

VII. ORGANIZATIONAL ALTERNATIVES FOR A PRIVATIZED STATE FUND

A. ORGANIZATIONAL ALTERNATIVES IDENTIFIED

The privatization options for the guaranteed available market were discussed in Chapter VI, while Chapter VII discusses the organizational alternatives for the State Fund. These separate discussions are intended to distinguish between the alternative methods of serving the residual market, and the organizational options available to the Fund. Various combinations of the residual market options and the State Fund organizational models are possible; for example the State Fund could be spun off as a non-profit mutual insurance company with or without a role as the guaranteed available market.

The following alternatives can be identified for the State to divest itself of the State Fund. These suggested organizational alternatives involve converting the State Fund to a private entity or disposing of the State Fund. These alternatives all assume that the State has decided to reduce or give up its interest in the State Fund, and that the State Fund could be converted to a viable entity independent of state government.

1. SELL THE STATE FUND TO A PRIVATE INSURER

One alternative would be to sell the business of the State Fund to an interested buyer. The business could become a new, independent company or it could be merged with an existing insurance company. The buyer could be a California company, an out of state company, or a foreign company. The price the sale could command is unknown, and it is not part of this study.

Outcomes of a sale:

- The State Fund could operate as a subsidiary of another insurance company or the business of the Fund could be merged into an existing company.
- State would lose control of the State Fund as an instrument of public policy.
- May create the largest private insurance company in the market, which would be subject to the 20% limitation on market share in the California competitive rating law, or the State Fund could be sold in pieces.
- Would likely not service the residual market.
- Would not be a state agency.
- Issues regarding the status of state employees would be subject to negotiation with the buyer. Relatively few State Fund employees would be able to find alternative employment with the State.
- Would be a for profit entity operated for the benefit of its private ownership.
- Would pay federal income tax and pass that additional cost on to policyholders.

- Its operating philosophy with regard to lines of insurance, geographic territories, marketing, dividends, level of surplus, underwriting selection, loss control, and claim management would depend on the new owners.
- The disposition of an equity distribution of surplus is beyond the scope of this study.

2. CONVERT THE FUND TO A STOCK COMPANY

Another organizational alternative is to convert the State Fund to a stock insurance company. This alternative would be similar to item (1) above except that policyholders of the State Fund would receive a transferable interest in the State Fund presumably based on their past premium payments or contributions to surplus. Initially at least, there would be continuity in the management of the State Fund.

The characteristics of a stock company would be similar to those identified above with a few exceptions as follows:

- Creation of a new stock insurance company in California.
- Current and former policyholders may take an equity interest in the new entity.
- Operated through the board of directors elected by the stockholders.
- May pay stockholder dividends.
- State Fund employees could continue employment with the restructured entity. However, their status as state employees would end and they would be offered a new compensation and benefits package by the successor private corporation. Employee unions would retain the right to represent their members initially; but upon expiration of any in-force contracts, the legal framework for labor relations would transfer from the jurisdiction of the Public Employee Relations Board to the jurisdiction of the National Labor Relations Board (NLRB).
- The present operating structure of the State Fund would continue to the extent possible.

3. CONVERT THE FUND TO A PRIVATE MUTUAL INSURANCE COMPANY

Another possibility is the conversion of the State Fund to a mutual insurance company. A mutual insurance company is a corporation owned and operated by and for its policyholders. Policyholders participate in the management of the company through the election of the board of directors, and they share in the profits through dividend payments from the company.

Characteristics of a Mutual would be as follows:

- A new mutual insurance company would be created in California with all the rights and responsibilities of a mutual insurer.
- It would not be a state agency.
- Depending on the structure of the privatization, State Government would have no majority input in managing the company. For example if the State wants to give up any say in the management of the State Fund, the directors of the new entity could be elected by the policyholders. Alternatively, the state (through the Governor) could continue to appoint some or all of the directors of the private entity. An intermediate position would be to grandfather current directors, appointed by the Governor, but allow for election of future directors by the policyholders after the terms of the current Board of Directors expire.
- Current and perhaps former policyholders would become owners and would have a nontransferable interest in the new entity.
- Employees would be converted to the private sector.
- Employees might be unable to continue PERS membership (see subsequent discussion of continued PERS membership under "Stock Company" below).
- Initially wages, hours and working conditions would continue under existing employee representation contracts, but upon expiration of those contracts, jurisdiction would transfer to the NLRB.
- Similarly, the representation rights of employee organizations would continue under existing employee representation contracts, but upon expiration of those contracts, jurisdiction would transfer to the NLRB.
- Any changes in the wages, hours or working conditions of State Fund's employees arising from the transition would be subject to negotiation, the resolution of which could entail significant expense to the State.
- Dividends could be paid to policyholders.
- The company would continue to be self-supporting, regulated by the Insurance Department, file its own rates, pay premium taxes, be a member of the Guaranty Fund, and write non assessable policies.
- The present operating structure of the State Fund would continue.

The states of Hawaii, Kentucky, Louisiana, Maine, Minnesota, Missouri, New Mexico, and Rhode Island have all legislatively established mutual insurance companies. These states did not have a state fund prior to this establishment, and four of them serve as the assured market in their state.

4. CONVERT THE FUND TO A STATE AUTHORITY OR SIMILAR PUBLIC CORPORATION

Characteristics would be the same as for a private mutual insurance company except the State Fund could remain a state agency. The basic difference from the State Fund's current status is that the nominal change in type of entity could result in the conversion of public employees to private employees.

This model consists of crafting an entity which meets certain policy objectives. The new entity could be designated a state agency. The enabling legislation could provide that the State Fund's employees are private, non-governmental employees. All other features of this model would be the same as enumerated for a private, non-profit, mutual insurance company.

The Authority would be exempt from virtually all provisions that are applicable to state agencies generally; and subject to all provisions applicable to non-profit insurance companies generally. The State Fund is currently exempt from State procurement procedures, state budget requirements, fiscal requirements, government records rules, and open meeting rules. Under this option the State Fund would also become exempt from civil service requirements.

Characteristics of a Mutual Authority or similar public corporation would be as follows:

- The entity would operate as the assured market and would compete with private carriers for providing workers compensation insurance in California.
- It would be a not-for-profit entity.
- It would be exempt from state operating requirements in areas of civil service, procurement, budget, fiscal requirements, record retention, and open meeting rules.
- Dividends could be paid to policyholders.
- Employees would be in the private sector.
- Employees might be unable to continue PERS membership (see subsequent discussion of continued PERS membership under "Stock Company" below).
- Employee status for collective bargaining might be either public or private; but perhaps the Legislature's declaration that they were private employees might be accepted by the California Public Employee Relations Board (PERB) and the Federal NLRB.
- State government could continue to have a say in managing the company through an appointed Board of Directors, if it so desired.
- The present management and operations of the State Fund would continue.

Similar approaches have been used in the states of Colorado, Kentucky, Oregon, Utah, and Texas. Utah was a state fund prior to converting to a quasi public, not for profit corporation, which operates like a mutual insurance company. The Oregon State fund was converted to a public corporation that operates like a mutual insurer in 1979. The Colorado Compensation Insurance Authority replaced the Colorado State Fund in 1987. Kentucky Employers is a not for profit, independent, self-supporting, municipal corporation that functions like a mutual insurer. The Texas Insurance Fund is a governmental corporation created by the legislature.

5. ESTABLISH A PRIVATE, NON-PROFIT SUBSIDIARY OF THE STATE FUND

The subsidiary could act as a labor lessor to the State Fund. A freeze could be put on future hires to the State Fund (at least to the extent that new employees to the organization were not already state employees). All future hires from outside state service would be made into the private subsidiary and "leased" to the State Fund. This would have the advantage of preserving the employment conditions of current employees while providing that, over time, the work force of the State Fund would be transitioned out of state service. A variation which would further minimize the size of government would be to enhance the compensation or benefits of employees in the private subsidiary with the intention of encouraging the State Fund's civil service employees to voluntarily elect to move over to the private subsidiary.

6. STATUS QUO

While technically not a privatization option, one possible result of the feasibility study is a determination to maintain the status quo.

