

**CDA HOLDING
COMPANY, INC.**



**THE FUTURE OF THE
HOLDING COMPANY**

A comprehensive study of the role and continued relevance of the
Holding Company, conducted by the ad hoc Future of the
Holding Company Committee

November 2004

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History of CDAHCI

The California Dental Association formed the CDA Holding Company, Inc. (CDAHCI or HCI) in 1993 to hold the shares of its operating subsidiaries, as a means to provide oversight to its subsidiaries' operations in a manner perceived to best protect its tax-exempt status as an association. In addition to its oversight function, the Holding Company also provided business support services to CDA and its operating subsidiaries. These business services included finance, human resources, information technology, legal affairs and mailroom/printshop services.

In 2003, a comprehensive study of the operating subsidiary structure identified several organizational changes which would provide the framework for a more cooperative and consolidated subsidiary relationship. The 2003 House of Delegates approved these changes, which included the establishment of mirror boards for 1201 and TDIC (separate boards composed of the same volunteers) and one CEO/President for both organizations. In addition, both boards have chosen the same volunteer to serve as chairman, further enhancing coordination efforts.

Also in 2003/early 2004, the executive director completed the last phase of a staff reorganization which reassigned tasks and staff among all companies, moved the service departments from HCI to CDA, adjusted work between divisions and finalized building renovations to accommodate space requirements made necessary due to the reorganization. The result has been the melding of executive management staffs into one executive team, a marked increase in communication and coordination between all staffs, and a redistribution of work which aligns work priorities with the strategic goals.

The CDA Holding Company, Inc., was formed in 1993 via House of Delegates Resolution #6S1-1993-H, to be a for-profit subsidiary of the California Dental Association. The *CDA Bylaws*, Chapter XV, Section 20-C(a) state the duties of the holding company:

CDA Holding Company, Inc. is to "...hold the shares of the subsidiary operating companies and to perform such administrative services for the association and the subsidiary operating companies as are deemed appropriate by its board of directors. The board of directors of the holding company shall establish such policies and procedures as it deems reasonable for the administration of CDA Holding Company, Inc. and its subsidiary operating companies."

The *CDA Bylaws* further direct that the chief executive officer of each subsidiary operating company report to the chairman of the board of CDAHCI, and that quarterly reports be provided by CDAHCI to the Executive Committee, Board of Trustees and House of Delegates. The bylaws further allow the CDAHCI board, by voting its shares, to both elect and remove subsidiary board members. CDAHCI holds and invests dividends received from the operating subsidiaries, and forwards dividends deemed reasonable and prudent on to CDA, retaining a portion for its administrative expenses. All requests for additional funding from the operating subsidiaries must be forwarded to HCI in the form of a resolution for its approval. Finally, all subsidiary bylaw revisions must be approved by the holding company, and ratified by the Board of Trustees and House of Delegates.

Committee Establishment/Composition

At its December 11, 2003 meeting, the CDAHCI board adopted Resolution #15-2004-HCB, which established the ad hoc Committee to Study the Future of the Holding Company. The report of the consultants who had worked on the TDIC/1201 restructure, PricewaterhouseCoopers, had identified several governance redundancies relative to the Holding Company. In addition, it was reported that recent tax law interpretations may represent an opportunity for CDA to take advantage of these developments and incur organizational tax savings. The HCI Board of Directors directed that a study be conducted, that an ad hoc committee be established and appointed its members as follows:

Members:

<i>Dennis M. Kalebjian, D.D.S., Chairman</i>	<i>CDAHCI Board Member, CDA Immed. Past President</i>
<i>Peter A. DuBois</i>	<i>CDAHCI Chairman, CDA Executive Director</i>
<i>Jeffrey R. Hazarian, J.D.</i>	<i>CDAHCI Board Member</i>
<i>Dennis L. Roginson, D.D.S.</i>	<i>CDAHCI Board Member, Past CDA Board of Trustees Mbr.</i>

Consultants: The following consultants were selected to work with the committee to accomplish this work:

