Managing Change: Leonard Schaeffer at HCFA and Blue Cross of California

In the course of his career to date, Leonard Schaeffer, currently head of Blue Cross of California, has had the opportunity to manage two organizations while they were, in his words, "being reinvented." One, the Health Care Financing Administration, was in the public sector; the other, Blue Cross of California, in the private. Large organizations, Schaeffer believes, "must reinvent themselves every five to seven years, or they die." The challenge for a leader in such a shifting environment is to "manage change." Nonetheless, he found the process of managing change to be different in private sector California than it had been in public sector Washington, DC.

Introduction: Leonard Schaeffer

A native of Evanston, Illinois, Schaeffer earned a degree in economics from Princeton in 1969. Before the age of 30, he had gotten a taste of both the private and the public sectors, first as a management consultant at an accounting firm and as the chief operating officer of an investment banking firm, and then as an official in Illinois state government. In the latter capacity, he served as deputy director of management for the Illinois Department of Mental Health and Developmental Disabilities before assuming the job, at age 29, of director of the state Bureau of the Budget. From state government, Schaeffer went back into the private sector, as a vice president at Citibank, before being recruited into the ranks of the Carter Administration in 1977 as assistant secretary for management and budget at the Department of Health, Education and Welfare. "I had a lot of authority early on," Schaeffer reflects, "and I learned early that if you make decisions ... without hesitation and you're very clear about why you're doing it and you're consistent, pretty soon people follow your lead." These were lessons Schaeffer would apply when Joseph Califano Jr., the secretary of HEW, tapped him for his most challenging job yet: restructuring and integrating the "two largest health care financing programs in the world"—Medicare and Medicaid.

Background: Changes at HEW

Schaeffer came to HEW at a time of ferment and change, when the scope and cost of social service programs were becoming a high-profile issue in the US. As part of an ambitious reorganization of HEW undertaken by Califano and HEW Undersecretary Hale Champion and intended to save, by Califano's reckoning, some $2 billion, the Medicare and Medicaid bureaus had been removed from their separate organizations (the Social Security Administration and the Social and Rehabilitation Service, respectively) in 1977 and placed in the newly created Health Care Financing Administration (HCFA—commonly pronounced "Hikfa"). "The urgent need to place HEW's disparate health care financing

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mechanisms ... under a single tough-minded, cost-conscious administrator," Califano declared, "has been recognized by President Carter, by the Congress and by the nation's governors. In creating the Health Care Financing Administration, I follow their lead." The move, Califano continued, could save "[l]iterally hundreds of millions of dollars ... through introduction of basic managerial techniques in this area."[1]

But in HCFA's first administrator Califano did not find the "tough-minded" manager he had sought; the integration of Medicare and Medicaid had proceeded at a snail's pace, and they remained separate bureaus. The administrator, according to one report, was hampered by "paper-thin" management ranks in Medicaid in particular and by the constraints of the civil service system in general.[2] "I had a great deal of respect for [my predecessor]. He was very much the philosopher, very concerned with ideas," says Schaeffer. "Unfortunately, the bureaucracy focused on philosophy as a substitute for action." Califano quickly grew impatient and critical, the *National Journal* reported in March 1978, "demanding to know why HCFA cannot move faster to integrate medicare and medicaid. ..." By September 1978, HCFA's first head had resigned, reportedly at Califano's behest. In his place, the HEW secretary appointed Schaeffer, then 33 years old, whom Califano commended for his "energy, intelligence and discipline. ..." Schaeffer would need all three traits to do the job.

Schaeffer's Mandate

"No task at HEW is more important," said Califano in announcing Schaeffer's appointment, "than realizing the vital objectives of the Health Care Financing Administration—to operate its major programs efficiently, to contain health care costs effectively and to root out fraud, abuse and waste energetically." In private conversations with Schaeffer, Califano had fleshed out the major concern that underlay these objectives. "When I first interviewed with Joe [for the assistant secretary post]," Schaeffer recalls,

> he made the point that most Americans at this time were beginning to feel that the big social welfare programs had failed, and that if we couldn't prove they were well-managed, there would be a backlash against them and poor people would suffer as a result. ... So the goal was to demonstrate that these programs could indeed be well-managed. ... I was very inspired by that goal.