Employees of the State Fund remain state employees and continue to be represented by current employee organizations. Employees remain part of the State health and retirement systems. All salaries and benefits continue to be paid from State Fund revenues. (Almost all 6,100 current State Fund employees have tenure in state civil service with oversight provided by the State Personnel Board. Approximately 5,300 rank-and-file employees are represented by one of eight collective bargaining units which establish wages, hours and other terms and conditions of employment through good-faith negotiations as required by the Ralph C. Dills Act (formerly the State Employer-Employee Relations Act). All permanent employees are members of the California Public Employees Retirement System (CalPERS).)

B. CRITERIA FOR EVALUATING ORGANIZATIONAL ALTERNATIVES FOR A PRIVATIZED STATE FUND

1. IMPACT ON THE CALIFORNIA INSURANCE MARKET

A material change to the largest player in the market would have collateral impact on other suppliers in the market. Some privatization alternatives, such as selling the State Fund to another present competitor in the market, could reduce overall competition in the market; while others, such as converting it to a stock company and setting up a traditional residual market mechanism to guarantee insurance availability could shift the burden of any operating loss in the residual market to other private carriers.

2. IMPACT ON THE INTERESTS OF THE STATE FUND'S INDIVIDUAL POLICYHOLDERS

The State Fund currently insures approximately 240,000 employers. Some of these employers have chosen to be insured with the State Fund for over 20 years.

Years Insured with the State Fund	1995 Policy Year Policy Count
<1	28,982
1<2	27,879
2<3	27,809
3<4	21,570
4<5	20,371
6<10	76,760
11<15	24,819
16<20	17,180
20+	15,079

Thus over 50% of State Fund's clients have been insured with the Fund for more than 5 years, 22% have been insured for more than 10 years and 12% have been insured with the Fund for more than 15 years. These employers have contributed to the State Fund surplus, which would therefore provide economic strength to their employees in the event of a catastrophe, such as a major earthquake.

Individual insured employers have an economic interest in the outcome of privatization. Change of ownership and/or management could impact the ease of obtaining coverage, the price and terms of coverage, the philosophy of adjusting claims, and who receives the profits of the enterprise.

3. IMPACT ON THE INTERESTS OF STATE FUND'S INSURED GROUP ASSOCIATIONS

The State Fund insures in excess of 200 groups including Sunkist Growers (which has been continuously insured by the State Fund since 1921), the California Farm Bureau (which has been continuously insured with the State Fund since 1947), the California Restaurant Association, the Golden State Builders Exchange, and Western Regional Master Builders. These associations have indicated that they insure with the State Fund because its size enables it to support local underwriting, safety services and claim adjustment in 21 district offices throughout the state; because it offers low priced coverage to the small accounts in their groups; because the groups receive rebates of administrative fees and dividends to support their program and reduce the cost of insurance to their membership.

As with the individual policyholders, the State Fund's insured groups have an economic interest in the outcome of privatization. Change of ownership and/or management could impact philosophies on: underwriting, administrative fees, and dividends.

4. IMPACT ON THE INTERESTS OF THE STATE OF CALIFORNIA (AS A STATE FUND CLIENT)

The State Fund adjusts the workers compensation claims of state employees, disaster service workers, and In-Home Support Services (IHSS), Greater Avenues For Independence (GAIN), and Business Enterprise Program (BEP) workers. The State Fund is also the paying agent for the Department of Industrial Relations' Subsequent Injury Fund claims. The State Fund has approximately 750 employees in 11 locations throughout the state servicing these state claims. A change in ownership and/or management of the State Fund could result in changes in the willingness of the new management to continue these contracts or changes in pricing, quality or local availability of service for these programs.

5. IMPACT ON THE INTERESTS OF EMPLOYEES AND THEIR REPRESENTATIVES

State Fund has 6,100 employees who have contributed to the success of the enterprise, and whose interests need to be protected to the extent possible in any transition. These employees are also represented by eight employee organizations who have won the right to represent their membership on matters of wages, hours and working conditions; these organizations have a financial stake in the outcome of privatization; and, depending when implementation occurs, may have contractual rights which need to be recognized. The interests

of employees and employee organizations will be recognized in analyzing each of the alternatives.