<i>J. David Gaynor, D.D.S.</i>	<i>Past Subsidiary Chair/President/CEO, Past CDA President</i>
<i>Douglas J. Frye, Esq.</i>	<i>Outside Legal Counsel, Bylaws/Governance Expert</i>

Staff Support:

Janice Johnson
Cynthia Schneider
Mark Soeth

Chief Governance Officer, Committee Coordinator
TDIC/1201 Vice President and Chief Financial Officer
CDA/CDAHCI Chief Financial Officer, TDIC/1201 Interim
CEO/President

Scope of Work and Objectives

The committee held its first meeting on January 29, 2004, and established the following committee scope of work and objectives for success:

Scope of Work:

- The ad hoc Committee on the Future of the Holding Company is charged with developing a thorough understanding of the current role of the Holding Company in the CDA organization, educating itself on current laws and corporate standards relative to holding companies and on the roles of holding companies in various types of organizations, and making recommendations relative to its future.

Objectives:

- Evaluate current procedures, historical perspectives and roles to develop an understanding of current processes and their purpose.
- Understand changes to corporate laws affecting holding companies, the impact these changes have on "arms-length" considerations, and how other nonprofits have changed their policies regarding holding companies.
- Develop a timeline for tasks to be completed, determine to which Holding Company board and Board of Trustees meetings this committee will report, and set future meeting dates.
- The HCI Chairman is including information on the establishment and work of this committee in his *Executive Bulletin*. The committee's philosophy regarding this review is that it be a "transparent" process.
- Review transition scenarios and recommended "checks and balances."
- Develop board presentations.

Project Timeline

The committee determined that it would set a goal of providing a recommendation relative to the future of the Holding Company to the November 2004 CDA House of Delegates. To accomplish this work, the committee established the following timeline, reporting plan and meetings schedule:

- March 11, 2004 – Committee meeting to receive additional legal and tax expert testimony. The committee also developed its position at this meeting.
- April 16, 2004 – Committee meeting to review drafted report.
- June 3, 2004 – Present its report, recommendations and resolutions to the Holding Company Board of Directors Meeting.
- July 15, 2004 -- Present its report, recommendations and resolutions to the Executive Committee Meeting.
- August 21-22, 2004 -- Present its report, recommendations and resolutions to the Board of Trustees Meeting.
- November 19-21, 2004 -- Submit *CDA Bylaws/governance* document revisions and report to the CDA House of Delegates for final adoption.

Documentation Review/Understanding the Past

As the committee began its review of the current role of the Holding Company, it was particularly aware of the past political considerations which lead to the formation of the Holding Company, its role in providing subsidiary oversight, and its "check and balance" position within the family of companies. It reviewed numerous documents as part of its preparation for conducting this study, including the following items:

- **HCI Action Item Chronology**: A complete, chronological listing of all non-routine actions taken by the Holding Company since its formation in 1993 was produced and provided to the committee for review.
- **CDA Update Article**: An extensive article in the *CDA Update*, dated October 19, 1992, provided insight relative to the formation of the Holding Company, its role, purpose and rationale.
- **HCI Budget Summaries**: The committee was provided with HCI's 2004 Budget Summary spreadsheet, HCI division activity summaries, TDIC's 2004 Budget Summary spreadsheet, 1201's 2004 Budget Summary spreadsheet and retained dividends summary as of January 2004.
- **Corporate Mission Statements**: The most recent mission statements for all companies within the CDA family were reviewed.
- **CDA Strategic Plan**: CDA's Strategic Plan, as approved by the 2003 CDA House of Delegates, was reviewed. Goal 8 instructs that CDA design and implement a corporate structure which ensures the functional integration of all CDA organizations.
- **Corporate Operations Task Force Report**: The 2002 report of the Corporate Operations Task Force, which was compiled after a multi-year review of the corporate structure was conducted, was provided to the legal consultant. Mr. Frye evaluated the legal and tax implications detailed in that report and ensured that his fact finding research addressed the issues noted.
- **ADA Restructure Review**: Consultant Frye was provided with 2003 ADA House of Delegates reports providing information regarding the ADA's analysis of its corporate structure.

