockholders.[5]

It is mere pretense that Blue Cross will be operating on a nonprofit – and thus somehow charitable – mission given that it is being privatized into a mutual insurer owned by its policyholders. Even worse, these policyholders interests may themselves be subjugated to the for-profit motive of outside stockholders if (and when) Blue Cross issues stock in a down-stream subsidiary (at which time it will have a fiduciary duty to serve stockholders' interests over those of the mutual policyholders or public).

There is ample historical precedence for concerns about the mutual policyholders' interests becoming subservient to stockholders' for-profit interests (and that of the mutual's own management which invariably compensate themselves with rich stock

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[4] For example, by adding to the end of the definition in (4) "... and/or ownership of any of the mutual's business through subsidiaries or affiliates whether down stream stock subsidiaries or otherwise.").

[5] *See, e.g., Pepper v Litton*, 308 U.S. 295 (1938) (a director of a stock corporation, under long settled law, owes a fiduciary duty to the shareholders of the company). Neither a board of directors nor a majority shareholder can use his or her voting power for personal benefit at the expense of minority shareholders. *See Connecticut General Mortgage and Realty Investments et al v. Normal Siddal et al.*, Fed. § L. Rep (CCH) P98, 409 (D. Mass. 1981 (neither directors nor majority shareholders can use their voting power for personal benefit at the expense of minority shareholders); *Jones v. H.F. Ahmanson & Co.*, 1 Cal.3d 93, 81 Cal.Rptr. 592, 460 P.2d 464 (Cal. 1969); *Donahue v. Rodd Electrotype Co. of New England, Inc.*, 367 Mass. 578, 593-594 & n.20 (1975). Any action taken by a board of directors that benefits a majority shareholder at the expense of minority shareholders constitutes a breach of the director's fiduciary duties. *See, e.g., Heckmann v. Ahmanson*, 168 Cal.App.3d 119, 214 Cal.Rptr. 177 (1985).

option in the stock subsidiaries – a practice glaringly not barred by either SB 1923 or SB1924).[6]

The New York Assembly Standing Committee on Insurance[7] characterized the conflicts of interest in a mutual with down stream stock subsidiaries in a report on mutuals, which stated in relevant part:

> The duty of a mutual company's management is to provide insurance to its member/owners at the lowest possible cost. Stock companies' primary obligations, however, are to their shareholder/owners. Most observers agree that stockholder pressures force publicly held companies to focus more heavily on short-term objectives impacting stock price and investor returns, while mutual insurers tend to concentrate on longer-term objectives. It is not clear how management in a company structure in which ownership is split between policyholders and stockholders can reconcile these divergent and quite possibly conflicting responsibilities."

Finally, the resulting conflicts of interest render the mutual a vehicle for profits in the stock subsidiaries and misalign the self-interest of the mutual's management in the stockholders' profits through stock options.[8]

An absolute prohibition on the issuance of stock to outside investors (and of stock options to management) in any subsidiary should be included in any bill.

Point 5: Section 5825 of SB1923 purports to establish additional "security" measures to protect the interests of Michigan and its taxpayers in a subsequent sale or conversion of the converted Blue Cross. But these restrictions are not sufficient and may lead to

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[6] The disastrous practice of transferring the business of a mutual insurer to down stream stock subsidiaries with outside shareholders is perhaps best epitomized by the example of a Iowa mutual as detailed in *Schiff's Insurance Observer (Oct. 1997). See* http://www.insuranceobserver.com/PDFpart/100197p6-22.pdf. ("In these situations the mutual and the stock company generally share the same management, board of directors, facilities, employees, and agents. The problem with this structure is that it creates conflicts of interest; management is faced with two mutually exclusive responsibilities: providing policyholders with insurance at the most efficient cost and providing shareholders with the highest return on their investment.")

[7] *See generally* The Feeling is Not Mutual, Report by the Assembly Standing Committee on Insurance (1998) at http://assembly.state.ny.us/Reports/Ins/199803/insureport.html#t20 at "Findings" and also "Potential for Conflicts of Interest in MHC Governance."

[8] *See, e.g.*, http://www.insuranceobserver.com/PDFpart/100197p6-22.pdf.

convoluted litigation in the future. Section 5825(1) attempts to limit the economic rights of the mutual policyholders, providing:

> A member of a nonprofit mutual disability insurer that has merged with a nonprofit health care corporation as provided in Section 5805(1) shall have no interest in, or residual rights to, the assets of the nonprofit mutual disability insurer; shall not receive policy or surplus dividends; and shall not be required to pay capital assessments by the nonprofit mutual disability insurer.