But Schaeffer also saw another aim in the work he would do at HCFA. "The logic in my mind," he says, "was that if you put these two purchasing organizations together, ... you could leverage the entire health care system. ... This was not just managing government, this was managing the third largest industry in America. ... HCFA was the largest single purchaser of health care—42 percent of the nation's total. You could use that 42 percent, which is almost monopoly power, to rationalize the

1 *National Journal*, March 25, 1978, pp. 471-2. Schaeffer notes that the HCFA reorganization "was not supposed to reduce personnel." The savings were expected to come from improved management.

2 Ibid.

entire health care system. The goal was not just to reduce government costs, but to reduce health care costs generally." Califano, Schaeffer adds, "loved that. He just loved that because he liked to think big." Elsewhere, however, there was less enthusiasm. "There was absolutely nobody who wanted that to happen outside [top] administration," Schaeffer remembers. "In fact, everybody was arrayed against it."

Inside HCFA

Schaeffer was sworn in as head of HCFA on October 30, 1978. The organization he inherited employed some 4,600 people directly and controlled a budget of $44 billion, $2 billion of which was funnelled into administrative costs. The remainder was paid out in Medicare and Medicaid benefits, 62 percent (or $26 billion) of which went to hospitals.[3] While HCFA included a number of regulatory and monitoring units,[4] the fledgling organization was dominated by the mammoth Medicare and Medicaid bureaus, which together fed a sprawling network of hundreds of thousands of health care providers, insurance carriers, and state and local agencies.

Despite their new organizational umbrella, however, the two programs were, when Schaeffer arrived, still widely separated both in organizational terms and in their sense of mission. Medicare, explains Schaeffer, "comes out of the Social Security tradition. It's a program that had superb staffing. ... People joined that organization because they believed in the mission; they believed that people who worked hard all their lives ought to get something at the other end. ... The beneficiaries [were] worthwhile." Medicaid, on the other hand, "came out of the welfare tradition. People were not beneficiaries; they were clients or recipients." Staffing was less strong, particularly in the financial area, and workers spent much of their time coping with scandals, on both the recipient and the provider end of Medicaid transactions. The employees had worked in totally different environments, Schaeffer continues—"in Social Security, it was paper and rules; on the welfare end of SRS, it was streetfighting." In fact, about the only thing the two bureaus shared, Schaeffer believes, was their limited view of their roles: "In both cases, these organizations were focused on the beneficiary, the recipient. ... They were parcelling out money. They [did not see themselves as being] in the health care business. ... Also, they didn't see themselves as working for HCFA. Bureaucratically, internally, nobody wanted to do it [i.e., merge] because it didn't make any sense in their minds."

This limited vision of the mission of Medicare and Medicaid extended to Congress which, says Schaeffer, "really hadn't gotten to health [as a national issue]." Medicare and Medicaid were not "health care programs yet. They were extensions of social security and welfare." Lawmakers' narrower view of the two programs was a matter of concern to Califano, who was in the midst of a dislocating shake-up of HEW's vast empire. "Joe was very nervous about the Congress," Schaeffer recalls. "They were on him because he was doing all kinds of new and different things. And this was a pretty big deal from the appropriations committees' point of view—this was big money."

3 Leonard Schaeffer, "The Health Care Financing Administration: Unlocking Resources," *Public Health Reports*, March-April 1980.

4 HCFA's umbrella encompassed the Standards and Certification Program, Professional Standards Review Organizations, and the Quality Control Programs.

First Moves

Congress' mood was a concern in the short term, largely because of the first step Schaeffer intended to take: to consolidate all but a handful of HCFA employees in one location. Schaeffer planned to move workers from scattered offices in Baltimore, Washington, DC and suburban Maryland to a site in Baltimore, where Medicare and Medicaid personnel could be housed in the same building. "The goal was to reorganize and relocate simultaneously," explains Schaeffer.

In mapping out his strategy, Schaeffer drew on lessons he had learned from observing then-Senior Vice President John Reed at Citibank. Reed had read Chairman Mao, Schaeffer recalls, and believed that to change Citibank "into the organization of the future, you had to destroy the old culture." Schaeffer did not intend anything quite as radical as what he had observed at Citibank: "You couldn't re-educate, you had to destroy it. And [Reed] went about doing that. He created a cadre of people who were called the managers, as opposed to the bankers. ... I thought it was pretty ugly," he says. "I didn't really want to duplicate that." He did, however, envision the physical move as an opportunity to break up old patterns of behavior and interaction and create new ones. "My theory was that it's not just people's attitudes," he says, "it's their relationships and the processes they go through and the way in which they interrelate. A physical move is a very good time to change not just people's jobs, but where they sit and who they talk to. When you move people to a new location where they're physically arrayed to support a new organization and a new process, the result is a new way of doing business."