Consultant's Initial Legal Analysis

At its January 29, 2004 meeting, Governance Legal Counsel Expert Mr. Douglas J. Frye, serving as a consultant to the committee, reviewed the purposes and funding of HCI and the governance oversight procedures currently in place. He stated that there is no California corporation law definition of a holding company, and that holding companies are simply corporations whose primary function is to hold the shares of another corporation. In addition, CDA's holding company includes as a bylaws-mandated duty, the providing of administrative services. He summarized that although there is no requirement under federal law for tax-exempt organizations to utilize a holding company to hold the shares of their taxable subsidiaries, tax-exempt organizations isolate their taxable activities in subsidiaries in order to prevent a determination that their taxable activities are "substantial," in relation to their exempt activities, and therefore, threaten their tax-exempt status. The tax law is also clear that a parent corporation may form a subsidiary to conduct a separate line of business, without the need for a holding company. For federal income tax purposes, a parent corporation and its subsidiary will be treated as separate entities, as long as the purpose for which the subsidiary is formed is reflected in true business activities. However, in order to avoid the attribution of the activities of the subsidiary corporation to the parent, the parent corporation must not control the day-to-day affairs of the subsidiary, so that the subsidiary becomes merely an extension of the parent.

The committee was encouraged to focus its review on corporate and tax laws which apply to our structure. A recent California court ruling interpreted California tax law to state that dividends received by a corporation from an insurance subsidiary are not subject to the dividends-received deduction and are thus taxable. Legislative relief is being sought to overturn this new interpretation, but until such relief is available, the tax liability to the Holding Company for dividends received from TDIC may be in excess of \$1,000,000. Under the court's interpretation, there would be \$30,000 to \$40,000 in annual tax savings if TDIC was able to pay dividends directly to CDA, rather than dividending to the Holding Company. It was determined that there is no consideration which requires we retain a holding company – and in fact, under the current circumstances, there is a cost to retaining CDA's holding company, as it is no longer a "safe harbor" for dividends.

TDIC and 1201 have for many years prepared separate tax returns, but now file a consolidated tax return so that tax credits and operational losses may be shared between entities. It was opined that the usefulness of a consolidated return would only be an issue if one of the subsidiaries realized significant and long-term deficits to offset the profits of profitable subsidiaries. A consolidated tax return is, at this point in our subsidiaries' maturity, probably not necessary.

The committee requested that the provided legal advice be corroborated with other industry experts to ensure its relevance to CDA's structure, and that tax experts ensure that the tax implications are fully researched and analyzed. These additional analyses were provided to the committee at its March 11th meeting.

Tax Law Analysis/UBIT Determination

At its March 11th meeting, Mr. Frye summarized that at the last ad hoc committee meeting, he and CFO Soeth had been charged to conduct further legal and tax implication due diligence in order to ensure that, should the committee recommend holding company dissolution or streamlining, no tax or legal implication had been left unconsidered. He confirmed there is no tax reason for a tax-exempt organization to utilize a holding company structure to hold the shares of taxable subsidiary entities, analyzed necessary steps to dissolve a holding company, and reviewed the Unrelated Business Income Tax (UBIT) considerations should dissolution be recommended. With respect to the UBIT considerations, given the existing structure, there would be no impact on the amount of UBIT received by CDA caused by the dissolution of the Holding Company. Currently, UBIT is received by CDA as rents from the subsidiaries and cost allocations for shared employees. Although neither of these sources of income account for any significant portion of the total activities of CDA, as they are passive in nature, they do generate significant gross revenues. Mr. Frye summarized his research into revenue rulings, tax law and numerous other cases and precedents, and determined that CDA's current level of UBIT does not threaten its tax-exempt status, but may subject it to IRS scrutiny. Outside legal counsel and tax experts were consulted in developing this opinion, including a nationally-renowned, non-profit tax law attorney. As discussed below, there are means to restructure CDA's source of UBIT, which will lower the profile of this item without substantive economic impact.