CIR questions whether this provision is wise, or even enforceable, and begs the question what happens if Blue Cross generates significant profits since the bill precludes dividends to policyholders. (Dividends in a mutual are the return of excess premiums.) As noted in our original letter, disenfranchising mutual policyholders makes an insurer susceptible to domination by management and may lead to abuse. Moreover, it is unclear whether the State of Michigan has the power to deny these ownership rights to the members of a cooperative corporation since these members will be contributing to the retained profits (*i.e.*, subscribers' reserves) of the insurer through their premiums. *See* Section 5805 (1) and (2) (denying policyholders the right to *any* assets upon dissolution or winding up).

The bills have it backwards because they do nothing to ensure that Michigan and its taxpayers are compensated for their existing charitable assets *by Blue Cross*, and yet the bills specifically deprive the *policyholders* of any rights to the value they will contribute to the mutual in the future, including dividends or assets upon a future conversion. To get it right, Blue Cross should compensate Michigan and its taxpayers now, and the policyholders should be entitled to share prospectively in the value they create in their mutual just like all other mutuals' policyholders.

Point 6: Section 5805(3) is ambiguous as to whether Blue Cross would be required to continue to offer MediGap until 2016, which time frame is also too short. In addition, the shift to "file and use" rate-making is a step backwards from protecting consumers with Blue Cross who would be better served by a prior-approval rate-making system applied to all health insurers.

Conclusion

The proposed conversion of Blue Cross into a mutual insurer should be rejected because, as shown, the stated rationales for the conversion are without merit. Moreover, the bills under consideration are wholly inadequate because they contain virtually no limitations on what Blue Cross can do with its capital (which is a charitable asset) or how deeply it can engage in for-profit health insurance. Ultimately, the bills' failure to compensate Michigan taxpayers for their estimated $6.4 billion in charitable assets jeopardizes Michigan interests now and in the future and serves to give Blue Cross undue advantage (free capital) in the insurance marketplace that its conversion was promoted to ostensibly level. Remarkably, the tried and tested mechanisms for capitalizing mutual insurers (*e.g.*, guarantee stock, surplus notes) have been completely ignored by the proponents of these bills to date, and demand inclusion to satisfy all three stated objectives: capital for Blue

Cross, compensation to Michigan and its taxpayers, and funding for ongoing health wellness activities. For the reasons above, the bills are unsound as proposed and obviously demand careful consideration on other than an expedited basis. They are not in the interests of Michigan, its taxpayers or consumers.

Please let us know if we can provide you and the Committee with any further assistance on this important matter.

Sincerely,

Brendan Bridgeland
Director

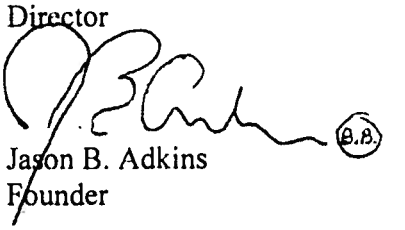

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EXHIBIT

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Center for Insurance Research

2298 Massachusetts Ave. • Cambridge, MA 02140

October 12, 2012

The Honorable Senator Joe Hune
Chairman, Senate Insurance Committee
P.O. Box 30036
Lansing, MI 48909-7536

Dear Chairman Hune:

We are writing to you and your committee to oppose the proposal to reorganize Blue Cross Blue Shield of Michigan (BCBSMI) from a public charitable organization into a mutual insurer owned by its policyholders (albeit a tax paying nonprofit) under the terms articulated by Governor Rick Snyder and BCBSMI and to urge the Legislature to slow down the consideration process to allow for proper deliberation on this highly complex matter. Remarkably, no specific legislation has yet been made public at this late date despite a scheduled hearing on October 16, 2012, shortly after which proponents expect immediate adoption of their bill.[1] Therefore, we address the positions that have been publicly articulated by the proponents.

The Center for Insurance Research (CIR) is a nonprofit, public policy and advocacy organization founded in 1991 that represents consumers on insurance matters nationally. CIR has extensive experience with mutual insurers, including in analyzing and policing complex transactions such as mergers, reorganizations and conversions. CIR has also analyzed and commented on other proposed Blue Cross/Blue Shield conversions in the past.

Proponents of the BCBSMI reorganization make several arguments to support the conversion itself and the emergency legislative approval process. We address the most salient points in our analysis below:

First, proponents claim that the proposed reorganization is not a "conversion" because BCBSMI will merely be changing into a nonprofit mutual corporation and not into a for-profit corporation owned by stockholders. Thus, they argue, the nonprofit mission of BCBSMI will be unchanged.

Response: This argument ignores the fact that BCBSMI will fundamentally alter its ownership structure, converting from a nonprofit charitable organization, with charitable purposes and obligations in service to taxpayers, *into a private corporation with private owners* (the policyholders, 1.1 million of which do not even live in Michigan). In fact,

[1] Two bills have been introduced (S. 1293 and 1294), but evidently only as placeholders given that they do not address most aspects of the proposed transaction.

