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TRANSFER OF ASSETS BY NONPROFIT PUBLIC BENEFIT CORPORATIONS TO FOR-PROFIT SUBSIDIARIES

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SUMMARY

Nonprofit public benefit corporations hold their assets in "charitable trust." A charitable trust is an entity that holds money or assets used for charitable purposes. Unlike for-profit corporations, any surplus revenues of a nonprofit public benefit corporation are not distributed as dividends, or spent pursuant to the directors' broad discretion. Surplus revenues and other assets of a nonprofit public benefit corporation belong to the public or to the charitable beneficiaries the trust was organized to serve. If the nonprofit public benefit corporation dissolves or converts to a for-profit corporation, the assets held in charitable trust must be donated, or "disgorged" so that the assets can continue to be dedicated to charitable purposes. The donation or "disgorgement" is made to a charitable group that will continue the original purpose of the charitable trust. This donation is known as a "charitable asset settlement" ("CAS").

In California, the power to enforce the fiduciary duties of nonprofit public benefit corporations resides with the Attorney General. However, if the nonprofit corporation is a "health care service plan," the enforcement power rests with the Commissioner of Corporations. This paper examines the nature and source of the Commissioner's power to govern activities by nonprofit health care service plans, specifically with respect to Blue Cross of California's transfer of assets to a for-profit subsidiary. This paper also examines how the assets of a nonprofit corporation should be valued when it converts to for-profit status.

I. INTRODUCTION

Blue Cross of California is a nonprofit health care service plan founded in California during the Great Depression. It has offered health care services to Californians through a variety of plans available to serve the differing needs of its many customers. In January 1993, Blue Cross created a for-profit corporation, WellPoint Health Networks, Inc., as a Blue Cross subsidiary. Blue Cross then transferred most of its managed care product lines and companies to WellPoint in return for 80% of WellPoint's stock. [No. 1] WellPoint sold the balance of its stock in an initial public offering, which netting $517 million. [No. 2]

When Blue Cross initially transferred its managed care operations to WellPoint, consumer groups such as Consumers Union, publisher of *Consumer Reports* magazine, petitioned the California Department of Corporations, and its commissioner, Gary Mendoza, to challenge the transfer under the Commissioner's authority to govern health care service plans. The consumer groups argued that under state and federal law, the assets of a nonprofit organization belong to the public. Thus, when the organization converts to for-profit status, the assets should be conveyed to charitable groups in a "charitable asset settlement" ("CAS"). Blue Cross denied that any assets it held belonged to the public or to charitable beneficiaries.

In August 1993, in response to public pressure, Blue Cross announced an agreement it had reached with the Commissioner of Corporations and the California Legislature. Under the agreement, Blue Cross would contribute $100 million to California charities in return for official approval of its plan to run its health operations on a for-profit basis. [No. 3] Blue Cross suggested that this payment would satisfy any legal obligation to repay the public for the years Blue Cross operated without paying taxes. [No. 4]

Despite this agreement, consumer groups continued their objection, saying that a $100 million contribution did not nearly approximate the charitable assets Blue Cross had accumulated over its years of operation. [No. 5] Ultimately, the agreement was abandoned because of public pressure. By August 1994, the consumer groups demanded that Blue Cross pay $2.5 billion in a charitable settlement, and the Commissioner of Corporations suggested that a payment of at least $1.1 billion was appropriate. [No. 6]

Blue Cross denied that it was obligated to pay the balance of its assets to a charity. Although other nonprofit insurance providers transferred assets to charitable organizations when they converted to for-profit organizations, [No. 7] Blue Cross claimed that because their original nonprofit corporation continued to exist after the transfer of assets, it did not have to make any charitable donations. [No. 8] In short, Blue Cross agreed with state officials that nonprofit corporations <u>converting</u> to for-profit entities were required to make a charitable settlement. However, Blue Cross disputed that they were <u>converting</u> to for-profit status. Blue Cross claimed they merely <u>restructured</u>, because they remained a nonprofit corporation. [No. 9] The dispute between Blue Cross and the Commissioner of Corporations continued.

In January 1995, Blue Cross proposed to transfer 100% of its assets, estimated at $2 billion, to a non-profit, public benefit corporation called California HealthCare Foundation. [No. 10] The primary assets in the transfer would be the stock Blue Cross currently holds in WellPoint. [No. 11] This plan has not been approved by the Commissioner of Corporations because of concerns regarding the section of the Internal Revenue Code under which the nonprofit foundation will operate. [No. 12] The nature of the Blue Cross transactions and the Commissioner of Corporation's power to govern them are the focus of this paper. This paper examines the nature of a nonprofit corporation that is held by the public in charitable trust and it examines the power of certain public officials to govern transactions by nonprofit corporations.

Specifically, this paper examines two issues regarding Blue Cross' transfer of assets. First, the paper examines California's authority to demand that Blue Cross convey its net assets to charity. This discussion examines California statutory authority for the Commissioner of Corporations to demand that Blue Cross make a CAS. This part of the paper also examines how other states regulate nonprofit conversions. Second, this paper examines how nonprofit corporations are valued, or how they <u>should</u> be valued, when they convert to for-profit status.

Although Blue Cross proposes to <u>transfer</u> its stock in a for-profit subsidiary to a nonprofit foundation, this paper will analyze this issue as if the assets that Blue Cross wants to transfer are in fact being <u>converted</u> to for-profit status. Under the current proposal, the Blue Cross board would administer the foundation organized under section 501(c)(4) of the Internal Revenue Code that would permit the foundation to liquidate stock it would hold in WellPoint, and to access capital markets. In other words, the proposed structure would enable the foundation to benefit from

WellPoint's for-profit activities. Since Blue Cross conveyed its assets directly to WellPoint, the analysis regarding conversions to for-profit entities is analogous. [No. 13]

II. THE COMMISSIONER OF CORPORATIONS HAS AUTHORITY TO GOVERN THE BLUE CROSS TRANSACTIONS.

This portion of the paper examines California's statutory authority to govern nonprofit conversions. In short, California statutory law empowers the Commissioner of Corporations to challenge conversions of nonprofit health care service plans to for-profit corporations. [No. 14] The Commissioner's power, conferred by the Legislature, to govern nonprofit conversions is derived from a common law power to govern "charitable trusts." The primary features of a charitable trust are: (1) designation of a trustee or trustee group; (2) to hold certain property; (3) and apply it or its income; (4) to a specific charitable purpose; (5) for unidentified beneficiaries; (6) who are of a specified class or group of the public. [No. 15]

In order to evaluate the proposed Blue Cross transfer, one must examine: (1) Blue Cross' original corporate form; (2) Blue Cross' power to convert to a for-profit entity; (3) the source of the Commissioner's power to govern the conversion; and (4) the requirements and elements of a CAS.