Employee UBIT/Reduction Alternatives/Cost Allocation Considerations

The committee was asked to consider the additional UBIT generated from the employee restructuring which occurred in late 2003, and to analyze its level of UBIT tolerance from this source. The committee received a report from CDA's tax advisor, PricewaterhouseCoopers, who believes that the movement of employees from HCI to CDA did increase its UBIT. In reviewing this item, Mr. Frye brought to the attention of the committee an IRS pronouncement (GCM 39108) which states an exempt organization receiving more than 50% of its income from UBIT may be exempt under IRC Section 501(6), if its other sources of income indicate a meaningful degree of membership support.

It is estimated that one-third of the association's revenue may constitute UBIT. There are several steps to consider reducing this. First, a substantial reduction of the association's UBIT can be achieved by restructuring the master lease for the 1201 K Street office space, so that TDIC is the master tenant and not CDA. This step will need the approval of the lender holding the first deed of trust on the building. Second, employees who provide 100% of their services to one subsidiary, could be employed directly by that entity in order to reduce the UBIT generated by the cost allocation payments received by the association for these services.

Another related issue evaluated was the method of pricing the services of CDA employees who provide services to the subsidiaries, specifically, whether a cost allocation method can be used or whether the services must be priced to generate a profit to CDA. This issue was raised by a recently proposed federal income tax regulation, which if adopted, may allow the IRS to redistribute these costs between related entities to prevent tax evasion or to clearly reflect the income of the entities. Using the cost allocation method merely treats the services of the employees as shared expenses, which are allocated according to use. A second opinion sought on this issue confirmed that an "at cost" allocation is commonly used by non-profit associations, and that over 130 other associations currently use that method. Also, in the case of TDIC, which accounts for approximately 80% of the costs of the shared employees, there is an independent business reason for using the cost allocation method, as it is required by the Department of Insurance.

Options for Streamlining CDAHCI

- **Liquidation/Dissolution**: Should the decision be made to dissolve HCI, methods to implement that action were evaluated. These methods would require TDIC to transfer its assets to the association. For this purpose, the tax implications of transferring appreciated assets from one corporation to another, and whether a tax recognition event occurs, were evaluated. Although generally an 80% or more owned subsidiary may distribute its appreciated assets to its parent company without recognizing taxable gain, if the parent is a tax-exempt entity, the gain must be recognized. A review of HCI's balance sheet indicates that its cash and depreciated

furniture/fixed assets can be transferred to CDA without gain recognition, since these are not appreciated assets. However, the transfer to the association of shares held by the Holding Company in the operating subsidiaries, which are an appreciated asset, will trigger gains. This would require CDA to recognize a substantial amount of income and the payment of many millions of dollars of tax. This option was discarded.

- **Streamlining:** Other options reviewed included the transfer of all of HCI's unappreciated assets up to the parent, retaining only the shares of the operating subsidiaries with the Holding Company. HCI would then become a "streamlined" or shell holding company, whose only purpose would be to hold the shares of the subsidiaries, receive dividends and elect subsidiary board members. "Shell" holding companies are the norm in the corporate world, and most are not administratively active. Should the pending legislation noted above pass, maintaining the holding company would result in taxes on the current level of dividends of approximately \$30,000 (if the legislation is not adopted, approximately \$100,000 in taxes would be incurred). HCI's cash (several million) and furniture/fixed assets could be transferred to CDA without gain recognition. A shell holding company could have only one board member and not meet or make reports, in similar fashion as TDCMS' current status.