The relocation to Baltimore had actually been in the works during his predecessor's tenure at HCFA, but no discernible progress had been made, largely, Schaeffer thinks, because the move was planned to take place over an 18-month period. "In government," he muses, "you're dead in 18 months. It's never going to happen." One reason it would not happen, both Califano and Schaeffer believed, was Congress. A move announced well in advance, Califano wrote in his 1981 book, *Governing America*, "would have been blocked by some investigation on Capitol Hill precipitated by employee unions and suburban Maryland and Virginia congressional members."

For this reason, Schaeffer decided to move the Medicare and Medicaid offices during a congressional recess. Neither Congress, nor OMB for that matter, would be briefed on the move in advance. "Congress didn't know about it," he says, "and in fact were never formally briefed."[5] Schaeffer also decided to act fast. On November 17, 1978—after being in office for about three weeks—he announced the move in his "Administrator's Report," an internal publication instituted by Schaeffer. The relocation, he wrote, would begin in less than three months, in early February, and finish up by mid-April.

5 Schaeffer was not the only one anxious to keep Congress out of HEW affairs. Hale Champion recalls that he and Califano had the diagrams for the reorganization of HEW drawn up in the Defense Department, and briefed the president and key aides only the day before they implemented it. "We couldn't let this get into the Congress," Champion says. "It had to be a fait accompli."

While setting the machinery for the relocation in motion, Schaeffer also worked on the reorganization of Medicare and Medicaid, and on creating an identity for HCFA. He began with a statement of purpose and worked from there. HCFA, he says, "had no unifying mission. I thought it was my job to develop a unified mission, goals, and a set of strategies, and then organize to make it happen. I spent a lot of time at the front end working on that," aided by senior staff at HCFA. The fruits of that effort were released in a March 29, 1979 Administrator's Report, and repeated and refined through many reports that followed. The "basic mission" of HCFA, Schaeffer wrote, was threefold: 1) to ensure "effective administration of its program in order to promote the timely delivery of appropriate quality health care to its beneficiaries"; 2) to make certain that beneficiaries were aware of services and provided access to them; and 3) to ensure that HCFA's "policies and actions promote efficiency and quality within the total health delivery system which serves all Americans." From there, Schaeffer went on to outline "key HCFA functions" and "major programmatic challenges," and to detail a reorganization which consolidated various bureaus from Medicare and Medicaid. Under this new scheme, says Schaeffer, "HCFA was organized along functional lines, not program lines. That was the big breakthrough. It was organized so that a top-down command and control structure would work. In other words, it was organized to implement administration policies." As with the move, Schaeffer intended to act fast. Announced in March, the reorganization was due to take effect just a few months later, on June 20.

Managing the Reaction

The response to the announced changes was decidedly negative. "There were constant groundswells of discontent," Schaeffer recalls. Predictably, the strongest resistance came from within HCFA, where employees were unhappy about having to choose between relocating to Baltimore or finding a new job elsewhere in HEW.[6] Schaeffer met with them, singly and in groups, to explain the changes and to counsel workers on their next move. He also tried to work "participatively" in the planning with the staff he had inherited, and to "persuade people in groups that my ideas were right, because it was very hard to fire people and harder still to recruit new people into government." That sense of permanence about the workforce added to its resistance to change. The attitude within the bureaucracy, says Schaeffer, was "'We've seen them come, we'll see them go, and we'll outlast you.' And my view was, 'You ain't gonna outlast me. I'm gonna be here. I'm gonna be here on Friday night, Saturday night, Sunday night. And you're gonna perform or move out.'"[7]

In the end, some people—Schaeffer estimates 20 or 30—did move out, choosing to retire or change jobs. "Gradually," he says, "some of the top staff ... that I inherited ... kind of migrated away." They may have migrated at least in part as a result of the message Schaeffer sought to hammer home in his talks with employees. "I used to talk a lot about building an institution," he recalls. "The idea was, we would build an institution that would last. ... We talked about that a lot so people understood

6 Schaeffer was able to get HCFA workers exempted from a hiring freeze then in effect at HEW.

7 "I was considered crazy" by employees Schaeffer recalls. "I worked all the time. I would schedule meetings at 7:00 at night, meetings on Saturdays, meetings on Sundays. They just couldn't understand that."

it was a new world, it was a new way of doing business. And it was, 'Could you make it in the new world?' Over time, a number of people bought in, but others didn't. I was a lot younger then, and it didn't cost me a lot emotionally. I would probably do it differently today."

