

December 13, 1999

Ms. Connie L. O'Connell  
Insurance Commissioner  
121 East Wilson Street  
P.O. Box 7873  
Madison, WI 53707-7873

**VIA HAND DELIVERY**

RE: Blue Cross & Blue Shield United of Wisconsin Conversion Application  
Case No. 99-C26038

Dear Commissioner O'Connell:

During the Public Hearing phase of the case on November 29 and 30, 1999, the testimony of individuals representing ABC for Health, Wisconsin Advocacy Coalition and Consumer's Union focused on Blue Cross & Blue Shield United of Wisconsin's (Blue Cross) creation of the holding company United Wisconsin Services (UWSI) in 1983 and some of the restructuring that occurred thereafter. There were many statements made during this portion of the hearing which were factually incorrect, or inaccurately implied that UWSI has benefited financially at the expense of Blue Cross. There were also statements made that the assets of Blue Cross comprise a charitable trust.

This letter responds to some of the material misstatements. The italicized statements are an amalgamation of statements made by representatives of these groups at the two days of hearings, which Blue Cross believes are misleading and inaccurate. Blue Cross offers the following statements in rebuttal. Blue Cross requests that this information be made part of the formal record.

**Historical and Current Relationship Between Blue Cross and UWSI**

- 1. Blue Cross engaged in a de facto conversion to for profit status in 1983 and gave certain subsidiary corporations, including Compicare and Dentacare, to UWSI at a time when it owned less than 100% of UWSI; thus, Blue Cross did not receive commensurate value for the*

*transfer of assets. Blue Cross shifted non-profit assets into for-profit subsidiaries and then sold them to the public without compensation back to Blue Cross.*

At the outset, as your office is well aware, the formation of UWSI and the transfer of certain Blue Cross subsidiaries into that holding company was done only after the appropriate filings were made with the Wisconsin Office of the Commissioner of Insurance (OCI). Wisconsin Statute Sec. 617.21(1)(a) prohibits a transaction between an insurer and its affiliates unless the transaction is reasonable and fair to the interests of the insurer. OCI did not disapprove any of these transactions.

Each transferred company was a for-profit and tax paying company from the date of its incorporation. At the time of the transfer of each of the aforementioned companies, Blue Cross owned 100% of UWSI. Documentation of all Blue Cross asset transfers to UWSI are part of Blue Cross annual statements which are public records on file with OCI.

The purpose behind the creation of UWSI was to establish a vehicle to allow Blue Cross access to capital, and to allow it to enter new markets which it could otherwise not enter due to BlueCross BlueShield Association license restrictions; in other words, UWSI's creation was intended to benefit Blue Cross. It has served that purpose. From 1983 through the time UWSI went public in 1991, Blue Cross made capital contributions to UWSI including the transfers of companies and reinvested dividends in an aggregate amount of \$22,015,829. Since 1991, as a result of selling its interest in UWSI or contributing shares of UWSI to its charitable foundation, Blue Cross has received consideration in an aggregate amount of \$78,802,865; more than a three fold return.

*2. Blue Cross has given its stock dividends in UWSI back to UWSI without adequate compensation.*

From 1991 through March 31, 1995 Blue Cross reinvested its cash dividends in UWSI. This reinvestment was agreed to by Blue Cross in conjunction with the underwriting agreement for the initial public offering of UWSI. During the majority of this period, through July 1, 1994, Blue Cross owned over eighty percent (80%) of UWSI. The time period for the dividend reinvestment was originally established to coincide with the period during which Blue Cross would receive benefit from participation with UWSI in a tax allocation agreement under which UWSI compensated Blue Cross for the use of its net operating losses. This intercompany agreement was filed with OCI in 1988, as were all subsequent amendments to that agreement. This agreement was never disapproved by OCI.

Under this agreement Blue Cross received value for tax losses that would likely have expired unused had Blue Cross not filed a consolidated federal income tax return with UWSI. The tax benefit to Blue Cross as a result of this tax allocation agreement was

\$17,650,159. The tax benefit far exceeds the portion of the dividend reinvestment which did not inure to Blue Cross' ownership in UWSI.

*3. Blue Cross improperly pays millions to UWSI for services.*

Intercompany Service Agreements duly filed with and reported to OCI document that Blue Cross purchases certain services from UWSI. However, the reverse is also true; UWSI likewise purchases substantial services from Blue Cross. These agreements are on a cost basis or at a market price for service sold to third parties.