A. Blue Cross' corporate structure.

In 1982, Blue Cross of Northern California merged with Blue Cross of Southern California to form one corporation providing the same services to the same group of members that the two organizations had separately served. The merged corporation, "Blue Cross of California," is organized as a nonprofit public benefit corporation. [No. 16] Blue Cross' Articles of Incorporation state that its net assets are dedicated to public purposes, and may not benefit any private person. [No. 17]

The California Corporations Code, adopted and amended by the California Legislature, governs the creation, administration, and dissolution of nonprofit public benefit corporations. [No. 18] A public benefit corporation may be formed for "any public or charitable purpose." [No. 19] The charitable aspect of a nonprofit public benefit corporation is clear from the legislative intent:

> Public benefit corporations are formed for a public or charitable purpose. They are not operated for the mutual benefit of their members but from some broader good. Members of public benefit corporations have no ownership interest in them. Upon dissolution of the corporation the assets must go to a similar nonprofit corporation or charitable organization, rather than to the members. Public benefit corporations include the traditional "charitable" corporations. The nonprofit law avoids the term "charitable," however, as its association with the tax law gives it a more restrictive meaning than is desired. [No. 20]

B. Blue Cross' power to change its corporate form.

Under California's nonprofit corporation law, Blue Cross has the power to change its corporate form in several ways, including converting to a for-profit corporation. Initially, public benefit corporations are expressly authorized to amend their articles. [No. 21] Second, nonprofit public benefit corporations can sell, lease, convey, exchange, transfer, or otherwise dispose of their assets, [No. 22] for any "consideration the board may deem in the best interests of the corporation." [No. 23] As long as there is no breach of the charitable trust, the assets can be exchanged for any consideration including, "money, property, or securities of any domestic corporation, foreign corporation, or foreign business corporation or any of them." [No. 24] A sale of corporate assets under this provision by a health care service plan is subject to Commissioner approval. "A corporation must give written notice to the [Commissioner of Corporations] 20 days before it sells, leases, conveys, exchanges, transfers or otherwise disposes of all or substantially all of its assets . . . " [No. 25] The Commissioner could also challenge the transaction under California Corporations Code section 5142 for breach of charitable trust. Under these provisions, Blue Cross was authorized to convey its assets to WellPoint in exchange for stock in the new for-profit corporation, as long as the Blue Cross directors deemed that consideration to be adequate. Also under these provisions, the Commissioner was authorized to challenge the conveyance if he believed the conveyance breached the charitable trust.

Third, Blue Cross could merge with any public benefit corporation or a religious corporation or a foreign nonprofit corporation, the articles of which provide that its assets are irrevocably dedicated to charitable, religious, or public purposes. [No. 26] Under the merger provisions, the Commissioner of Corporations must receive notice of any merger [No. 27] and if the Commissioner approves in writing, the public benefit corporation can merge with any domestic corporation, foreign corporation or foreign business corporation, without regard to whether that corporation is nonprofit, or charitable. [No. 28] It is arguable that these merger provisions govern Blue Cross' proposed transfer of stock to the foundation. This is so because under the proposal the Blue Cross board will manage the foundation and the foundation will hold all Blue Cross assets. It is almost as if Blue Cross would merge into the foundation.

Regardless, the rights and obligations under the merger provisions are very similar to those under the amendment and sale provisions. The impact is that Blue Cross is authorized to make dramatic changes in corporate form, however those changes are labeled, as long as the changes are for adequate compensation, and the charitable trust is not breached. In summary, Blue Cross' transactions are authorized under the Corporations Code provisions outlined above, and the Commissioner has supported the ability of a nonprofit corporation to convert to a for-profit entity. [No. 29] Most important for the Blue Cross transactions, is that no change of corporate form under the statutory provisions outlined above extinguishes the charitable trust obligations of a nonprofit public benefit corporation. Charitable obligations survive an articles amendment, [No. 30] and the dissolution of a corporation from a sale or merger. [No. 31]

C. <u>The source of the Commissioner of Corporation's power to govern Blue Cross' proposed transfer.</u>

1. <u>The Commissioner has exclusive jurisdiction over health care service plans.</u>

The Commissioner of Corporations has exclusive jurisdiction over nonprofit health care service plans to enjoin or otherwise remedy breaches of charitable trust. Prior to 1980, a confusing combination of statutory and judge-made law governed nonprofit corporations and health care service plans. The Uniform Supervision of Trustees for Charitable Purposes Act, passed by the California Legislature in 1959, gave power to the attorney general to govern charitable trusts. [No. 32] Other sections of the Corporations Code governed nonprofit corporations that were not charitable trusts, and vested enforcement power with the Commissioner of Corporations. The California Health and Safety Code recognized entities called "health care service plans" after the Knox-Keene Health Care Service Plan Act of 1975 passed the legislature. Enforcement authority over these entities was vested with the Commissioner of Corporations. [No. 33] Thus, the attorney general and Commissioner had overlapping enforcement jurisdiction over nonprofit corporations that were health care service plans.

In 1980, the legislature passed Corporations Code sections 10810 to 10840 which govern nonprofit corporations formed for the purpose of providing medical services, and insurance plans. [No. 34] These sections give the Commissioner of Corporations exclusive jurisdiction over entities that are both health care service plans, within the meaning of the Knox-Keene Act, and charitable trusts within the meaning of the Uniform Supervision of Trustees for Charitable Purposes Act. [No. 35] The sections also provide that a nonprofit public benefit corporation may be formed for the purposes of defraying or assuming the cost of professional medical services. [No. 36] Blue Cross of California is a health care service plan within the definition of Knox-Keene. [No. 37]

The Knox-Keene Act is significant to the discussion of nonprofit public benefit corporations because health care service plans under the act are governed by the Commissioner of Corporations and the Department of Corporations. [No. 38] The Corporations Code sections covering nonprofit public benefit corporations which provide health services, state that the Commissioner of Corporations has supervisory authority over health care service plans. That is, the Commissioner of Corporations, and not the Attorney General, has supervisory power over nonprofit, public benefit corporations which are health care service plans. [No. 39]

2. <u>The Commissioner's enforcement authority over health care service plans includes the power to demand a CAS.</u>

The Commissioner of Corporations can challenge any corporate action, even though it does not involve a change in corporate form. "The [Commissioner of Corporations] may . . . give rulings as to whether the [Commissioner] will or may oppose a proposed action, or article amendment, as inconsistent with or proscribed by the requirements of a charitable trust." [No. 40]

If a health care service plan seeks to amend its status to a for-profit corporation and if it has any assets, "the amendment requires the advance written approval . . . " of the Commissioner. [No. 41] Since Blue Cross is a nonprofit public benefit corporation and transferred its assets to Wellpoint, a for-profit corporation, the Commissioner had to approve the transfer in advance. Research does not indicate whether Blue Cross sought the Commissioner's advance approval. Based on Blue Cross' claims that they did not convert to a for-profit entity, but merely exchanged their assets for stock in a for-profit entity, they would likely dispute the need for the Commissioner's approval. It is clear, however, that the Commissioner bases his challenge to the Blue Cross transaction on this Corporations Code provision. [No. 42]

When the Commissioner challenges a nonprofit conversion because of a breach of charitable trust, he is primarily concerned with ensuring that the charitable assets remain dedicated to the original charitable purpose. Thus, the Commissioner can enjoin the conversion to preclude the breach of charitable trust, or he can demand a CAS, to ensure that the charitable assets continue to benefit the public.

