



Delta Dental of Washington

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Petitions: Board Response

WDS BOARD RESPONSE TO PROPOSED BYLAW AMENDMENTS

The Washington Dental Service Board of Directors met yesterday to review the results of the September 6th special member meetings and the petitions which were approved by voting members. The organizational changes that the proposed amendments would have required were deeply concerning to the Board. As a result, a number of them were vetoed by WDS's Independent Directors, and several others were determined by the Board to be illegal or unenforceable and will not be implemented.

The Board of Directors recognizes and understands the concerns of our member dentists as well as the broader challenges facing the dental industry. However, these petitions would hurt rather than help our ability to adapt and thrive under changing industry conditions, and to support the long-term interests of the dentists who are our business partners.

Our goal remains to continue to serve our customers – and to support members' ability to serve their patients. To do so, we will seek to foster an environment in which to discuss industry changes and actions that can be taken to better position dental practices for the future, all the while ensuring that patients continue to receive high quality dental care.

In the immediate term, we will convene the Member Advisory Panel (MAP) in the coming weeks. There, MAP members will ask questions, share concerns and discuss a thoughtful path forward. We look forward to a constructive dialogue on topics such as access to quality care and the claims denials/appeals process, as we continue working toward a beneficial, shared future.

Below is a summary of pertinent background information and the decisions made/confirmed by the WDS Board.

TO: The Members of Washington Dental Service (“**WDS**”)

FROM: The WDS Board of Directors (“**Board**”)

DATE: September 29, 2017

RE: Decisions as to Bylaws Amendments Recently Voted on by Members

Two special meetings of WDS members were held on September 6, 2017, at which members voted in favor of adopting certain Bylaws amendments that had been proposed by member petitions. Prior to those meetings, we had notified members of certain vetoes and other concerns and objections we had relating to the proposed amendments. We are writing now to explain how the Board plans to proceed with respect to those proposed amendments.

Some Historical Context

A little historical context may help explain our thinking about the proposed Bylaws amendments. Washington Dental Service was founded in 1954 by a group of forward-thinking dentists who were seeking, not to benefit their profession, but rather to pursue the larger social-benefit purpose of offering dental benefits coverage as a means to increase access to and utilization of dental care by Washington residents. In keeping with this purpose, the founding dentists organized WDS as a non-profit corporation, sought tax-exempt status from the IRS, and made themselves members of a non-profit rather than owners or shareholders of a for-profit corporation.

By the late 1980’s, federal and state antitrust regulators began suing health insurers whose boards of directors were controlled by providers – the regulators’ argument was that it is illegal for providers to control both sides of the “price negotiation” over their own compensation. As part of this surge in enforcement, Washington State’s Attorney General filed lawsuits against a half dozen local health plans, asserting that providers’ ability to control or influence their fee-setting decisions violated state antitrust laws. The Washington Attorney General required those plans to adopt a governance structure under which independent (i.e., non-provider) directors would have the ability to control the setting of providers’ fees, and also to veto any efforts by providers to amend the independent fee-setting mechanism in a way that might allow a recurrence of antitrust violations.

Rather than wait for WDS to be sued, the dentists who controlled the WDS Board at that time proposed that members implement an independent fee-setting structure, modeled after the governance structures the Washington Attorney General had required other

health plans to adopt in order to settle their antitrust lawsuits. This independence-based structure was approved overwhelmingly by WDS members in 1991. Since then, the structure has had the desired effect of avoiding challenges based on the provider-control issue.

In 2011, new industry survey data revealed that WDS's reimbursement rates were among the highest in the nation; and large employers began to question why treatment costs for their Washington employees were higher than for employees in other states. Faced with these realities, the Board's fee-setting committee reluctantly concluded that reimbursement rates payable to network dentists would have to be reduced in order to enable WDS to remain competitive and continue expanding dental benefits coverage in Washington. After many years of steadily increasing reimbursement rates, this fee reduction was a financial shock to many WDS members.

In reaction to the 2011 fee reduction, some WDS members petitioned to hold a special meeting in late 2011, for the purpose of considering Bylaws amendments that would weaken the independent fee-setting mechanism that had been established 20 years earlier. Members subsequently approved those proposed Bylaws amendments, and the Board's independent directors then had to consider whether to consent to the proposed dismantling of the independent governance provisions. Because those provisions promote good corporate decision-making, and their preservation was considered important from a legal standpoint, the independent directors exercised their authority under the Bylaws to veto several of the proposed 2011 amendments that threatened the independence of WDS's governance.