Some employees did complain to their representatives in Congress, who were disturbed to see jobs migrate from their districts. Two lawmakers from Maryland unsuccessfully sought to delay the relocation, citing both the strain on local workers who would be uprooted and questionable savings from the move. "Some people can't move and for them, this means losing their jobs," one congressional aide told the *Washington Post* in November 1978. But Schaeffer was able to counter the effects of these claims by meeting with William Schaefer, then mayor of Baltimore, and other legislators from Maryland to play up the benefits to the city that would accrue from an influx of new residents, new jobs, and new construction. He was also asked to brief Maryland Congresswoman Barbara Mikulski (now a US senator), but in general, upset about the move remained localized. "It was local politics," says Schaeffer, "not health care, or reorganization. It was jobs for Maryland."

Schaeffer also encountered resistance from bureaucracies outside HCFA, especially the Social Security Administration, which was reluctant to give HCFA the necessary office space at its new location. He found himself doing hands-on management to keep the move on track. "A lot of what you've got to do," he says, "is to physically make it happen. You go out and say, 'I want that building.' [You're told,] 'Well, it's a motel.' 'Well, tear down all the walls.' 'Well, we can't do that.' 'Well, give me a hammer and I'll do it.' ... There's tremendous inertia."

A final source of resistance—or, more properly at this point, concern—came from health care providers and the health care industry. While they saved their ammunition for later battles with Schaeffer, especially over his proposal for uniform reporting requirements for hospitals, representatives from various provider groups did talk with Schaeffer about the proposed move. "I met endlessly with the AMA and the AHA [American Hospital Association] and the Catholic hospitals and the children's hospitals and the home health agencies," he recalls. "You name it, every kind of provider in the world wanted to talk." Schaeffer tried to keep those conversations contained within his office. "I didn't like anybody going over my head, so I tried to handle that stuff," he says. Moreover, he felt it was his role to protect Califano and his undersecretary, Hale Champion. "They did not want to be bombarded by all these interest groups."

While providers were initially restrained in their reaction to events at HCFA, they tracked Schaeffer's moves closely. "The industry understood what ... this notion of leveraging ... was about," he says. "The people who really got it were the hospital industry and the pharmaceutical industry. And I was unaware that there was a lot of coverage [in industry publications]. ... They realized what was going on and they didn't want it to happen. They really didn't want it to happen."

The coverage, had he known about it at the time, would have been disturbing to Schaeffer, who was anxious to keep a low public profile for himself and for his organization. "My attitude was, 'I'm an internal guy, I'm not going to make media waves,'" he explains. "The secretary does the public stuff."

The View from the Top

Throughout the first hectic months as HCFA's chief, Schaeffer met with very little interference from Califano or Champion. "They left me alone, literally alone," he says. In a calendar crowded with months of meetings and planning sessions concerning the move and the reorganization, Schaeffer had only three or four briefings with the HEW secretary on those matters. Both men liked it that way. Califano, says Schaeffer, was "a very driven guy. He's extremely impatient. ... He had it in his mind that this move was important. ... And once it got started, once he got the sense that this was going to happen the way he wanted it to, he basically left me alone. And I took this whole idea about leveraging the health care system to its extreme. I think what he knew about he liked, and what he didn't know about, he delegated. ... He did not audit my work." Such freedom from direct oversight brought its attendant risks, but Schaeffer was untroubled by the exposure. "I was out on a limb, but it never bothered me," he recalls. "Clearly, if the thing had gone wrong, the limb would have been cut off and I would have gone down. But I liked that and I didn't feel exploited."

Underlying that trust between him and Califano was, Schaeffer believes, a shared ambition. "I wanted to make a difference," he explains, "and I think the place that Califano and I connected, maybe better than almost anybody else, is on that basis. He wanted to be in government to make a difference." The two men also shared an implicit understanding of their separate roles in HEW. "I think one of the reasons Joe liked me," Schaeffer reflects, "is that he was convinced that I knew some management secrets, and that I would work very, very hard, and that I would not get in the newspapers." Califano expected, moreover, that Schaeffer would "never get between [him] and politics, and would never get between [him] and the White House." It was also expected that Califano would handle the political side of dealings with Congress.