The Commissioner's power to demand a CAS under the Corporations Code is a codification of the common law "cy pres" power. The term "cy pres" means "as near as possible." A CAS demands that a nonprofit public benefit corporation converting to for-profit status donate its assets to a charity that approximates, "as near as possible," the charitable intent of the original trust.

D. The requirements and elements of a CAS.

When a health care service plan seeks to convert to for-profit status, the Commissioner can demand a CAS to prevent a breach of the charitable trust. The requirements for the Commissioner to demand a CAS are (1) the existence of a charitable trust; (2) a conversion, transfer, sale, or other transaction that would terminate the devotion of the assets to the original charitable purpose, or any other breach of the charitable trust; and (3) the power or jurisdiction of the Commissioner over the transaction.

Each of these elements is present in the case of the Blue Cross transactions. First, Blue Cross, as a public benefit corporation, holds its assets in charitable trust. Second, the conveyance of businesses to WellPoint involved the transfer of charitable assets to a for-profit, or non-charitable entity. Third, the Commissioner has the statutory jurisdiction over Blue Cross to demand that they continue to devote their net charitable assets to a charitable purpose.

Despite the Commissioner's power in this instance to demand a CAS, there are several difficulties in executing a CAS: (1) identifying assets that are subject to a CAS; and (2) valuing those assets. Initially, any assets pledged to a charitable trust are subject to a CAS. Also any assets held by an entity the expressly devotes its entire assets (such as in articles of incorporation) to a charitable trust would be subject to a CAS. The issue becomes more tricky when dealing with assets held by a company, that are not directly attributable to expressly charitable assets. For example, benefits received by a charitable trust on the basis of tax exemptions can be subject to a CAS because the benefits were conferred by the public, on a charitable trust, for the purpose of benefitting the public. Even so, it can be difficult to identify which assets resulted from tax benefits, and more difficult still to value those assets. Since the Blue Cross articles of incorporation devote the company's "net assets" to charitable purposes, this should include all identifiable assets of the company. However, when WellPoint sold 20% of its stock at an initial public offering, they essentially sold 20% of what had been Blue Cross assets. Even if Blue Cross transfers all its WellPoint stock to the foundation, the Commissioner must determine if the 20% of the assets sold to the public were "charitable assets."

III. STATUTORY AUTHORITY OUTSIDE OF CALIFORNIA TO CHALLENGE NONPROFIT CONVERSIONS.

Other states have statutory provisions governing the conversion of nonprofit corporations to for-profit corporations. States treat nonprofit to for-profit conversions in several different ways.

A. Nonprofit to for-profit conversion is prohibited.

Arizona, New Jersey, New Mexico, and New York prohibit nonprofit to for-profit conversions. Arizona's nonprofit corporations provisions state, "No corporation organized under this chapter may: (1) Amend its articles of incorporation to convert its status to a corporation organized for profit, either foreign or domestic; (2) Merge or consolidate with a domestic corporation or foreign corporation organized for profit, unless the corporation surviving the merger or consolidation is a nonprofit corporation." [No. 43] New Jersey prohibits conversion to a corporation operated for pecuniary profit. [No. 44] New Mexico prohibits a health care plan from converting to a for-profit corporation, and further mandates that any plan be operated primarily for the benefit of its subscribers. [No. 45] New York similarly prohibits such conversion. [No. 46]

B. <u>Conversion is permitted with approval from Attorney General or other supervising state authority.</u>

Alabama, Arkansas, California, Georgia, Kentucky, Mississippi, Missouri, North Carolina, Pennsylvania, Tennessee and Virginia permit conversions subject to the approval of a supervising state authority. [No. 47] California's provisions are outlined above. Georgia and Tennessee's provisions are very similar to the statutes in the other states. The statutes permit amendment upon either: (1) prior approval by a superior court in a proceeding in which the Attorney General received notice; or (2) proof that the assets are transferred or conveyed to any persons who would have received them had the corporation dissolved. [No. 48] These alternative procedures are designed to ensure that assets of a charitable corporation cannot be diverted from their intended purpose by conversion to a for-profit corporation. [No. 49] Tennessee permits a nonprofit corporation to merge with a for-profit corporation subject to approval outlined in the code. [No. 50]

Each of these code provisions demands that charitable assets held in trust must be conveyed to the intended beneficiaries, or otherwise be devoted to a similar charitable purpose.

C. <u>Conversion of a nonprofit health service plan permitted without requirement that charitable assets remain devoted to charitable purposes.</u>

Maryland permits nonprofit health care service plans to convert to a for-profit stock health insurers under certain conditions. [No. 51] The Insurance Commissioner must approve any conversion, and may not approve the conversion unless (among other conditions): (1) it is equitable to the enrollees; and (2) no part of the assets or surplus of the nonprofit health service plan will inure directly or indirectly to any officer or director of the corporation. [No. 52] The first condition is designed to protect members of the health care service plan from losing substantial health benefits, or other investments in the plan. However, there is no other requirement in the Maryland provision that charitable assets remain devoted to their original charitable purpose.

D. <u>American Bar Association proposals.</u>

The American Bar Association (ABA) promulgated two acts discussing authority to govern corporate transactions. The Revised Model Business Corporation Act [No. 53] ("RMBCA") promulgated in 1984 makes no provision authorizing nonprofit to for-profit conversion. [No. 54] In 1987, the ABA promulgated the Revised Model Nonprofit Corporation Act ("RMNCA") [No. 55] The RMNCA is organized along the same lines as the RMBCA except that it expressly provides for the merger of a nonprofit corporation into a for-profit corporation. [No. 56] These conversion provisions are highly similar to the provisions adopted in California in 1980, and discussed in detail earlier in this paper. The ABA's model Acts have not been adopted outright by an jurisdiction but the Acts have influenced nonprofit corporation codes in various states.