Option Pros and Cons

The committee reviewed numerous internal and external considerations as part of its deliberation process, including analysis of the following:

Impact to Executive MBO Program: The subsidiary CEO evaluation mechanism, currently performed by the subsidiaries' boards and approved by HCI, would require transfer to another entity. It was suggested that the CEO review function could properly and more effectively be transferred to the Committee to Review the Executive Director (CRED) – referred to in the *Rules of the Board of Trustees* as the "Evaluation Committee." The committee recently has improved its sophistication and knowledge in evaluating executives through the organization's embracement of the "Management by Objectives" (MBO) program. The Evaluation Committee now includes the Executive Committee, two board members and the Foundation chairman, and could absorb this work. Additionally, an MBO system of evaluating executives on an ongoing basis could be accomplished by the Evaluation Committee by meeting quarterly to receive updates on goals. This would enable one entity, the Evaluation Committee, to have the unique perspective of knowing the direction, goals and accomplishments of all of CDA's entities. The committee recommends that the TDIC/1201 chairman also be added to the Evaluation Committee.

CDA Executive Director Oversight: Should the role of HCI be diminished, the positioning of the executive director to maintain his oversight role currently reinforced by his role as CDAHCI chairman, must be incorporated into another function. Oversight of the subsidiaries could be assured not only by his serving as vice chairman on the subsidiary boards (current procedure), and serving as the sole director of HCI with the authority to remove subsidiary board members if necessary, but also by sitting on the Evaluation Committee when evaluating the subsidiary executives (CDAF & TDIC/1201).

Approval of Subsidiary New Programs: Under a new streamlined HCI model, new subsidiary ventures/programs would be approved by the respective subsidiary board, and management of a new program would be evaluated by staff management. Subsidiaries would produce a newly required quarterly report to the Evaluation Committee, as any new proposal would represent a new MBO objective for the executive. Under corporate law, each subsidiary's board would have the power to approve new issues, with very few issues requiring shareholder approval.

Subsidiary Bylaws Approval: Resolution #6S1-1993-H, which approved the formation of the Holding Company, embodies numerous policy and administrative protocols, including the requirement that all subsidiary bylaws changes receive the ratification of the Board of Trustees and House of Delegates. The scope of the subsidiaries, as embodied in the *CDA Bylaws*, would require House of Delegates ratification if a venture was not addressed in the subsidiaries' scope in the bylaws.

Subsidiary Board Member Removal: The committee reviewed scenarios during which a subsidiary board or board member could be removed by the one proposed board member of HCI. The ability to remove subsidiary board members would still be a point addressed in the *CDAHCI Bylaws*. Furthermore, the current TDIC/1201 board is made up of half Board of Trustees and CDA officer members, ensuring CDA/parent continuity of goals. If, as the sole HCI board member, the executive director should remove subsidiary board members from office by virtue of calling a special shareholder meeting, that action, like all HCI actions, would be reported at the next Board of Trustees meeting.

Audit Committees: To further provide for corporate oversight, the committee proposed at its April meeting an increased scope of work for the existing subsidiary audit committees. Both TDIC and 1201 currently have established audit committees, made up of board members who have received additional education in the duties of corporate audit committees. By increasing the scope of these committees to "self-evaluate" their respective companies, the committee feels confident that yet another layer of oversight is achieved. It is the committee's recommendation that the operating subsidiaries' audit committees' scope, composition and function be revised to address these issues:

- Additional training/education be provided to the audit committees.
- Expert counsel/consultants be made available to these audit committees as necessary.
- Increase the composition of the audit committees from 3 to 5 members, with the two additional positions filled by the new public members added to the board.
- The third public member of the operating subsidiaries will serve on the Finance Committee.
- The nominating and selection process for public members will be evaluated, so that specific criteria for desired expertise, especially in their additional role as audit committee members, can be developed and shared with the Screening Committee.
- Enhance the scope of the audit committees to mirror the responsibilities/duties of publicly-held corporations' audit committees.
- The audit committees' composition should not include any board members who serve as members of their respective finance committees.

Public Member Considerations: The committee analyzed the contributions provided to the HCI Board of Directors by the public members, and discussed the expertise these members bring to the deliberation process. Experience in areas of banking, corporate law, insurance and many others provide a layer of knowledge the board, if made up solely of volunteer dentists, would not possess. It is a recommendation of the committee that a total of 3 public members serve on the subsidiary boards. In reviewing the recommendations that public members be mandated for positions on the audit and finance committees, the group felt strongly that their addition was crucial.