Now, almost six years later, we again find ourselves facing many of the same initiatives that were proposed and rejected in 2011. This time, the proposals have been described as being aimed at making quality patient care the "exclusive focus" of WDS, although it is difficult to see how the proposed amendments accomplish that objective. As was true in 2011, most of the 2017 proposed amendments are aimed at weakening and dismantling WDS's independent governance structures, and in particular its independent fee-setting mechanism. In other words, most of the 2017 proposed amendments would undo the decision that was made over 25 years ago to place provider compensation in the hands of truly independent directors.

During the last quarter century, WDS has experienced significant growth in its customer base and complexity as a business. In addition, corporate governance "best practices" have evolved considerably during that time. The necessity for and wisdom of our independent governance structures is even stronger today than it was when they were first adopted.

We believe our members should take a step back and look at the bigger picture here. Under our existing governance structures, we have achieved a continuing expansion of dental coverage in Washington State, a growing customer base for our member-dentists, reimbursement levels that are generally higher than our competitors both in and out of state, and significant charitable contributions that advance oral health among our neediest

citizens. The dental profession is currently challenged by a number of profound threats, such as increasing efforts by employers to bargain for lower treatment costs and shift healthcare costs to their employees, and increasing scrutiny by employees and other consumers on the price/value equation of their healthcare services. But these threats are not an outgrowth of our internal governance structures, which have been quite effective at advancing our shared interests.

Board Considerations

The WDS Board has carefully considered the amendments proposed in the 2017 petitions and the proceedings at the recent special meetings, and has also sought additional legal and other advice concerning those proposed amendments. In arriving at appropriate responses to the various proposed amendments, we have taken many considerations into account:

1. First, our duty as fiduciaries is to be faithful and obedient to the corporation's non-profit mission. WDS's primary mission is articulated as a multi-factor objective, namely "advancing the public's oral health by providing quality dental benefits at an affordable cost." This mission requires that we balance a number of specific objectives, some of which are often in tension with others. The overall mission cannot be achieved by focusing solely on one factor (such as cost, or quality care).
2. Second, there are several compelling justifications for WDS's current governance structure, under which a majority of the Board members are independent directors who control their own nomination/election processes and the setting of dentists' reimbursements. Without such independence-based structures, a non-profit healthcare benefits corporation is inevitably exposed to conflicts of interest and price-fixing risks. It is essential to err on the side of caution with respect to antitrust risks, in part because price-fixing allegations can be ruinous to an insurer like WDS, which is increasingly consumer-facing. Beyond the antitrust concerns, there are strong corporate law reasons and corporate governance "best practices" that strongly support the avoidance of conflicts of interest in decision-making. In addition, WDS's tax exemption is an important asset that must be protected by maintaining the current degree of control by independent directors.
3. Third, the independent directors' consent rights under Article X of the Bylaws were intended to protect the antitrust insulation that the independent fee-setting mechanism provides. This intent would not be satisfied if member-dentists could easily delete the consent right or create conflicts and ambiguities by amending non-listed provisions. We conclude that the independent directors' consent right as to amendments of the provisions listed in Article X would be rendered meaningless if it were not equally applicable to indirect efforts to weaken or dismantle those protected provisions.
4. Fourth, as directors, we are the persons charged with the fiduciary obligation to manage the corporation's business and internal affairs responsibly. The members do not have that same obligation, and cannot use amendments to a process-oriented document like the Bylaws to override our fiduciary obligations and impose substantive business decisions on the Board and the corporation. We view several of the proposed

amendments as conflicting with the Board’s management responsibilities, for example those amendments relating to medical loss ratio, director compensation and independent review boards. Limits like these put the corporation at a competitive disadvantage, and constrain our ability to react quickly and wisely in the face of turbulent industry conditions.

5. Fifth, we are making today’s decisions (which are described below) out of a profound sense of duty to WDS as a non-profit corporation. When we decide to veto or limit the impact of certain proposed amendments, we do so out of a belief that it is our fiduciary duty to do so.
6. Finally, we started planning to reorganize WDS into a holding company structure back in 2009. The process culminated with a public hearing conducted by the Office of the Insurance Commissioner in 2013. During that entire time, the proposed reorganization was a matter of public record, and we described it in our 2013 Annual Report to all members. The petitioners’ claim that WDS somehow concealed the reorganization from members is baseless.

Decisions by Board and Independent Directors as to Member-Approved Amendments

With all of this as background, the following chart details the decisions that the Board and the independent directors have made with regard to the Bylaws amendments approved by members at the September 6 meetings. Some of the proposed amendments have been vetoed by WDS’s independent directors based in part on antitrust concerns, as to which the Board has obtained additional advice since the meetings. Other proposed amendments have been identified as legally deficient for other reasons described in the chart, including that they interfere with the Board’s management discretion and responsibilities. As mentioned earlier, we have taken the decisions described in the chart out of a belief that it is our fiduciary duty to do so.