IV. <u>VALUING NONPROFIT PUBLIC BENEFIT CORPORATIONS TO DETERMINE THE AMOUNT OF A CHARITABLE ASSET SETTLEMENT.</u>

California law does not provide or mandate any mechanism for valuing nonprofit corporations that convert to for-profit status. [No. 57] A review of literature discussing corporate valuation reveals that no single model provides the best method for valuing nonprofit corporations. There are four generally accepted methods for valuing a business: (1) discounted cash flow analysis; (2) asset appraisal (adjusted book value method); (3) comparison to similar publicly traded companies ("capitalized historic earnings method"); (4) acquisition analysis. [No. 58] Which of these methods is appropriate for a particular valuation depends upon the goal of the valuation, and it is often appropriate to use multiple valuation methods for comparison. [No. 59]

Efforts to valuate Blue Cross present several problems. First, Blue Cross may own very few assets such that liquidating the assets would generate very little cash. Second, when assets are dedicated to earning a profit, the assets can be used to raise cash. That is, investors will either buy part of the company in exchange for cash, or loan cash to the company, so that the company can expand its operations. Since a for-profit business can raise cash in these ways, the company can grow more quickly than it could as a nonprofit corporation, unable to raise public cash. Valuing a nonprofit corporation that is converting to for-profit status must include an estimate of the business' profits, <u>and</u> an estimate how dramatically those profits will grow after it is able to raise cash from private investors.

Third, Blue Cross has likely received great benefits, such as tax benefits from operating as a nonprofit corporation. Additionally, Blue Cross may have received government grants to assist its growth. Placing a cash value on these benefits accrued over the years is very challenging. Similarly, there is great risk in <u>creating</u> a health care service plan, that should be reflected in the price one is willing to pay for an on-going and successful corporation. [No. 60]

The California Legislature has previously examined the methods available to valuate corporations converting from nonprofit to for-profit status. In 1985, the Assembly Committee on Finance and Insurance held hearings discussing the responsibilities of various government agencies in nonprofit to for-profit conversions. Several individuals testified at the hearings regarding the possible methods available to valuate a nonprofit corporation. [No. 61] Much of the discussion focused on the conversion of Foundation Health Plan ("FHP") to a for-profit operation. The FHP example is useful in analyzing valuation concepts. [No. 62] This section of the paper examines: (1) the standard methods of valuation; (2) the goals of the valuation process; and (3) the optimal valuation methods in light of the stated goals.

A. <u>Standard methods of valuation.</u>

1. <u>Discounted Cash Flow.</u>

Discounted cash flow ("DCF") valuates a business by estimating the future income or "revenue stream" of the company, and discounting the income to reflect its worth in dollars at the time of the conversion. The DCF model is based on two assumptions: (1) cash now is worth more than an equal amount of cash in the future; and (2) future cash flows are reasonably predictable. [No. 63] DCF examines the company's assets, liabilities, and revenues, and estimates what the net revenues would be for the first year of its for-profit operation. Valuating the Blue Cross assets under this model would entail examining the assets transferred to WellPoint, estimating the revenue stream (based on current premium receipts, and any other revenue), and estimating the costs (which would be higher than its nonprofit costs since the new corporation would not benefit from tax exemptions). These estimates would produce an estimated annual earning. This estimate would be repeated for subsequent years, and net earnings for each year would be totaled. Typically, a projection of annual revenues is made for each of the first five years in which the corporation will operate at a profit. [No. 64] The annual revenue is totaled, and the total is "discounted" to reflect its value as of the time of the valuation. For the Blue Cross assets, the accuracy of this valuation method depends on four factors. First, the earnings growth the assets will enjoy must stabilize within the five-year period over which the earnings are estimated. [No. 65] If the earnings growth fluctuates, grows dramatically, or drops significantly, the estimate will be flawed. Second, any historical earnings used to estimate future earnings must be adjusted to account for "nonrecurring costs." The estimator must examine historical earnings as part of the projection for future earnings. However, the companies and assets transferred to WellPoint will continue in their current state, and there are some costs that impacted Blue Cross' historical earnings, that will not be incurred again. These "nonrecurring" costs are one-time expenditures such as developmental costs, initial marketing costs, and initial organization costs. These costs must be eliminated from the historical earnings to reflect the fact that without such costs, the earnings on the WellPoint assets will be higher. [No. 66]

Third, the WellPoint operation must be evaluated in terms of its potential for growth. This can be done by examining the growth trends of companies currently operating in the same market as WellPoint. [No. 67] The last factor relates to the reasonable "rate of return" the estimator believes the assets will have. The "rate of return" refers to the profit WellPoint can expect given the assets it has dedicated for earning profits. Estimating the rate of return depends on two factors: (1) the odds that the estimated growth will in fact be achieved; and (2) the reasonable reward for money invested in <u>any</u> enterprise. [No. 68]

2. <u>Asset Appraisal (adjusted book value method).</u>

An "asset appraisal" is an individual valuation of all the tangible assets of a business to determine the total value of the business. [No. 69] This is a useful valuation method when the business being valuated is "asset bound" -- that is, where the physical assets of the company contribute significantly to the value of the corporation. Asset bound businesses are those which have significant <u>inventories</u> (the sales of which comprise the primary income stream); <u>plant</u> (buildings, factories and warehouses which the company owns); and <u>equipment</u> (machines used in manufacture, storage, transportation, administration, etc.). [No. 70] A steel mill, for example, has buildings, foundries, raw materials, inventory, and transportation assets, all of which can be sold on the open market. The total value of all these assets reflects a large portion of the total assets of the steel mill. The value not reflected in such a liquidation is the value of existing contracts, customer loyalty, and good will.

An "asset valuation" of the Blue Cross assets would appraise the value of all Blue Cross' assets transferred to WellPoint which could be sold for cash. Two factors determine the outcome of an asset appraisal: (1) the existence of a market for the assets; and (2) the value of the assets on those markets. The "value" of the assets, in turn, depends upon: (1) replacement costs of the assets; (2) size of the market in which the assets would be sold; and (3) ability to convert the assets to alternate uses. [No. 71]

The asset appraisal method is not effective in valuating the Blue Cross assets transferred to WellPoint because much of the asset value is derived not from fixed assets like real estate and inventory, but from intangible assets such as name recognition, customer loyalty and good will. The great majority of WellPoint's revenue comes from the stream of premium payments that the company receives in exchange for issuing policies. Customers do not pay premiums in order to receive tangible products, and WellPoint does not use the premium payments to purchase raw materials. Instead, the premium payments are exchanged for a service -- the service of processing and paying insurance claims. WellPoint uses the premium revenue to pay the cash value of claims, and to pay for the costs of processing claims. The primary costs are: (1) the cash WellPoint pays directly to health care providers or to the insureds; (2) salaries; (3) office space; and (4) computer equipment and other supplies used for claim processing. Because of the nature of WellPoint's business, and the costs of running it, it is possible for WellPoint or any health care service plan to operate without owning any significant tangible assets. The company could lease or rent its office space, office equipment, real property, claim processing equipment, etc. In short, WellPoint could actually <u>own</u> very little, and still be worth hundreds of millions of dollars as an on-going business. WellPoint could not sell their claims processing equipment and expertise for much money if they sold it piece by piece, but the company as a on-going enterprise is worth a great deal.