Each of the alternatives would have an impact on management of the State Fund. Without the constraints of the civil service system, there would be increased flexibility to recruit specialized talent (e.g. actuarial, medical cost containment, marketing, legal and information technology) in private labor markets at salary levels which are more competitive with private industry. Civil Service salary levels are generally compressed at supervisory and management levels which forces promotion from within and denies the State Fund access to the available labor pool above entry level employees. Privatization will also allow the State Fund the flexibility to compensate employees through incentive, bonus and performance based compensation programs.

6. TRANSITIONAL COSTS (OR SAVINGS)

Each of the alternatives would involve additional costs (or savings) and these will be identified where possible.

C. ANALYSIS OF THE ORGANIZATIONAL ALTERNATIVES

1. SALE OF THE STATE FUND TO A PRIVATE INSURER

The impact of the sale of the Fund on stakeholder interests would be determined in the short term by the terms of the sale, which are subject to negotiation, and in the longer term by the intentions of the buyer. Therefore there is no certain way to anticipate the outcome of a sale beyond recognizing that the state would be effectively giving up its stake in the State Fund in an essentially irreversible decision.

The only precedent for the sale of a State Fund occurred in 1994 when the Accident Fund of Michigan was sold to Blue Cross/Blue Shield. That sale was facilitated by several unique factual circumstances. First, there has always been a traditional residual market mechanism in place in Michigan; and the Accident Fund of Michigan had no responsibility for the residual market beyond paying its pro rata share of any operating losses of the residual market. Second, the management of the Michigan State Fund fought for years to keep the Fund from being categorized as a state agency; in 1989 the Michigan Supreme Court, after several years of litigation, declared for the first time that the Fund was a state agency. Third, there was no constitutional language specific to the Accident Fund, nor was there statutory language expressly disclaiming state ownership of the assets of the Accident Fund as there is in California. [CA Insurance Code 1171 states "The State shall not be liable..."] Thus the sale in 1994 just returned the Fund to its prior status.

A. IMPACT ON THE CALIFORNIA INSURANCE MARKET.

The impact of the sale of the Fund on competition in the market would depend on the characteristics and actions of the buyer.

For example, a possible buyer of the Fund could be another California workers compensation carrier. Consolidation of two large carriers in the market could reduce the overall level of competition. However, the competitive rating law (Ins. Code section 11732) declares that the rates of a private insurer with 20% or more of the premium written by private insurers are subject to prior approval of the Insurance Commissioner. Such a restriction may discourage other California buyers from acquiring the Fund and increase the likelihood that the Fund would be purchased by a large health insurer or a national property/casualty carrier with limited current involvement in the California market. Even a carrier with no current exposure in the California market would immediately run into the 20% limitation as the State Fund's market share slightly exceeds 20%.

On the other hand, if the buyer were a new participant in the marketplace, the degree of competition might be enhanced.

The creation of a new residual market facility would also have an impact on the workers compensation market, as discussed previously.

Rate stability may also be jeopardized, especially for the smaller employers. The rates that would be charged by the stock company or by the new assigned risk plan may differ from those charged by the State Fund.

B. IMPACT ON THE INTERESTS OF STATE FUND'S INDIVIDUAL POLICYHOLDERS.

As mentioned previously, a large portion of the State Fund's policyholders are small employers or classes of employers which are not generally attractive to private insurers. If the State Fund were to be sold, it would presumably be managed for the beneficial interest of its new owners. Depending on the underwriting policy of the new owner, these employers may have to look for coverage with a new carrier, find coverage with a servicing carrier for the residual market, or be subject to price changes. Under new ownership there can be no long term guarantee of continuity in underwriting philosophy or price stability.

The selling of the State Fund would likely be accompanied with the establishment of a new residual market mechanism. The impact of a new mechanism on policyholders has been discussed previously.

State Fund's surplus has been built up from the flow of income from insurance and investment operations. In a sale the rights of policyholders to share in some or all of the proceeds would have to be determined. And since the surplus has been built up over the entire history of the State Fund, past policyholders might also assert some interest in any proceeds. Moreover, in the event of any sale of State Fund, some parties who are not necessarily policyholders of State Fund might argue that at least a portion of any proceeds from the sale should be dedicated to a public purpose, which might or might not be the provision of workers compensation insurance.