Evaluation Committee: The issue of designating a committee of the board to conduct oversight duties for the Board of Trustees was reviewed. The time required by the Evaluation Committee to conduct this additional work was analyzed. It was opined that the efficient planning of meetings and the increased responsibility of the Executive Committee (as members of the Evaluation Committee), could be absorbed. It was noted that reducing the number of HCI board members to one, would only reduce volunteer participation by 3 at-large positions. Furthermore, the committee believes that sufficient oversight is achieved by the new role of the enhanced audit committees, followed by Evaluation Committee review of executives' goals and quarterly reports to the board, and finally, Board of Trustees and House of Delegates ratification of actions and review of reports.

Input and Education Process

In order to ensure full communication relative to the committee's progress and to facilitate its desire to reinforce a transparent review process, a reporting expectation was put in place as an operational procedure. Formal meeting notices were mailed in advance of meetings; full agenda packages with discussion, action and background pieces were prepared and mailed in advance of meetings; formal minutes were produced and the committee's developments were included in the executive director's *Executive Bulletin*. The CDAHCI quarterly reports to the February 21 and May 22-23, 2004 Board of Trustees meetings, which were included in board agenda packets and mailed to over 160 CDA, component and subsidiary leadership, included a detailed description of the committee's activities.

Conclusion

In summary, and after extensive discussion, the committee recommends that the holding company must continue, but its function be streamlined, making HCI a passive/shell corporation. By restructuring the holding company, the following improvements to CDA's governance structure are realized and the following work will be accomplished to effectuate these proposals:

1. The MBO program for all executives (CDA, TDIC/1201 and CDAF) will be under one purview – the Evaluation Committee. Language revisions have been submitted to include the CDA Foundation and operating subsidiaries' chair on the committee. Additionally, the CDA Executive Director will join the Evaluation Committee in reviewing the subsidiary chief executives and the Foundation's Executive Director.

2. The oversight, responsibility and control of the subsidiaries will continue to be tied directly to the Board of Trustees.
3. The Board of Trustees will receive quarterly reports from the Evaluation Committee relative to subsidiaries' major initiatives and performance.
4. The *Holding Company Bylaws* will be revised to reflect a reduction of its board members to one.
5. The *Rules of the Board of Trustees* will be revised to instruct the Screening Committee to select the CDA Executive Director as the one board member of the Holding Company.
6. The *CDA Bylaws* will be revised to delete language relative to the scope of the Holding Company, which directs that it provide administrative services to CDA and the subsidiaries.
7. The Holding Company will be streamlined, with its scope reduced to holding the shares of the subsidiaries, receiving dividends and electing and removing subsidiary board members.
8. Management will look to reduce the assets of HCI in order to simplify it, by transferring fixed assets and cash to CDA. No gain recognition will be triggered.
9. Both TDIC's and 1201's bylaws will be revised to increase the number of stated public board of directors members from one to three, reducing the number of volunteer positions by two.
10. Both TDIC's and 1201's bylaws will be revised to reflect a new scope for their audit committees and to ensure that two public members and three volunteer members make up the composition of those committees.
11. Both TDIC's and 1201's bylaws will be revised to reflect that the third public member serve as a member of the respective finance committee.

The committee believes that by streamlining the Holding Company, the following will be accomplished:

- Oversight will begin with a self-evaluation process instigated by a revised scope of the audit committees.
- Overall oversight of the subsidiaries is returned directly to CDA – both through evaluation processes conducted by the Evaluation Committee and the executive director, and through the Board of Trustees, receiving the Evaluation Committee's reports and acting upon major subsidiary new ventures/policies.
- The top executives' MBO process is centralized and conducted by one body.
- The operating subsidiaries retain their status as CDA subsidiaries, whose shares are held by a streamlined CDAHCI, with all Board of Trustees and House of Delegates reporting requirements intact.
- A layer of governance is removed without jeopardizing CDA's tax-exempt status.

In conclusion, the committee, its consultants and staff appreciate the opportunity to conduct this study and make proposals to increase CDA's organizational efficiency and structure.

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