The "asset valuation" or liquidation method of valuation is not the most accurate method of valuating the Blue Cross assets transferred to WellPoint.

3. <u>Comparison to similar publicly traded companies ("capitalized historic earnings method").</u>

The capitalized historic earnings method identifies publicly traded companies that are comparable to the company being valuated, and examines the historical earnings of those publicly traded companies. Publicly traded companies are examined because they must routinely disclose their earnings as part of their reporting obligations. Using these reports, the estimator develops an "earnings per share multiple" that reflects the company's earnings for each share of stock it has outstanding. [No. 72] The estimator also examines the "fair market value" that the stock markets assign to each share of the public companies' stock. The estimator can compare the amount a company earns per share, and the value that the stock markets assigns to each share, and draw a conclusion as to how the "market" values the companies' earnings.

This comparison helps the estimator analyze the connection between a company's earnings multiple and the fair market value based upon the company's share price on the stock market. The estimator uses this information to examine the converting company's earnings per share, and extrapolate what the fair market value of the company would be if it was publicly traded. This is the basis for estimating the overall value of the company.

An estimator could use this valuation method to determine the value of the Blue Cross assets transferred to WellPoint. However, in the case of WellPoint, a more accurate empirical estimate exists already. When WellPoint received the Blue Cross businesses, it sold 20% of its own stock to the public, and gave the remaining 80% of its stock to Blue Cross. The stock it offered in an initial public offering sold for $517 million. If 20% of the stock was worth $517 million, one could estimate that 100% of the stock is worth $2.585 billion. This is probably the basis for the Consumer's Union demand that Blue Cross make a CAS worth $2.5 billion. Although this empirical measure is fairly accurate, a better measure would be the total value of the WellPoint stock based on the price <u>at which the stock is currently traded.</u> That is, although the WellPoint stock <u>initially</u> sold for $517 million, the market value of WellPoint stock has likely changed since the initial offering. [No. 73] The current value of the publicly traded WellPoint stock would be the most accurate measure of the total value of all the WellPoint assets. However, since Blue Cross intends to comply with the CAS by transferring all of the WellPoint stock it holds to California Healthcare Foundation, the dollar value of the stock would be largely irrelevant. Blue Cross would donate to charity the entire amount of the charitable assets it holds except for the 20% of WellPoint stock sold through the initial public offering. The issue for the estimators is whether the any part of the stock sold in WellPoint's public offering constituted charitable assets that should be donated to the foundation.

4. Acquisition analysis.

This generally accepted valuation method analyzes purchases of similar business to estimate the price at which the converting business would sell in its entirety. [No. 74] This approach requires an evaluation of a sample of recent acquisitions of businesses similar to the business in question. With this sample, one can identify the relationship between the price paid and the underlying characteristics of the business, such as recent earnings, net assets, revenue growth, and location. [No. 75]

The strength of this approach is that one can examine the basis by which willing purchasers and sellers arrived at a sale price. The disadvantage is that there may not be many examples from which to choose, and of those examples, there may not be much information available if the sale involved a privately held company.

5. Valuation methods used in California by the Commissioner of Corporations.

The Commissioner of Corporations has used valuation methods found in Internal Revenue Service ("IRS") codes when valuating business for the purpose of determining the amount of a CAS. [No. 76] Essentially, the IRS codes combine the valuation methods discussed earlier in this section, in attempting to find the "fair market value" of assets. [No. 77] The IRS codes define fair market value as, "[t]he price at which the property would change hands between a willing buyer and a willing seller, neither being under any compulsion to buy or to sell, and both having reasonable knowledge of the relevant facts." [No. 78]

The following two sections attempt to identify which of the valuation techniques is appropriate for the Blue Cross - WellPoint transfer.

C. Goals of the valuation process.

The valuation method that should be used in any particular circumstance depends upon the goal or purpose of performing the valuation. There are two goals relevant to the Blue Cross case that result in two different values. One goal of valuing a company is to determine the company's worth for the purpose of investing in it. This goal results in the "going concern" value. The second goal of corporate valuation is to determine the company's worth if the entire company, include control of the company, is sold. This goal results in the "transfer" value.

1. Valuing for the purpose of investing in the corporation ("market value of a going concern").

"Going concern" value estimates the value of a company if one were to invest in or purchase part of the company. This estimate assumes that someone else will manage and control the company, and the investor will simply own a small share of it. The investor wants to know the total value of the company to determine the fair price for the small portion of the company that the investor plans to buy.

For example, when 20% of the WellPoint stock was sold in an initial public offering, the share price investors were willing to pay was based in part on the fact that the investors would not control the company.

2. Valuing for the purpose of transferring ownership of the corporation ("transfer value").

"Transfer" value estimates the total value of the company as a going concern, plus the value that attaches to being able to manage or "control" the company. It is important to estimate the cash value of "control," and when companies are sold in their entirety, the sale price should include a "control premium." A "control premium" is an amount of money the buyer pays to the seller for the benefit of obtaining control of the company.

For example, in the FHP conversion, discussed earlier in this paper, the management of FHP estimated that the company was worth $21 million. The Commissioner ultimately demanded a CAS of approximately $38 million, which was the highest of three estimates of the company's value by the public accounting firm. During the course of FHP's conversion, Maxicare, an FHP competitor, offered to purchase FHP for at least $10 million more than the highest CAS amount. The Commissioner declined to approve that offer and the Commissioner's decision was upheld by a California Superior Court. The Superior Court judge indicated that the price Maxicare would pay was higher, but that did not mean that the conversion value was improper. "[T]he legal test [for fair market value] in this court's view, is not whether [the offer] was the highest lawful bid, but whether there was a fair value. Those are two different questions . . . It may well have much higher value to a competitor than the fair market value, to somebody who simply would be investing in this enterprise, and not in any competitor by doing so." [No. 79] Blue Cross did not sell "control" when they transferred their businesses to WellPoint. The Blue Cross board maintained management power over WellPoint. Thus, even though the "transfer" value of the Blue Cross businesses may have been higher than the "going concern" value of the same businesses, the proper goal of the valuation may well be the "going concern" value.

D. Optimal valuation method.

The goal of evaluating a nonprofit corporation converting to for-profit status is to measure the value in the company that is derived from the charitable assets the nonprofit corporation holds in trust. Under the current Blue Cross proposal, the public will retain its interest in the charitable assets. The proposal would transfer all the WellPoint stock Blue Cross holds to a nonprofit health care foundation. There does not appear to be any indication that Blue Cross board members will personally benefit from the transaction, or that the public will cease benefitting from the charitable assets. For this reason, it appears that the "going concern" value of the Blue Cross stock is an appropriate measure for a CAS. This is particularly true since Blue Cross is not endowing the new foundation with cash, but with all the stock it holds in WellPoint. As long as Blue Cross transfers its entire interest in the WellPoint businesses, the new charitable foundation will benefit to the greatest extent possible.