As used in the chart below, the term “**GNC**” refers to the Governance & Nominating Committee, “**IDs**” refers to Independent Directors, “**MAP**” refers to the Member Advisory Panel, “**MDs**” refers to Member Directors, and “**PCC**” refers to the Provider Compensation Committee. In addition, the term “**vetoed**” is used as a shorthand reference to a decision by the independent directors not to grant their approval of a member-approved amendment as required under Article X of the Bylaws. The petitioners’ proposed amendments are listed in this chart in numerical order, without regard to the timing of their consideration in the first or the second special meeting of members.

Actions/Responses to Member-Approved Bylaws Amendments

| <u>Article/Section of Bylaws</u> | <u>Summary of Member-Approved Amendment</u> | <u>Action or Response by Board or IDs</u> |
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| II.1 and II.2 | Annual and special meetings of members to be open to | The Board intends to comply with this amendment, but also to |

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| | invited guests | adopt reasonable implementing rules to clarify vagueness and preserve integrity and efficiency of corporate governance |
| II.4 | Member voting on contested elections of IDs or MDs must be by written ballot and final vote counts must be disclosed | Vetoed by IDs; although Article II, Section 4 is not listed in Article X of the Bylaws, the IDs and the Board consider this amendment to be within the IDs' veto power because the reference to members electing IDs in contested elections would be inconsistent with the protected provisions listed in Article X |
| II.5 | Members may bring a parliamentarian to member meetings to observe and advise members | The Board intends to comply with this amendment, but also to adopt reasonable implementing rules |
| IV.1.B.2.a | Eliminates certain "independence" criteria for IDs, such as reference to DDPA membership standards and exclusions of (i) President/CEO, (ii) other employees, (iii) members, (iv) D.D.S. or D.M.D. degree holders, and (v) persons with a financial interest in a dental care organization | Vetoed by IDs |
| IV.1.B.2.c (and IV.1.B.2 intro) | President/CEO is no longer an <i>ex officio</i> Board member, and director categories are reduced to two | Vetoed by IDs |
| IV.1.B.3.a | Members are given power to elect IDs | Vetoed by IDs |
| IV.1.B.3.b | Second reference to "Directors" in fourth | Vetoed by IDs |

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| | sentence is changed to singular “Director” | |
| IV.1.B.4.a | Members can nominate IDs; GNC is no longer the exclusive source of ID nominations; if a member-nominated ID candidate exists, non-expiring IDs must select at least one GNC-nominated candidate and at least one member-nominated candidate to be voted on by members in a contested election | Vetoed by IDs |
| IV.1.B.4.b | Members can nominate MDs; GNC is no longer exclusive source of MD nominations; if a member-nominated MD candidate exists, Board must select at least one GNC-nominated candidate and at least one member-nominated candidate to be voted on by members in a contested election | Vetoed by IDs |
| IV.1.B.4.c | CEO is no longer an <i>ex officio</i> Board member | Vetoed by IDs |
| IV.1.C.2 | Board has power to nominate IDs for election by members | Vetoed by IDs; although Article IV, Section 1.C.2 is not listed in Article X of the Bylaws, the IDs and the Board consider this amendment to be within the IDs’ veto power because the amendment would conflict with the process for nomination and election of IDs under the protected provisions listed in Article X |
| IV.1.C.8 | Board’s power and duty include working with OIC and participating in an | This amendment is inapplicable because the holding company does not receive or review |

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| | independent review board | claims; if the amendment were applicable to either the holding company or its operating subsidiary, claims review processes are a matter of business judgment on which the Board has already exercised its discretion; in the absence of an IRB requirement imposed by the OIC or the state legislature, the Board believes that a requirement to participate in an independent review board would put the corporation at a competitive disadvantage and impinge on the Board's ultimate authority and discretion to manage its business and internal affairs; the Board therefore does not intend to comply with the mandatory aspects of this amendment |
| IV.1.G | Role of IDs in electing IDs is reduced to a role in nominating them | Vetoed by IDs |
| IV.1.H | Directors' and officers' expense reimbursements must be reasonable; payment to directors of a "reasonable fee" for meeting attendance based on prevailing industry practices is eliminated, although reasonable compensation for service in another capacity is allowed | WDS's governing statute (RCW 24.03.030(4)) authorizes payment of reasonable compensation to directors, and its Articles of Incorporation (Article III(C)) authorize payment of reasonable compensation to directors for services rendered; recruitment and retention of an experienced, skilled and highly effective Board is critical to management of WDS's affairs in a highly competitive industry, and the Board believes this amendment would impinge on the Board's ultimate authority and discretion to manage the corporation's business and internal affairs; since this amendment does not explicitly prohibit the payment of fees for Board service, the |

