

Who Benefits?

The Role of Executive Compensation in Health Care Conversions

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Bonuses, salary increases, and other financial incentives for top executives often play a not-so-subtle role in the corporate restructuring scheme when non-profit health insurers convert to for-profit. In some states, executive compensation packages have caused significant public outcry and created intense debate. In Maryland, for example, the Insurance Commissioner denied a Blue Cross Blue Shield application for conversion based largely on evidence that executive pay outs were the primary motivation behind the company's decision to convert.¹

In July of 2003, Blue Cross Blue Shield of North Carolina withdrew its plans to convert within days after a third-party consultant recommended that state regulators oversee and possibly modify the

increases in executive compensation tied to the deal.² Although the Board of Trustees cited the length and cost of the conversion process as its reasons for withdrawing the application, the unanimous vote to set aside

WHAT WENT WRONG IN MARYLAND?

Blue Cross Blue Shield of Maryland (BCBSMD) made its first attempt to convert to a for-profit entity in 1994. The state Insurance Commissioner rejected the proposal because of its failure to preserve the plan's charitable purpose. BCBSMD then lobbied for legislation that would allow it to convert, but its efforts were unsuccessful.

In 1997, BCBSMD merged with Group Hospitalization and Medical Services of Washington, D.C., and Maryland-based CareFirst became the holding company for both plans. In 2000, CareFirst affiliated with Blue Cross Blue Shield of Delaware, then, in 2002, it filed a second application to convert. The application included a proposed acquisition by California-based WellPoint Health Networks, the corporation that owns Blue Cross of California, Blue Shield of Missouri, and Blue Cross Blue Shield of Georgia. The application for conversion and acquisition required the approval of the Insurance Commissioners of Maryland, Delaware, and Washington, D.C.

In March of 2003, former Maryland Insurance Commissioner Steve Larsen denied CareFirst's application for conversion and acquisition. "We concluded that the evidence was absolutely overwhelming that the bonuses were at the center of the deal, and, as a result, that the deal was not in the public's interest," Commissioner Larsen stated.¹ In his report, Commissioner Larsen also cited the "substantial and credible evidence that the decisions to convert and be acquired were inappropriately influenced by the prospect of large pay outs for some individuals at CareFirst."² Commissioner Larsen also noted that "[t]he bonuses seem to have risen to a level of paramount importance to the Board, perhaps even being more important than whether or not the company itself would be sold."³

In June of this year, a federal judge approved a settlement requiring CareFirst to remain non-profit for the next five years. In July, Insurance Commissioner Alfred Redmer announced plans to file civil charges against CareFirst for allegedly violating laws governing non-profit insurers, and to levy \$500,000 in fines against the insurer, pointing to CareFirst's "flagrant attempts to profit from the proposed sale."⁴ Redmer also plans to levy personal fines totaling \$30,000 against three top officers at CareFirst.

In August, federal prosecutors launched an investigation into CareFirst's failed conversion plan. The specific federal violations alleged are still unknown.

1 Baltimore Business Journal, March 5, 2003.

2 Exhibit A: Report of the Maryland Insurance Administration, March 5, 2003, Regarding the Proposed Conversion of CareFirst, Inc. to For Profit Status and Acquisition by Wellpoint Health Networks, Inc. Attached to Order: MIA-2003-02-032, p. 137. Available at: <http://www.mdinsurance.state.md.us/documents/FinalMIARepor-CareFirst3-5-03.pdf>.

3 Ibid. at 142.

4 Baltimore Business Journal, July 9, 2003.

conversion plans was likely influenced by the possibility that executive compensation could be severely limited.

Here in Washington, Premera Blue Cross (PBC) has filed a conversion application that is currently being reviewed by Insurance Commissioner Mike Kreidler and his staff. The application includes a plan to issue stock options to executives if the conversion is approved. According to an article in the Seattle Times, Premera admits that the stock-ownership plan “lacks crucial details to calculate the value of any potential pay out to Premera insiders.”³ Premera’s plan also fails to provide guidelines for exercising or expiring the stock options.

What forms does executive compensation take?

Although Premera has publicly stated that there will be no “conversion-related bonuses” for its top executives, its current proposal does not preclude severance packages or other forms of compensation.⁴ Financial incentives can take many forms, including restricted stock awards, long term incentive pay outs (LTIPs), exercised and unexercised stock options, retirement plans, automobiles, travel allowances, and relocation expenses. And, because “bonuses” do not include any of the above-mentioned forms of compensation, salary increases, exercised stock options and the like can significantly boost overall cash compensation while still allowing Premera to keep its “no conversion bonuses” promise to the public.