Regardless, the best way to valuate the WellPoint stock, including that stock sold in the public offering, is to use the four valuation methods discussed in this paper and examine the results to see which appears most appropriate for the transaction in question. The "asset valuation" model is probably not sufficient for valuing the Blue Cross stock because the tangible assets of WellPoint probably do not begin to approximate its worth. The discounted cash flow method is probably very useful as long as the historical earnings can be established and the future earnings will stabilize within the time frame established by the estimator. The "capitalized historic earnings method" is probably the most useful single measure for valuating the Blue Cross stock. Since some of the very same stock Blue Cross holds is publicly traded, an estimator can obtain a very clear sense of how the capital markets value the WellPoint businesses as "going concerns." An estimator may want to use that measure along with the other measures, including the acquisition analysis, if any comparable sales are available.

Given the inherent problems with trying to valuate nonprofit corporations, a final issue in conversions is whether the Commissioner of Corporations should retain control over the conversion that would permit the Commissioner to adjust the CAS after a period of years in the event the original CAS proves substantially inadequate. The Legislature has considered whether there should be a mechanism which enables the Commissioner to demand more assets if the new for-profit corporation begins earning huge profits. [No. 80]

If the Commissioner demands a CAS from a converting corporation, and the new for-profit corporation makes huge profits in its first year, the assumption is that the valuation was too low. In theory, the Commissioner could continue to monitor the corporation and after one or two years, demand an additional CAS from the hugely profitable corporation. The argument against such an adjustment mechanism is twofold: (1) conditions change and trying to update an evaluation is a worthless exercise; and (2) an adjustment mechanism may have to rebate part of the CAS if the for-profit corporation loses money in its first years of for-profit operation. [No. 81] In the Blue Cross case, the Commissioner could demand that WellPoint convey to the foundation some portion of the assets or cash gained from the public offering. This could be justified by the notion that the stock transferred from Blue Cross to the foundation does not represent all the charitable assets once held by Blue Cross.

V. CONCLUSION.

The Commissioner of Corporations has enforcement authority over Blue Cross because the company is a nonprofit public benefit health care service plan. The Commissioner's authority includes the power to enforce Blue Cross' charitable trust obligations, to enjoin a breach of the charitable trust, and to remedy a breach of the trust by demanding that Blue Cross make a CAS.

Blue Cross' most recent proposal to convey all its WellPoint stock to the California HealthCare Foundation is a charitable asset settlement that would ensure that assets originally held by Blue Cross remain dedicated to benefitting the public. The valuation issues discussed in this paper are important in this proposal because the Commissioner must determine whether any of the WellPoint stock sold in the public offering constituted charitable assets once held by Blue Cross. If that stock can be attributed to charitable assets Blue Cross was supposed to hold in trust, the Commissioner would be empowered to demand that WellPoint convey stock, assets, or cash to the new foundation to make the CAS adequate.

NOTES

[No. 1] Louise Kertesz, California Law To Check Non-Profit Loophole, Business Insurance, June 14, 1993, at 14.

[No. 2] Id.

[No. 3] Calif. Blue Cross to Make Payback for Conversion, National Underwriter, Life & Health/Financial Services Edition, September 6, 1993, at 37. The Blue Cross proposal would have paid $5 million per year for 20 years to various California charities.

The California Legislature had pressured Blue Cross to make a charitable settlement. A bill sponsored by Assemblyman Phil Isenberg, D-Sacramento, had passed the Assembly and would have required Blue Cross to make charitable payments in the amount of tax free benefits they had received over the years. Assembly Bill 1784, available on WESTLAW, CA-BILLS library, 1993 A.B. 1784.

[No. 4] Id.

[No. 5] At the time of Blue Cross' agreement to pay $100 million over 20 years, estimates by members of the legislature and the public suggested the Blue Cross' actual obligation was at least $400 million to $500 million. Calif. Blue Cross to Make Payback for Conversion, National Underwriter, Life & Health/Financial Services Edition, Sept. 6, 1993, at 37.

[No. 6] Sabin Russell, A Drive to Make Blue Cross pay $2.5 Billion to Charity, S.F. Chron, Sept. 13, 1994, at A15.

[No. 7] When Health Net, a nonprofit health care service plan, converted to for-profit status in 1992, it donated $300 million and 80 percent of its stock to the California Wellness Foundation, a new charity that focuses on violence prevention. Id. The donation was made under heavy pressure from state regulators and consumer groups. Id.

[No. 8] Id.

[No. 9] Louise Kertesz, California Law to Check Non-Profit Loophole, Business Insurance, June 14, 1993, at 14.

[No. 10] BNA Health Care Daily, Jan. 3, 1995. The Articles of Incorporation for California Healthcare Foundation indicate it was formed on September 12, 1994 as a public benefit corporation in the care of Marron, Reid & Sheehy, attorneys for Blue Cross of California. Abstract of Articles of Incorporation available on WESTLAW (PH-CACORP 01912464). According to the Foundation's articles of incorporation, its nonprofit purposes entail promoting, "the availability of and access to quality and affordable health care and related services to the people of the state of California." Jennifer Thelen, Charity of Advocacy for HMOs? The Recorder, Sept. 30, 1994, at 1.

[No. 11] Id.

[No. 12] BNA Health Care Daily, Jan. 3, 1995. Critics of Blue Cross' most recent plan raise two concerns. First, Blue Cross' plan to transfer its current board of directors to the new foundation would "undermine its ability to act independently of [Blue Cross'] interests." Second, allowing the new foundation to organize under Internal Revenue Service Section 501(c)(4) would not provide adequate operational safeguards to insure the public's interest is represented by the foundation. The critics argue that the foundation should operate under section 501(c)(3) which provides much greater restrictions than does section 501(c)(4) on conduct and activities of nonprofit foundations.

These two concerns are outside the scope of this paper since they deal with the conflict that attaches to interlocking directorates and the tax structure of charitable foundations. For a more complete discussion of these issues, see BNA Health Care Daily, Jan. 3, 1995 (available on NEXIS, CURNWS library); and Jennifer Thelen, Charity or Advocacy for HMOs? While Blue Cross Has Agreed to Contribute its Assets to Public Purposes, its New Foundation Could Also Play a Lobbying Role, The Recorder, Sept. 30, 1994, at 1.