Once the rights of all interested parties are determined, it would be necessary to allocate the proceeds among them, and State law has no provisions for such an allocation. In this regard, State laws governing the demutualization of mutual insurance companies (i.e. the legal process of converting a mutual insurance company to a stock insurance company) might provide some guidance, but that body of law was not designed to accommodate the competing interests that could arise upon the sale of the State Fund.

Sale of the State Fund could also positively or negatively impact the security of current insured employers in the event of a major earthquake. Since the surplus

would be under the control of the new owners, it is possible that less surplus would be available to support events such as a natural catastrophe. On the other hand, acquisition of the State Fund by a large, national insurer could increase the surplus available to cover a catastrophe.

Policyholder dividends could continue to be paid by the new owner(s) and would be subject to their program for dividend distributions.

C. IMPACT ON THE INTERESTS OF STATE FUND'S INSURED GROUP ASSOCIATIONS

State Fund currently provides California employers with access to insurance through trade group associations such as the California Farm Bureau Federation, Golden State Builders Exchange, Western Regional Master Builders and the California Restaurant Association. Historically, representatives of these associations represented the interests of their members and all California employers through their participation on State Fund's Board of Directors. This connection could be diluted or lost as new ownership appoints Board members. At the same time, this represents a large segment of the Fund's business that the new entity would likely value.

Among the values of the State Fund to associations has been its network of local full service offices throughout the State (no other carrier in California has such an extensive network), its willingness and ability to insure and provide service to their numerous small employer members, its up-front administrative fee rebates, and group dividend calculations. Administrative fees are a portion of the group premium which is returned to the associations to cover their costs in supporting the group insurance marketing program.

In a sale, these arrangements would be subject to the policy decisions of the new owners.

D. IMPACT ON THE INTERESTS OF THE STATE OF CALIFORNIA (AS A CLIENT)

The State Fund has been serving the needs of the State by administering the State's workers compensation program for its employees, the IHHS program, the Disaster Relief program, etc. These services are provided to the State at cost, so the State Fund is neither making a profit nor sustaining a loss by providing these services. Periodically the State (or an agency of the State) decides to reevaluate the relationship in the interest in contracting with outside third parties for these services. These evaluations have always been one-sided in the sense that the State Fund has never requested to withdraw from the relationship. After a sale, presumably both the State and the new owner(s) would be actively evaluating the relationship and the State could be forced to replace the services

provided by the State Fund at a competitive market price. Presumably the willingness of new owners to continue the relationship would be contingent on the ability to make a profit.

E. IMPACT ON THE INTERESTS OF THE STATE FUND'S EMPLOYEES AND THEIR REPRESENTATIVES

Current State Fund employees who transition to the new entity would no longer be State employees; they would presumably serve as at-will employees of the privatized State Fund. Some measure of job security could be negotiated into the sale as was done in Michigan, e.g., all employees guaranteed continued employment for the first year following sale and 75% of employees guaranteed continued employment for an additional three years. Such an arrangement cannot be assured in the case of the State Fund, however.

Compensation and benefits would depend on the salary structure of the acquiring entity. Knowing in general terms the relationship between state salary ranges and private industry salary practices, we could expect that average salaries for non-supervisory employees would be substantially similar to current salary levels but would have a greater swing about the mean. Above average employees might benefit from the broader salary ranges typically used by private employers, although the loss in retirement and other benefits of being a State employee might more than offset any increase in current cash salaries. Civil service salary ranges are compressed from the top at supervisory and managerial levels, so supervisors and managers might well benefit financially from privatization if they are able to maintain stable, long term employment with the acquiring company (or in the private sector generally). If not, it is possible that the State could be liable for any losses to such personnel that are occasioned by the sale of the State Fund.

Employees moving to the new entity would not be covered by CalPERS, since the new entity would not be a government employer. The ability to remain in CalPERS - covered employment is a key issue with a majority of the 6,100 employees who are currently "vested" in the system. These employees are covered by defined benefit pension plans.

This option offers the lowest probability for continuity of salary, benefits, union representation rights, and CalPERS membership, and presents the greatest risk to continued employment for State Fund employees.