Even if Premera does not award any “conversion-related bonuses” per se, the company’s annual bonus plan (offered to vice presidents and above) currently gives executives bonuses equal to 40% of their base salary if financial targets are met.⁵

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Under this scheme, if executive salaries increase upon conversion, so too will bonuses. For example, an executive with a salary of \$500,000 prior to the conversion would receive \$200,000 in annual bonuses if financial targets were met. If that executive’s salary was increased to \$1 million post-conversion, the bonus would double to \$400,000, and would be attributed solely to the salary increase, not the conversion itself. Premera has never promised that executives will not receive conversion-related raises.

In fact, salary increases began occurring at Premera several years prior to its announcement of plans to convert. In 1999, then-CEO Betty Woods received a raise and bonus that resulted in a 60% increase in her overall compensation to \$736,650.⁶ The chain of events leading up to Premera’s decision to convert demonstrates that Premera’s insistence at a 2000 state Senate committee hearing that it had “no intention of converting” may have been disingenuous.⁷

In a number of other conversions across the country, salary increases for top executives have been implemented prior to the filing of conversion applications. For example, in North Carolina, Blue Cross Blue Shield executives received up to a 239% increase in compensation between 1994 and 1996, five years before the com-

pany announced plans to convert.⁸

Maryland's CareFirst CEO William Jews made a base salary of \$1 million when the company filed its conversion application. He also received perks such as health, disability and life insurance, a leased car, and a country club membership.⁹

No coincidence: conversions and compensation go hand-in-hand

In 2001, one year before Premera announced its plans to convert, CEO Brereton "Gubby" Barlow received \$1.136

million in compensation.¹⁰ That same year, the CEO of Regence Blue Shield, which is the largest insurer in the state, made only \$421,861.¹¹ Had Premera been a publicly traded company in 2001, Barlow would have ranked number 13 on the list of the most highly paid executives in the state based on cash compensation.¹² In nearly every category, Premera executives were paid two to three times more than their counterparts at Group Health and Regence Blue Shield in 2001.¹³ The table on the following page illustrates this disparity.

LAYING THE GROUNDWORK: PREMERA'S TIMELINE

1997

Betty Woods, CEO of Blue Cross of Washington and Alaska (now Premera) takes a big pay cut, from \$742,111 in 1995 to \$481,914 in 1996. The cut is due in large part to public criticism.

1999

Betty Woods receives a raise and bonus that results in a 60% increase in her overall compensation. In 1999, she receives \$736,650.

2000

April: Premera is called before a Senate committee to discuss whether it plans to remain non-profit or convert to a publicly traded company. Premera indicates it has "no intention of converting."
July: Barlow steps up to become Premera's new CEO. Prior to joining Premera in 1997, he served as both CFO and senior vice president of AHI Healthcare Systems Inc. Prior to that, he served as the CFO of HealthNet and participated in the Blue Cross conversion in California.

2001

Barlow is compensated over \$1.136 million, up from \$1.074 million in 2000. In almost every category, Premera executives are paid between two and three times more than executives at Regence and Group Health.

2002

Premera announces its plan to convert to for-profit status. In October, Premera issues its first stock option plan for executives and employees. Barlow publicly pledges, however, that there will be no "conversion-related bonuses" at Premera.

POSITION	PREMERA SALARY	REGENCE SALARY	GROUP HEALTH SALARY
CORPORATE COUNSEL	\$731,000	\$166,000	\$264,000
MEDICAL DIRECTOR	\$447,000	\$241,000	N/A
CHIEF ACTUARY	\$694,500	\$184,000	N/A
VICE PRESIDENT, SALES & MARKETING	\$556,000	\$209,000	\$271,000

Across the board, compensation peaks when conversions or acquisitions occur. When Anthem Inc. converted to a for-profit entity in 2001, for example, CEO and President Larry Glasscock received over \$15.7 million in total compensation, up from a mere \$2.5 million in 2000. In 2002, he held steady at just over \$15.8 million.¹⁴

Similarly, when BCBS of Georgia converted to for-profit Cerulean in 1996, CEO, President, and Director Richard Shirk more than doubled his compensation to \$1.1 million, up from \$484,000 the year before.¹⁵

And, when BCBS of Wisconsin converted and changed its name to Cobalt in 2001, SVP and General Counsel Stephen Bablitch received over \$3.5 million the following year, up from \$437,000 in 2001. Chairman, President, and CEO Thomas Hefty received a hefty raise from \$919,044 in 2001 to over \$2.7 million in 2002.¹⁶

The bottom line is that executives at for-profit health insurance companies make considerably more than their nonprofit counterparts.

How does executive compensation look at for-profit insurers?

The bottom line is that executives at for-profit health insurance companies make considerably more than their non-profit counterparts. In June 2003,

WHO'S WHO?