[No. 13] There is no statutory law or judge-made law specifically confirming that Blue Cross' current proposal is subject to laws regarding nonprofit conversions. The legal maneuvering and lobbying that has characterized Blue Cross' plans since January 1993 indicates that law in this area is, at best, unsettled. This paper evaluates the various laws and regulations as they have been applied to the Blue Cross plans. There is considerable dispute as to what laws, if any, directly govern the situation. The purpose of this paper is to survey the applicable laws and regulations that can govern this plan, and discuss how they have been applied to the current situation.

[No. 14] In 1980, the Legislature amended the Corporations Code to confer enforcement authority over nonprofit health care service plans to the Commissioner of Corporations. All other nonprofit corporations are governed by the Attorney General. "Notwithstanding any other provision of this division, as to a health care service plan which is formed under or subject to [this section] , all references to the Attorney General . . . shall, in the case of health care service plans, be deemed to refer to the Commissioner of Corporations." Cal. Corp. Code 10821 (West 1991)

[No. 15] Howard L. Oleck, Nonprofit Corporations, Organizations, and Associations 763 (Fourth Edition, Prentice-Hall, Inc.) (1980).

[No. 16] Second Article, Blue Cross of California Articles of Incorporation; filed with March Fong Eu, Secretary of State, June 8, 1992. The Second Article reads, "This corporation is a nonprofit public benefit corporation and is not organized for the private gain of any person. It is organized under the Nonprofit Public Benefit Corporation Law for public purposes."

[No. 17] Ninth Article, Blue Cross Articles of Incorporation. "The property of this corporation, a nonprofit hospital service corporation, is hereby irrevocably dedicated to public purposes; upon the abandonment, liquidation or dissolution of this corporation, its net assets shall be distributed by the Board of Directors for such public purposes as a majority of the members of the Board of Directors may determine. In no event may the net assets be distributed so as to inure directly or indirectly to the benefit of any private individual, organization, corporation, trust or to any officer, member or Director thereof."

[No. 18] Cal. Corp. Code sections 5140-6710 (Deering 1994).

[No. 19] Cal. Corp. Code sec. 5111 (Deering, 1994).

[No. 20] Cal. Corp. Code sec. 5110 (Deering 1994), Comments based on Legislative Committee summary.

[No. 21] "By complying with the provisions of this [public benefit corporations] chapter, a corporation may amend its articles from time to time, in any and as many respects as may be desired, so long as its articles as amended contain only such provisions as it would be lawful to insert in original articles filed at the time of the filing of the amendment . . . " Cal. Corp. Code sec. 5810. (West 1994).

[No. 22] Cal. Corp Code sec. 5911(a) (West 1994).

[No. 23] Cal. Corp. Code sec. 5911(c) (West 1994).

[No. 24+] Id.

[No. 25] Cal. Corp. Code sec. 5913 (West 1994)

[No. 26] Cal. Corp. Code sec. 6010(a) (West 1994).

[No. 27] Cal. Corp. Code sec. 6010(b) (West 1994).

[No. 28] Cal. Corp. Code sec. 6010(a) (West 1994).

[No. 29] "[T] he ability to convert from nonprofit to for-profit status for a fair charitable settlement should be preserved." Franklin Tom, Commissioner of Corporations, Conversion Hearings, at 10.

[No. 30] "Amendment of the articles of a corporation, pursuant to this chapter, does not, of itself, abrogate any requirement or limitation imposed upon the corporation, or any property held by it, by virtue of the trust under which such property is held by the corporation." Cal. Corp Code sec. 5820(a) (West 1994).

[No. 31] For example, the merger provisions explicitly state that a change in corporate form does not extinguish the charitable obligations. "Upon merger pursuant to this chapter the separate existence of the disappearing corporations ceases and the surviving corporation shall succeed, without other transfer, to all the rights and property of each of the disappearing corporations and shall be subject to all the debts and liabilities of each and trust obligations upon the property of such a disappearing corporation in the same manner as if the surviving corporation had itself incurred them." Cal. Corp. Code sec. 6020(a) (West 1994).

Any suit against a nonprofit corporation that disappears because of merger or conveyance, can be prosecuted to judgment against the company that received the charitable assets. Cal. Corp. Code sec. 6020(c) (West 1994).

[No. 31] Cal. Govt. Code sec. 12580 et seq. (West 1994). See also, Van de Kamp v. Gumbiner, (1990) 221 Cal. App. 3d 1260, 1278, 270 Cal. Rptr. 907, 917 (detailing the regulatory history of health care service plans).

[No. 33] Cal. Health & Saf. Code secs. 1340-1399.63 (West 1994).

[No. 34] Cal. Corp. Code secs. 10810 - 10840 (West 1994).
[No. 35] Cal. Corp. Code secs 10810 - 10840 (West 1994).
[No. 36] Cal. Corp. Code sec. 10810 (West 1994).
[No. 37] Health care service plans are defined as, "any person who undertakes to arrange for the provision of health care services to subscribers or enrollees, or to pay for or to reimburse any part of the cost for such services, in return for a prepaid or periodic charge paid by or on behalf of such subscribers or enrollees." Cal. Health & Saf. Code sec. 1345 subd. (f) (West 1994).
[No. 38] Cal. Health & Saf. Code sec. 1341 (West 1994) ("Responsibility for the administration and enforcement of this chapter is vested in the Commissioner of Corporations).
[No. 39] Cal. Corp. Code sec. 10821 (West 1994). The California Court of Appeals has explicitly stated that this Corporation Code provision places all statutory and common law power, previously held by the Attorney General, with the Commissioner of Corporations. "Express provisions of the Nonprofit Public Benefit Corporation Law now grant the Department [of Corporations] sole authority to enjoin or otherwise remedy breaches of charitable trust, to approve self-dealing transactions, and to remedy unauthorized self-dealing." Van de Kamp v. Gumbiner, 221 Cal. App. 3d 1260, 1284 (1990).
[No. 40] Cal. Corp Code sec. 5820(b) (West 1994).
[No. 41] Cal. Corp. Code 5813.5. (West 1994).
[No. 42] Corporations Commissioner Gary Mendoza has stated publicly that although he initially approved Blue Cross' plan to transfer its business to WellPoint, he now demands that Blue Cross donate the net value of WellPoint "to charitable purposes under a state law that applies to 'public benefit' companies that switch to for-profit purposes." Jennifer Thelen, Charity of Advocacy for HMOs? The Recorder, Sept. 30, 1994, at p.1.
[No. 43] Ariz. Rev. Stat. Ann. secs. 10-1003(1-2); 10-2302(1-2) (1994). It is unclear whether the first provision of the Arizona statute could be read to prohibit the sale of assets by a nonprofit corporation.
[No. 44] N.J. Stat. secs. 17:48-2; 17:48A-2 (1993).
[No. 45] N.M. Stat. Ann. sec 59A-47-4(D) (Michie 1994).
[No. 46] N.Y. Ins. Law sec 4301(j) (Consol. 1994).
[No. 47] Ala. Code sec 10-3A-100 et seq (1994); Ark. Code sec. 4-28-301 et seq. (Michie 1994); Ga. Code Ann. sec. 14-3-170 et seq. (Michie 1994); Ky. Rev. Stat Ann. sec 273.277 et seq (Baldwin 1994); Miss. Code Ann. sec. 79-11-319 et seq. (1994); Mo. Rev. Stat. sec. 355.195 et seq. (1994); N.C. Gen. Stat. sec. 55A-38 et seq. (1994); 15 Pa.C.S. 5961, formerly 7951 (1988); Tenn. Code Ann. sec. 48-61-101 (1994); Va. Code Ann. sec. 13.1-894 et seq. (Michie 1994).
[No. 48] Ga. Code Ann. sec. 14-3-1041(a)(1-2) (Michie 1994).
[No. 49] Id. (comments).
[No. 50] Tenn. Code Ann. sec. 48-61-101 (1994).
[No. 51] Md. Ins. Code Ann. sec. 356AA (1994).
[No. 52] Id. sec. 356AA(b)(1-3).
[No. 53] Revised Model Business Corporation Act, adopted by the Committee on Corporation Laws of the Section of Corporation, Banking and Business Law of the ABA (American Bar Foundation, 1985).
[No. 54] Theodore C. Falk, Converting From a Nonprofit To A Business Corporation, 23 U.S.F. L. Rev. 443, 446 (1989).
[No. 55] Revised Model Non-Profit Corporation Act, adopted by the Subcommittee on the Model Non-Profit Corporation Law of the Business Law Section of the ABA, Michael C. Hone, Reporter.
[No. 56] Falk, Converting From a Nonprofit To A Business Corporation, at 446 (citing, RMNCA secs. 11.01 and 11.02 (1987).
[No. 57] Research revealed only one state expressly provided a valuation method for nonprofit conversions. The Georgia codes governing nonprofit corporations and amendments thereto offer a method of valuing nonprofit corporations planning an amendment to for-profit status. Any nonprofit converting to for-profit status must donate assets to the persons who would have received the assets had it dissolved--that is, the intended charitable recipients. These assets must have a value, "equal to the greater of the fair market value of the net tangible and intangible assets (including good will) of the corporation, or the fair market value of the corporation if it were to be operated as a business concern . . . "