Since the employees would become employees of the acquiring corporation (or in any event, of a privatized State Fund), they would no longer be State employees, and they presumably would no longer be represented by current State employee unions. Given the low degree of unionization in the insurance

industry, it is unlikely that the employees of the acquiring corporation would be unionized. Current employee unions could lose membership, dues, and status.

The State Fund's personnel and labor relations function would probably take on the policies and practices of the acquiring corporation.

F. TRANSITIONAL COSTS

Independent Valuation of the State Fund: In order to judge the adequacy of purchase offers for the State Fund, the state would have to undertake its own economic valuation of the State Fund. This is because the economic value of an insurance company is something different than its statutory surplus. Such a valuation would require both actuarial and accounting consulting fees. The state would also want to engage the services of a merger and acquisitions firm to manage the process.

The privatization effort might likely encounter some degree of litigation engendered by the privatization process. In Michigan, policyholders sued (and ultimately lost) in a bid to obtain a share of the proceeds of the sale. As noted above, other interested parties, who are not necessarily policyholders, might also assert an interest in the proceeds.

Implication of Transferring State Fund Employees to the Private Sector: Given that State Fund employees would lose their civil service status and the value of future accrual of benefits in the PERS defined benefit retirement plan, prudence would dictate that the State expect employee litigation and, ultimately, a significant cost.

According to CalPERS staff, it is doubtful that the employees of the new entity, by their interpretation of the Federal Employee Retirement Income Security Act (ERISA), could be covered by CalPERS for future service, since the new entity would not be a government employer. As discussed above, the ability to remain in CalPERS-covered employment is a key issue with a majority of the 6,100 employees who are currently "vested" in the system. CalPERS is doubtful that State Fund may remain a participating employer as a private entity, believing that CalPERS would lose its exemption from ERISA as a "governmental plan" if private, non-governmental entities were allowed to participate. That opinion was supported by a legal opinion from outside CalPERS counsel.

On the other hand, other independent counsel have opined that the mere presence of private participating employers does not render the exemption for a "governmental plan" inapplicable. The Department of Labor allows *de minimis* participation by private employers. It could be argued that State Fund's 6,100 employees represent a *de minimis* percentage of the 200,000 participants in the plan for "Miscellaneous Employees" and of the 1,000,000 total plan participants.

Ultimately, working this out successfully would depend on obtaining an opinion letter from the Department of Labor which would guarantee that CalPERS' ERISA exemption would not be put at risk for covering a group of privatized State Fund employees and obtaining the cooperation of the CalPERS Board to support the plan.

While the independent counsel believed they could work with CalPERS to find a way for the State Fund to remain in CalPERS should the Fund become privatized, it was also their opinion that the advantages to the privatized Fund of running its own benefits program would ultimately be in the Fund's best interests. It is theoretically possible to develop a retirement program for the new corporation which would be integrated with the employees' vested CalPERS pension rights and would provide a retirement benefit which would be actuarially equivalent to what the employee would have received for uninterrupted service under the CalPERS plan.

PERS retirement benefits are funded at about 85% of full actuarial present value and provision must be made in the sale to adequately fund the remaining unfunded liability. Likewise health benefits for retirees are completely unfunded and provision for the actuarial present value of these benefits for existing and future retirees must be made. Currently the annual charge on a pay-as-you-go basis is \$8 million.

Turning to the question of employee organization rights, under this option, existing union contracts (if any were in effect) would survive the transition to the new stock company. However, the standing of the employee unions after expiration of any in-force contracts remains in question. Since the employees are no longer state employees, state employee unions may or may not choose to continue representing them after the expiration of in-force contracts. Representation could be transitioned to affiliated private sector unions. Unless they chose to continue representing the employees under NLRB jurisdiction, the current public sector unions will lose membership, dues, and status.

2. CONVERSION TO A STOCK COMPANY

The impact of creating a stock company on stakeholder interests would be determined by the distribution of stock in the new company. Assuming existing management is carried over to the new company, there should be continuity of management philosophy in the short term. However, the possibility exists for material change over the long run as stockholders assert their interest in running the company for their own benefit. It is unlikely that the State could require a private stock company to provide a guaranteed available market for all employers.