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the proponents admit that "Ownership of a mutual resides with its policyholders whose voting power is established in the bylaws." BCBSMI Briefing Materials at page 5. Profits from the mutual will accrue to the benefit of those new owners (and not to the public). Therefore, it is a conversion of ownership in the most traditional sense.

Moreover, the nonprofit designation is without meaning since all mutual insurers are supposed to provide "insurance at cost" and operate without a traditional profit motive (and BCBSMI will pay state and federal taxes). The purpose of the mutual will be to serve the interests of its policyholder-owners.[2] This structure also begs important questions: who will actually control the insurer (proponents suggest policyholders will have voting rights), who has the authority to enforce its charter, who benefits from its financial success (such as dividends) and what rights will policyholders possess with regards to future operations and potential corporate changes (*i.e.* mergers, conversions or other). The more the hybrid mutual is structured to protect the public mission, the more the policyholders' rights will have to be suppressed. Our experience is that when policyholders are disenfranchised, the more insular and powerful the management becomes, making the insurer vulnerable to abuse and a loss of mission while leaving citizens and policyholders alike reliant on overworked and underfunded state regulators.[3]

Second, proponents claim that, because it is not a conversion, no appraisal is required to value the public's interest in BCBSMI to ensure that the taxpayers are fully compensated for their past contributions as part of the reorganization. Therefore, they argue that the proposal for BCBSMI to pay $1.5 billion over 18 years (or $83 million/year) is fair because it amounts to nearly half of the company's reserves. Moreover, they argue that the company cannot afford to pay more because it needs the reserves to continue operating.

Response: When a charitable asset is transferred to a private corporation with private owners, the public's value must be appraised and paid to an entity with an ongoing charitable purpose. *Otherwise the new entity will be unjustly enriched by the public's*

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[2] *See, e.g., Penn Mutual v. Lederer*, 252 U.S. 523, 40 S.Ct. 397 (1920) at 525, 398 ("It is of the essence of mutual insurance that the excess in the premium over the actual cost as later ascertained shall be returned to the policy holder."); 533, 400 (mutual insurers act wholly for the benefit of their policyholders and are co-operative enterprises); 535, 401 (policyholders are the members of a mutual and elect the board of directors).

[3] An example of just such a nonprofit mutual is The Beacon Mutual Insurance Company, which was created and capitalized by the Rhode Island legislature, with a public mission and gubernatorial-appointed directors, and yet devolved into a bastion of favoritism, corruption and incompetence while state oversight was lacking for years and policyholders were overcharged and mistreated. A belated regulatory examination documents in 312 pages Beacon Mutual's pervasive misdeeds and breaches of duty. *See* http://www.dbr.state.ri.us/documents/divisions/insurance/examinations/Beacon_Mutual-4-20-07.pdf

assets, which were built up by taxpayers' historic subsidy of BCBSMI since its founding in 1939.

Moreover, the value of BCBSMI today far exceeds the present value of the $1.5 billion-over-18-year payment (which is far less than $1.5 billion). In fact, it had subscribers' reserves of $3.2 billion at the end of 2011, which was up $300 million from the $2.9 billion reported in 2010. *See* www.bcbsm.com/home/bcbsm/annual_report.shtml. These subscribers' reserves represent the mere "book value" of the company (its assets above liabilities), and the fair market value of this profitable ongoing concern is obviously much higher than $3.2 billion as discussed below.

Third, proponents argue that the $83 million per year to be paid to a charitable entity over 18 years will be used to promote "healthy lifestyles, provide better access to health care and improve public health," according to the Governor, thereby fully continuing the company's mission to Michigan more generally.

Response: As noted above, BCBSMI had a book value of $3.2 billion (subscribers' reserves) at the end of 2011. Its market value could well exceed twice that amount or $6.4 billion, particularly given its market dominance. Obviously, paying $1.5 million over 18 years is far less valuable and, in fact, has a present value of only $902 million based on BCBSMI's current rate of return on investments.[4] Clearly, this sum falls far short of the fair market value of BCBSMI.

Proponents have never addressed this inconsistency, except to argue a *non sequitur* that BCBSMI needs the capital to operate. There are mechanisms for financing a fair payment to Michigan *without* limiting BCBSMI's ability to operate. For example, mutual insurers are often started with outside capital, called guarantee stock, which is either paid off over time as the mutual can afford to do so and/or receives dividends on the mutual's profits on an ongoing basis. The charitable entity to be created could own the guarantee stock for the fair market value of BCBSMI, and receive dividends and/or interest payments. Thus, an ongoing stream of payments (not limited to 18 years) could be used to promote "healthy lifestyles, provide better access to health care and improve public health," and would be done without giving away Michigan's financial interest in BCBSMI as is currently proposed. In addition, other financing mechanisms exist, including the issuance of surplus notes (subordinated debt that is treated as subscribers' reserves) that could finance payments to the new charitable entity and/or become the mechanism by which the new charitable entity receives regular payments.