This example essentially requires the converting corporation to estimate the higher of: (1) the liquidation value (plus good will); and (2) the discounted cash value, discussed later in this section.
[No. 58] Transcript, Interim Hearing: Review of Departments of Corporations, Insurance and Justice responsibilities in conversion of public benefit corporations from nonprofit to for-profit status: Case Study - FHP, Inc. and Foundation Health Plan conversions and involvement of additional health plans, California Legislature, Assembly Committee on Finance and Insurance, Interim Hearing; Alister McAlister, Chairman, December 4, 1985, (hereinafter Conversion

Hearings), at 235 (reprint from Management Focus, November-December 1981). For a comprehensive view of the specifics of corporate valuation, see V. Brudney and W. Bratton, Brudney & Chirelstein's Cases & Materials on Corporate Finance, p. 32-102 (4th ed. Foundation Press, 1993).
[No. 59] Id. at 236.
[No. 60] Conversion Hearings, p.123 (statement of Jim Schultz of Consumer's Union). "The risk of creating health care maintenance organizations was assumed . . . by the people of the State of California and other states, by providing start-up capital in the form of federal grants. The people of the State of California assumed the financial risk to their tax dollars of starting health maintenance organizations, and therefore, we believe that they are entitled to the full assets of those health maintenance organizations at the time of conversion."
[No. 61] Conversion Hearings.
[No. 62] FHP announced its intention to convert to for-profit status in September 1985. FHP provided the Commissioner of Corporations with two estimates of its net assets. Initially, FHP estimated its net assets at $13.5 million, and later revised that estimate to $21.5 million. Conversion Hearings, p. 71. The Department of Corporations was unsatisfied with these estimates, and demanded a third estimate. The third valuation was performed by a large public accounting firm, Ernst & Whinney. Ernst & Whinney used three of the accepted methods of business valuation: adjusted book value; capitalized historical earnings; and discounted future cash flow. They also examined the benefits, such as tax breaks, that FHP accrued while operating as a nonprofit corporation. The highest valuation using these three methods was $38 million, and the Department of Corporations demanded that amount as a CAS. Conversion Hearings, p. 71-72.
[No. 63] Conversion Hearings, p. 236 (reprint from Management Focus November-December 1981).
[No. 64] Tom Kelley, a partner at Peat, Marwick, Mitchell & Company, who specializes in valuating health care business, indicated that "a five-year pattern" is typically used in estimating future earnings growth. Conversion Hearings, p. 48. It is unclear why five years is standard, but it is generally accepted that the valuation must focus on a finite time frame. Because cash flow can fluctuate, and other uncertainties exists, adhering to a finite time frame is the only feasible means of completing an estimate. Conversion Hearings, p. 237.
[No. 65] Id. at 49.
[No. 66] Id.
[No. 67] Id. at 49 (stating that in the Health Maintenance Organization industry, growth projections estimate that companies will grow by 100% over the course of a five year period (either in enrollees or in revenues).
[No. 68] Id. at 49.
[No. 69] Mr. Thomas L. Kelly, Partner, Peat, Marwick, Mitchell & Company, Conversion Hearings, p. 46.
[No. 70] Id.
[No. 71] Id.
[No. 72] For example, assume that a publicly traded company, "Health Plan," had earnings in one year of $1 million. Health Plan had 100,000 shares of stock outstanding that were publicly traded. Thus, each share earned $10. The estimator would say that Health Plan had an "earnings per share" of $10.
[No. 73] For example, as of February 7, 1995, WellPoint stock was trading on the New York Stock Exchange for almost $28 per share. In the prior year, it had traded as high as $37 per share, and as low as $24 per share. Wall Street Journal, Feb. 7, 1995 at C6 (NYSE listings, traded under "WelpointHlth," symbol, "WLP").
[No. 74] Conversion Hearings, p. 237.

[No. 75] Id. at 237-38.
[No. 76] Franklin Tom, Commissioner of Corporation, Conversion Hearings, p. 14-16, 31-32.
[No. 77] The valuation techniques used by the Commissioner are: (1) discounted future cash flow; (2) asset appraisal (adjusted book value method); and (3) capitalized historic earnings method. Conversion Hearings, at 14.
[No. 78] IRS regulation Section 20.2131 1-B.
[No. 79] Conversion Hearings, p. 74 (quoting an unidentified Superior Court judge's order).
[No. 80] Conversion Hearings, p. 25. Research into the conversion provisions of other states did not reveal any statutes expressly authorizing, or detailing a mechanism for, continuing supervision by the supervising authority.
[No. 81] Johnson, Conversion Hearing, p. 26