A. IMPACT ON THE CALIFORNIA INSURANCE MARKET

A stock company would likely continue to be a competitor in the California workers compensation marketplace. However, it is possible that the State Fund would diversify its underwriting into other states and/or other lines of insurance.

The creation of a new residual market facility would also have an impact on the workers compensation market, as discussed previously.

B. IMPACT ON THE INTERESTS OF STATE FUND'S INDIVIDUAL POLICYHOLDERS

Under the sale option, we discussed the disposition of small insureds; under the stock company option, the concerns for policyholders would be similar. Similarly, the issue of the distribution of the proceeds of a sale would relate to the allocation of stock.

The new owners and managers would determine the long term approach to employers now insured by the State Fund. The ability of all current employers to find the same levels of coverage and service they have experienced with the State Fund could not be guaranteed.

Rate stability may also be jeopardized, especially for the smaller employers. The rates that would be charged by the stock company or by the new assigned risk plan may differ from those charged by the State Fund.

C. IMPACT ON THE INTERESTS OF STATE FUND'S INSURED GROUP ASSOCIATIONS

Under this alternative, the current level of services to associations could continue. Associations could continue to be represented on the Board. However, the long term impact of the conversion to a stock company on group associations would be subject to the direction taken by management of the new entity.

D. IMPACT ON THE INTERESTS OF THE STATE OF CALIFORNIA (AS A CLIENT)

Similar to what was discussed under Sale above.

E. IMPACT ON THE INTERESTS OF THE STATE FUND'S EMPLOYEES AND THEIR REPRESENTATIVES

Since there would be greater continuity of management under this option than under a sale, there would presumably be greater job security for employees

under this option. Employees however would lose civil service status and become "at will" employees of the new corporation. This would bring about the same risks as are reflected in Section VII, C 1, E above.

F. TRANSITION COSTS

As noted above, the rights of current and former policyholders to shares in the new stock company will be an important step in the privatization process. There is no State law that applies directly to a privatization of the State Fund, but some indications can be gleaned from a review of the steps and costs required in a demutualization. It should be noted, however, that privatizing the State Fund will likely be more involved than demutualizing an insurance company. For that reason, useful information might be gleaned from a detailed review of the Blue Cross of California/WellPoint merger, pursuant to which Blue Cross became a for-profit entity.

Transition costs can be incurred in the areas of valuation of the company, achieving corporate changes, personnel costs of converting to a private company, possible litigation costs, and possible federal income tax changes.

In a 1992 study of the mutual property/casualty business, Conning & Co. found that:

"Demutualization is an expensive and arduous process which engenders additional disclosure and reporting requirements to the Securities and Exchange Commission, a conversion from statutory to generally accepted accounting standards, a possible depletion of the company's resources due to policyholder distributions and the ever-imminent threat of a hostile takeover."

"While demutualization statutes differ from state to state, there are great similarities because many were patterned after the model conversion act promulgated by the National Association of Insurance Commissioners (NAIC). The act requires a resolution approved by three fourths of the entire board of directors to adopt a plan of conversion to be submitted to the state insurance commissioner. All policyholders must be notified and a public hearing held. If the commissioner approves the plan following the hearing, it must be submitted to a vote of the policyholders and be approved by two thirds of all votes cast."

"Various formulas may be used to establish the basis for distribution of stock to the policyholders. The remaining steps are crucial, yet not all statutes speak to the questions of determination

of net worth, eligibility of policyholders, and timing of distribution."
(The Conning Commentary, October 1992)

An article this year in Contingencies (May/June 1996), an actuarial periodical, suggested a demutualization process can be completed in about 2 years and identified the following steps in the process:

- Convert to GAAP accounting-3 to 5 years of historical statements
- Assess the tax impact
- Prepare a plan for the demutualization
- Conduct hearings
- Prepare and distribute proxy material to policyholders-several mailings
- Secure regulatory approval
- Draft and review the business plan, including use of the proceeds for any incremental funds to be raised
- Prepare the public offering document
- Select the underwriters
- Solicit the policyholders
- Establish procedures for dealing with the new ownership format (consider potential conflicts of interest, financial reporting requirements, requisite disclosures, etc.)

The Contingencies article reported that the demutualization of Guarantee Mutual was estimated to cost \$20 million.