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| | | Board intends to continue paying market-based compensation (supported by independent consulting advice) for meeting attendance and other services rendered by directors |
| IV.I.L.2.b | Eliminates the requirement that at least three IDs be members of the GNC at any given time | Vetoed by IDs |
| IV.1.M.2 | Eliminates the requirement that at least three of the five members of the PCC must be IDs, and the role of IDs in appointing IDs to the PCC | This amendment is inapplicable because Article IV, Section 1(M) has not been part of WDS's Bylaws since 2013, when the PCC was relocated to the operating subsidiary in connection with the reorganization into a holding company structure; in any case, the IDs have vetoed the amendment if it were deemed to apply to either the holding company or the operating subsidiary |
| IV.2.B.c | Requires the Board to vote (and report the vote count) on all recommendations by the MAP on policies relating to dental procedures, claims processing and adjudication, and relations with the dental profession, to the extent the Board Chair has so requested | This amendment is inapplicable because Article IV, Section 2 has not been part of WDS's Bylaws since 2013, and the MAP no longer resides at the holding company level; if the amendment were deemed to apply to either the holding company or the operating subsidiary, the Board would intend to comply with it only to the extent that doing so would not impinge on the exclusive authority of the PCC as to reimbursement rates or the Board's ultimate authority and discretion to manage the corporation's business and internal affairs |

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| VIII | Expands recordkeeping and access rights to include committee minutes, as well as items to which access is required by statute | The Board intends to comply with this amendment |
| X | Eliminates requirement to obtain approval by IDs for any Bylaws amendments affecting specified provisions relating to the independence of corporate governance, or subjecting IDs to different rights, privileges, liabilities and duties than MDs | Vetoed by IDs; although Article X itself is not expressly listed as one of the provisions that can be amended only with the IDs' approval, the IDs and the Board believe it is implicit in the independent fee-setting structure and Article X that IDs must also have authority to veto changes to the veto provision itself |
| XIV | Adds more detail as to disclosures required to be included in the annual report to members, such as categories of administrative expenses, claims denial information, inflation/CPI information, financial statements of all affiliated entities, and contributions to and use of contributions by the corporation's foundation | The Board intends to comply with this amendment, interpreting any vagueness in the new requirements in a reasonable manner |
| XV.1 (and Ex. A) | Requires WDS to comply with a new Exhibit A which mandates that a minimum percentage (94%) of premium revenues must go to claims costs, and also mandates paying enrollee rebates and annually reporting MLR data to members | This amendment is inapplicable to WDS which, as a holding company, does not issue, sell, renew or offer specialized dental health care service plan contracts or specialized health insurance policies; even if the amendment were applicable, the Board believes that mandatory provider-reimbursement percentages and rebate requirements would create a deterrent to provider fee reductions in violation of |

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| | | antitrust laws, would limit the discretion and ability of the PCC to obtain “the most favorable terms” from providers, and would interfere with the Board’s ultimate authority and discretion to manage the corporation’s business and internal affairs; the Board therefore would not intend to comply with this amendment even if it were deemed applicable to either the holding company or its operating subsidiary |
| XV.2 | Requires WDS to cause its affiliated entities (e.g., its operating subsidiary, Delta Dental of Washington) to amend their governing documents to require compliance with Exhibit A | In addition to the legal defects cited in the preceding paragraph (pertaining to Article XV, Section 1), the WDS Board does not intend to comply with this amendment because it would be impossible; the Articles of Incorporation and Bylaws of its operating subsidiary prohibit the sole member (WDS) from adopting any amendment that would diminish, weaken or modify the subsidiary’s independent fee-setting structure, and the operating subsidiary’s Bylaws protect the management discretion of the subsidiary’s Board against infringement via Bylaws amendments |

We understand that all participants in the oral health industry are facing rapidly changing external conditions, which are challenging our members’ livelihoods. We do not believe the proposed Bylaws amendments would alter the trajectory of our industry, no matter what action we take as directors. We firmly believe that WDS and its members continue to share the same mission – to provide access to and increase utilization of quality dental care for Washington residents. We have taken the actions described above in the belief they are necessary to fulfill our fiduciary duties and to maintain breadth of coverage and competitive premiums and reimbursement rates. Together, we must address the desires of today’s dental patients for quality care as well as for simple, low-cost, predictable and user-friendly dental coverage. We believe that increased dialogue and collaboration with our members may enable us to find new approaches to the challenges we face collectively.

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