TRACING CONVERSIONS AND ACQUISITIONS OF NON-PROFIT BLUES

Cerulean (formerly BCBS of Georgia) converted to a for-profit entity in 1996, and was subsequently acquired by WellPoint in 2001.

WellPoint is the for-profit successor of Blue Cross of California. In addition to acquiring Cerulean, WellPoint also purchased BCBS of Missouri in 2001.

Cobalt, Inc. is the for-profit corporation formerly known as BCBS of Wisconsin.

Anthem, Inc. owns former Blues plans in Indiana, Colorado, Maine, New Hampshire, Ohio, Kentucky, Nevada and Connecticut. Additionally, Anthem purchased Trigon, the for-profit successor of BCBS of Virginia, in 2002.

Overall, the value of unexercised stock options held by the highest paid executive of each company totaled \$744,777,145.

Families USA released a report on executive compensation among 11 for-profit, publicly traded insurers. The companies featured in the report were: Aetna Inc.; Anthem, Inc.; CIGNA Corporation; Coventry Health Care, Inc.; Health Net, Inc.; Humana Inc.; Oxford Health Plans, Inc.; PacifiCare Health Systems, Inc.; Sierra Health Services, Inc.; UnitedHealth Group Incorporated; and WellPoint Health Networks.

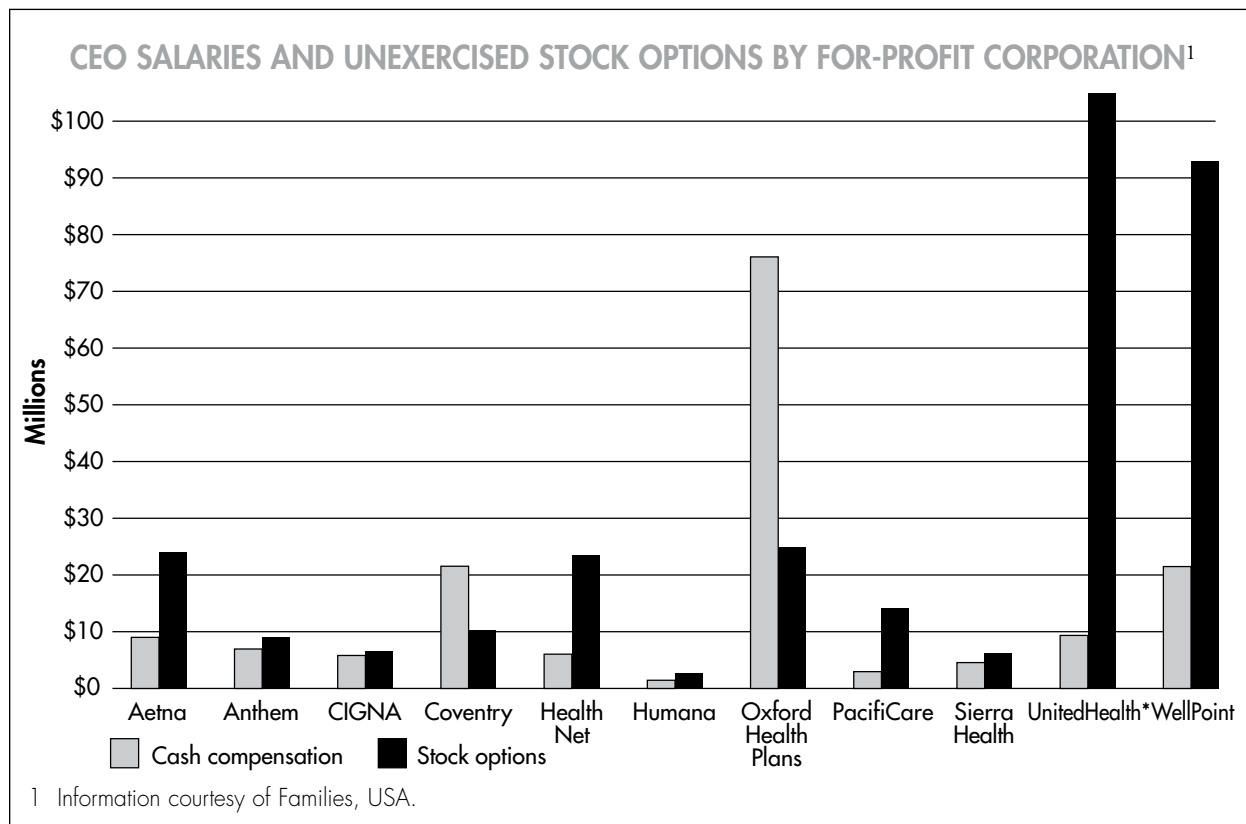
The study showed that in 2001 the average compensation awarded to each company's highest paid executive (excluding unexercised stock options) was \$15.1

million. Together, the companies paid a total of \$166 million to their most highly compensated executives.