To provide an order of magnitude, the State Fund's current surplus would have ranked it number 11 in a 1994 ranking of mutual insurers by size of surplus.

The personnel costs of converting to a private stock company would have to be considered. These costs could be the responsibility of the new owner(s), the State General Fund, or both:

- making up the 15% underfunding in CalPERS for the accrued retirement benefits of current employees.
- funding the annual \$8 million employers' share of current retirees' health plan premiums.
- development of a new private retirement system under federal law that is comparable to CalPERS.
- creation of new payroll and employment history record systems which are estimated to exceed \$3 million.

3. CONVERSION TO A NON-PROFIT MUTUAL INSURANCE COMPANY, MUTUAL AUTHORITY, OR SIMILAR PUBLIC CORPORATION

A. IMPACT ON THE CALIFORNIA INSURANCE MARKET

Impact depends greatly on whether the State Fund is charged with providing a guaranteed available market for all employers. If so, it would be acting in substantially the same fashion as it currently does in the marketplace. Recently created Mutual Insurance Companies, Authorities, and Public Corporations in other states have all been limited to single state, single line operations, and most were designated as the assured market.

If the charter permitted, the new entity could be free to diversify by state and by line. Absent a requirement that it provide a guaranteed available market, it would begin to publish rates appropriate to the broad middle range of risks, becoming more competitive for those risks, selectively underwriting risks, choosing to insure those which were compatible with its rating plan and relegating to the residual market those which could not be written at standard rates.

B. IMPACT ON THE INTERESTS OF STATE FUND'S INDIVIDUAL POLICYHOLDERS

Again the impact depends greatly on whether the State Fund is charged with providing a guaranteed available market for all employers. If so, it would be acting in substantially the same fashion as it currently does.

Since no individual or transferable equity interest would be created for individual policyholders, no valuation process would be necessary; nor would there be a need to figure out what an individual policyholder's rights are under the transition. Policyholders have an indivisible interest in the State Fund both before and after the transition. Whatever the value of their interest before the transition, it would be the same after the transition.

If the new company were not designated as the assured market, there would be concerns about policyholders as discussed in the sections on forming a stock company and in the sections on guaranteed market alternatives.

C. IMPACT ON THE INTERESTS OF STATE FUND'S INSURED GROUP ASSOCIATIONS

There would be little impact, as the company structure and operations would not change significantly. If the company were not to be the assured market, there would be concerns for small employers obtaining coverage.

D. IMPACT ON THE STATE OF CALIFORNIA AS A CLIENT

There would be little impact, as the company could continue serving the State as it currently does. If the company were not a state agency, there may be changes in the company's participation in offering services to the State.

E. IMPACT ON THE INTERESTS OF STATE FUND'S EMPLOYEES AND THEIR EMPLOYEE ASSOCIATIONS

The impacts on employees would be similar to those identified above under conversion to a stock entity.

F. RELATIVE COST OF THE GIVEN DIVESTITURE METHOD

Compared to the alternatives discussed previously, the costs of these alternatives would be less. This alternative might avoid the costs of valuation, determining the values of individual policyholder equity interests (although some valuation of other asserted interests could be needed), the underwriting costs of a public securities registration, and the possible costs of litigation over policyholder interests in the new company. Costs of the conversion of employees to private employment would also be incurred.

4. ESTABLISH A PRIVATE, NON-PROFIT SUBSIDIARY OF THE STATE FUND

Since this alternative only privatizes new employees, there would be minimal impact on the California market, individual policyholders, group policyholders, and services to the State.

There would be an impact on employees and on management of the State Fund as new hires would be privatized.

Costs may be incurred in establishing the new company and legal costs may be incurred in converting existing civil service positions into private positions.

Ultimately, the State Fund would be devoid of employees and decisions may have to be made regarding its future; many of the issues addressed with respect to other alternatives would then have to be addressed.

5. MAINTAIN THE STATUS QUO

If the status quo were maintained, there would be no impacts or costs incurred in the criteria evaluation areas. Employees would continue as civil service workers. The State would continue to compete with private insurance companies in the workers compensation market, to provide California employers guaranteed insurance availability and to provide a competitive yardstick.