Fourth, proponents argue that BCBSMI will pay an estimated $100 million in state and local taxes, which will level the playing field with competitor health insurers.

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[4] Using a 6% discount rate (*i.e.* its actual rate of return), the actual present value of $1.5 billion is approximately $902 million. *See* http://news.bcbsm.com/news/2012/news_2012-03-02-14000.shtml ("BCBSM once again outperformed national benchmarks when managing its investments, achieving rates of return averaging just over 6 percent.")

Response: While leveling the playing field is appropriate, these funds would go to Michigan's general fund (and local government), thus pulling these dollars out of health care. Premiums will have to rise to cover the discrepancy. The payment of $83 million a year for 18 years to a nonprofit entity under the proposal would similarly have to be paid for. Proponents never address this aspect of the reorganization, nor the added costs of the conversion itself, which could be substantial.

Fifth, Kevin Clinton, commissioner of the Office of Financial and Insurance Regulation, was quoted in the press that safeguards would have to be instituted to make sure the mutual stays in Michigan and is not sold, demutualized (converted to stock form) or merged away – at which point the fair market value of the mutual would be transferred to the new charitable entity, he said.[5]

Response: Ensuring that BCBSMI stays in Michigan is critical. However, the stated remedy will not protect against future changes to the as yet unknown statutes (which happen with frequency once the limelight is faded years down the road). It also disenfranchises the mutual policyholders who will contribute to the reserves of the company after its mutualization (which is unfair to those policyholders). The time to value Michigan's interest is now, before the policyholders' begin making contributions to build up the mutual's future reserves through their premiums. Thus, while Mr. Clinton's proposed safeguards implicitly acknowledge that the mutual has a fair market value that it is far in excess of the proposed 18 year payment (with a present value far less than $1.5 billion), his approach inappropriately postpones the time for assessing Michigan's charitable asset, and thus we believe would disenfranchise the policyholders (and/or invite future claims that Michigan's interests has been diluted). The policyholders must be protected against this misuse of the mutual as an empty corporate shell.

Sixth, proponents argue that the legislature should expedite the review process of the legislation (still publicly undisclosed) because the federal Affordable Care Act will make its products unsuitable and because its long (18 month) rate review process will allow its competitors to unfairly obtain its proposed rates and under-price BCBSMI's products.

Response: The stated concerns about the slow or disparate rate regulation that currently applies to BCBSMI suggest their own remedy - rate reform. There is nothing about BCBSMI's nonprofit charitable status that would prevent rate regulation from being applied to it on equal terms as all other insurers, and it could be assessed state taxes or agree to make payment in lieu of taxes (PILOT) payments as a result of its changed obligations and opportunities due to the ACA. In fact, of the dozen or so nonprofit charitable Blue Cross/Blue Shield organizations around the country, only BCBSMI is claiming that the Affordable Care Act and rate regulation necessitates that it convert to a mutual (or any other form).

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[5] *See* http://www.mlive.com/business/index.ssf/2012/09/legislature_pushes_forward_wit.html

Seventh, Commissioner Clinton was quoted as stating that rates will likely go up for certain people after the transition, but that they would be a result of the Affordable Care Act and not Blue Cross's new structure. The Blues transition, Clinton said, should actually level the playing field and create more competition among insurers since the company would have to start paying taxes. It currently takes about 18 months for Blue Cross to get rates approved by the state. That would shrink to about two or three months under the new plan, which is typical for other insurers.[6]

Response: In reality, the Affordable Care Act will make the rate regulation much simpler for all insurers, including BCBSMI and having nothing to do with a conversion. Clearly, whether and why rates may increase deserves a substantial and concerted focus by the legislature before adopting conversion legislation. Among other things, paying $100 million in taxes plus $83 million to the charitable entity annually will have to be accounted for.

For the foregoing reasons, the conversion of BCBSMI into a mutual insurer is unsound as proposed and unjustified on an expedited basis. There are a myriad of issues that must be addressed to ensure it is justified, fair and in the interest of Michigan and its residents, and the current proposal satisfies none of these criteria.

Please let us know if we can provide you and the Committee with any further assistance on this important matter.

Sincerely,

Brendan Bridgeland
Director

[6] *See* http://www.mlive.com/business/index.ssf/2012/09/legislature_pushes_forward_wit.html