Each company's highest paid executive also had an average of \$67.7 million in unexercised stock options. Overall, the value of unexercised stock options held by the highest paid executive of each company totaled \$744,777,145. The chart below illustrates how compensation was distributed among the highest paid executives at these 11 publicly traded health insurers.¹⁷

Why should the public be concerned about executive compensation?

Although Premera claims that a conversion will allow it to build capital "to increase insurance reserves in line with rising medical-care costs, to invest in better technology and services for members and



health-care providers, and to fund growth,”¹⁸ experience in other states demonstrates that conversions do not always yield such “positive” results.

Premera admits that converting to a stock corporation is not a necessity, citing its steady financial performance in recent years.¹⁹ The question, then, is whether Premera’s interest in converting would wane if the Insurance Commissioner imposed conditions on the transaction that limited salaries, bonuses, stock options, and other forms of executive compensa-

tion. Before the public can make an informed decision about whether or not to support the conversion, Premera must first provide answers to the many questions that remain about stock options, severance packages, and pay increases for top executives.

It is crucial that Premera prove to both its policy-holders and the public at large that the real reason behind its decision to convert is *improving the quality of health-care* — not just improving the quality of life for the company’s top executives.

CASE STUDY #1: WELLPOINT HEALTH NETWORKS

Blue Cross of California (BCC) transferred a majority of its assets to a for-profit subsidiary in 1993. In 1994, Wellpoint CEO Leonard Schaeffer was making approximately \$1.2 million in annual compensation.¹

In May, 2003, Wellpoint granted Schaeffer an 18.5% increase in compensation, for a total of \$19.26 million in salary, bonuses and option grants. This represents a 1,505% increase in compensation for Schaeffer since 1994.

Schaeffer holds approximately \$66 million in unexercised exercisable options, and \$15.1 million in unexercisable options, according to SEC filings. Wellpoint’s Executive Vice President David Colby holds \$20.1 million in unexercised exercisable options.

1 Crabtree, Penni. “State Study Hits Waste by HMOs,” San Diego Business Journal, 4/18/94, p.1. According to a report in Fortune, Schaeffer saw “his compensation swell from \$922,000 in 1991 to \$1,383,000 in 1993,” the year that Blue Cross of California spun off most of its business into the for-profit Wellpoint HMO. Loomis, Carol J. “The Real Action in Health Care,” Fortune, 7/1/94, p. 149.

CASE STUDY #2: ANTHEM INC.

According to SEC Filings, Anthem Insurance Companies’ CEO/President Larry Glasscock was paid \$15.9 million in total compensation for 2002. In 1998, Glasscock left the Blue Cross Blue Shield of the National Capital Area, a nonprofit Blues plan in Washington DC, with two years of salary and bonuses in a severance package valued at \$2.8 million. Therefore, it appears that Glasscock’s compensation at the for-profit Anthem in 2002 is 1,035% higher than he was paid at his previous nonprofit position in 1998.

Endnotes

- 1 Please see the insert, above, detailing the events that led to the Maryland Insurance Commissioner's decision to reject the conversion application of CareFirst, a nonprofit health care insurer.
- 2 The O'Connor Report, Volume 3, Number 8, July 2003.
- 3 Kyung M. Song, "Premera Filing Envisions Stock-Option Plan." The Seattle Times, October 31, 2002.
- 4 Premera Form A Filing, available at: <http://www.insurance.wa.gov/special/premera/PremeraApplication.asp>.
- 5 The O'Connor Report, Volume 3, Number 8, July 2003.
- 6 The Seattle Times Staff and News Services, "Business Briefs." April 8, 2000.
- 7 Rebecca Cook, "Senate Questions Health Insurers: Nonprofit or Not?" The Seattle Times, April 5, 2000.
- 8 Triangle Business Journal, July 14, 1997; July 8, 2003.
- 9 Baltimore Business Journal, November 15, 2002.
- 10 Kathleen O'Connor, "Where Healthcare Dollars Go." The Seattle Times, July 11, 2002.
- 11 Ibid.
- 12 Ibid.
- 13 Ibid. See table above.
- 14 Consumers Union. Compensation in these calculations includes salary, bonus, other annual compensation, restricted stock awards, and LTIP pay outs.
- 15 Ibid.
- 16 Ibid.
- 17 Families USA, "Top Dollar: CEO Compensation in Medicare's Private Insurance Plans." June 2003.
- 18 Brereton "Gubby" Barlow, "Publicly Traded Premera Won't Shortchange Customers." The Seattle Times, May 12, 2003.