*4. Blue Cross sells UWSI products without adequate compensation.*

The in-house and independent agency sales force does sell Blue Cross as well as UWS products. However, rather than being a detriment to Blue Cross, this arrangement helps Blue Cross and UWS by spreading the costs of the distribution system over all of the companies involved, thus reducing overhead.

*5. The President, Chief Executive Officer and Chairman of the Board of Blue Cross and UWSI somehow is compensated twice for his dual responsibilities.*

Through an intercompany service agreement between UWSI and Blue Cross, (also filed with OCI) Blue Cross is charged its share of the services Mr. Hefty performs on behalf of Blue Cross. He does not receive separate and additional compensation from Blue Cross or from any other subsidiary of the holding company.

**Plan of Conversion**

*6. Blue Cross can buy back the stock of the new holding company at less than fair market value.*

Pursuant to the terms of the Registration Rights Agreement filed as part of Blue Cross' application for conversion, if the Foundation exercises its registration rights, Blue Cross at its option may purchase shares at a value equal to ninety-seven percent (97%) of the market value calculated over a recent period. The three percent (3%) discount Blue Cross would receive is intended as a proxy for the fees and costs the Foundation would have to pay to a broker to sell its shares on the open market. The discount Blue Cross would receive equates to approximately half of the costs the Foundation would typically have to pay if an underwritten sale of its shares were to proceed.

**Nature of Blue Cross Assets**

*7. Blue Cross is a charitable trust holding all of its assets in trust for the public.*

Statements were made that Blue Cross is a charitable trust based upon three different theories; 1) the statutory language of former Wis. Stat. Sec. 613.81; 2) Blue Cross' previous tax exempt status; and 3) Blue Cross' nonprofit status. Although Blue Cross has proposed to contribute the entire equity value of the company to a Foundation, under the law Blue Cross in and of itself is not a "charitable trust."

Blue Cross is organized as a not for profit company. However, unlike most not for profit companies, Blue Cross is subject to state and federal taxation, including state property taxes. Blue Cross lost its state tax exempt status in 1972 and became subject to federal taxation and state property taxation in 1987. Since losing its tax exemptions, Blue Cross has paid over \$72 million in taxes. The fact that at one time Blue Cross was tax exempt does not indicate a charitable purpose. Many non-charitable organizations can be tax-exempt. In fact, the Internal Revenue Code lists 27 different categories of tax exempt organizations, only one of those categories grants an exemption based upon an organization's charitable purpose.

In 1939 the Wisconsin Legislature adopted enabling legislation to provide for the organization of hospital service insurance corporations with the purpose of easing "the burden of payment for hospital services." Wis. Stat. Sec. 180.32 (1939). The enabling legislation also declared every hospital service insurance corporation to be a "charitable and benevolent" corporation because they were exempt from taxation. The Wisconsin Legislature did not "create" Blue Cross & Blue Shield United of Wisconsin, but merely passed legislation which allowed six Milwaukee hospitals to establish Blue Cross' predecessor, Associated Hospital Service, Inc.

Today there is no statute declaring service insurance corporations to be a charitable organization. The Legislature recognized that service insurance corporations are now taxable entities and therefore they do not by definition operate as charitable and benevolent institutions.

Furthermore, testimony at the November 30 hearing characterized the Supreme Court's holding in Associated Hospital Service, Inc. v. City of Milwaukee, 109 N.W.2d 271 (1961) as legally recognizing Associated Hospital Service (Blue Cross' predecessor) as a charitable institution. However, to the contrary, the Supreme Court did not find that Associated Hospital Service was a charitable and benevolent organization; rather it found that the legislature has the authority to grant tax exemptions to service insurance corporations and that an organization need not prove that it engages in charitable and benevolent activities to qualify for the exemption. *Id.* at 278.

The mere fact that Blue Cross is a nonprofit organization does not in itself render the organization a charity. Trade associations, athletic clubs and social clubs have no charitable mission and are nonprofit. Wis. Stat. Sec. 181.0120 defines a "nonprofit organization" as an organization which does not make distributions.

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If the Commissioner has any questions concerning these responses or any other parts of the hearing testimony, Blue Cross would be pleased to answer them.

Very truly yours,

Stephen E. Bablitch

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