All of these implicit arrangements suited Schaeffer well, he says. He dealt primarily with staff—with OMB on the executive side and with congressional aides on the legislative side. He had little appetite for the horse trading that went on in Congress, or for extended debate and discussion on policy issues. "I find that after you have laid out what your world view is, laid out the pieces," Schaeffer says, "that I lose interest in the debate. I'd rather see if we can get something done. ... What I try to do is shorten the distance or the timespan between the conceptual thinking and making something happen," an especially important notion in government where, he believes, change "doesn't just happen, you have to force it."

The debates and discussions, moreover, "were not simply [about] what's the right thing to do. They're balancing acts—how do you build a constituency in Congress to get [other things] done. And Joe really wanted to play that game. That was his deal." Schaeffer, for his part, was happy not to play the game. "I developed good relationships with the [congressional] staff, but I would never do the trades on one issue in order to get support on another completely unrelated issue," he says. But, he notes, "I'm not afraid of politics. What I was not interested in was these unrelated trade-offs in the legislative process, which I think distort public policy."

Among the many demands of his job, the expectation that he would "not get in the newspapers" was a major source of worry. "In government," he says, "you're ruled by the media." One of his least pleasant tasks at HCFA was reading the "green sheets" every day—newsclippings on HEW culled from newspapers across the US. "Medicare and Medicaid were so big," he recalls, "that they were always in the green sheets. There was some scandal some place every damn day." Overall, however, Schaeffer was generally successful in keeping the changes and resulting turmoil at HCFA out of the newspapers. While there was a brief article on the relocation in the *Washington Post* the day after he announced the move, the issue soon faded from view. "Maybe one of the reasons it wasn't opposed more vociferously," he muses, "is that there was just too much going on and it was happening way too fast."

As Schaeffer was to learn later on in his tenure, his appearance in the press, especially in a negative light, would get Califano's attention immediately. "I was testifying [before Congress] one day," he recalls, "and talking about the need for improved reporting. Somebody said, 'Why do you need all this additional data?' And I said, 'Well, we really don't know precisely where the money goes.' [Next day,] headlines, across the country: 'HCFA chief says he doesn't know where the money goes.' That makes you sick." Schaeffer heard quickly about the news story: "I got a call from the secretary. [From] everybody. 'What happened?'" Fortunately, he adds, "by that time I had a good enough relationship with [Califano] that he was okay, he understood it." Such encounters with the press, however, left a legacy. "Everything becomes much more rehearsed," says Schaeffer. "... Roughly one-third [of his daily schedule] was spent in 'preps,' preparation meetings for whatever you're going to do next. And you become much more guarded about what you say in public. ... I had a reputation for being very frank and very outspoken and over time, you have to learn to control that."

But while he sought to keep negative press stories to a minimum, Schaeffer also worked to enhance HCFA's public standing and recognition. "We had an identity campaign," he says, which made use of HCFA's many publications to help "foster the new agency identity." For example, all publications were required to carry the new HCFA mission statement and a description of the agency. "Before I got to HCFA," Schaeffer notes, "it was an unknown agency. ... People used to call it 'Hifka' because nobody knew what it was. When I left, everybody had heard of it."

Exit

With the completion of the move and the integration of Medicare and Medicaid, Schaeffer began to concentrate his energies on cost-cutting issues—an area that was to prove more controversial than the reorganization. As it turned out, however, he would have only a little over a year to devote to the effort. In the summer of 1979, Califano left HEW, a casualty of an administration shake-up. Schaeffer stayed on to work under his successor, Patricia Harris, but eventually concluded that she was "a caretaker and not an innovator." He left HCFA in 1980, before the election that swept Ronald Reagan into the White House.

Summing up his achievements at HCFA, Schaeffer notes that "it's hard to evaluate whether this thing was successful or not" because of the lack of objective criteria in government. Nonetheless, he adds, with the integration of Medicare and Medicaid and the introduction of reimbursement reforms, he was able to prove "the theory that you could indeed leverage the rest of the health care system.

[Those reforms led to] the biggest single change in hospital reimbursement since 1965, and it slowed the rate of hospital cost increase, period." Moreover, he suggests,

> one of the ways that you evaluate success in bureaucratic situations is [to ask,] 'Does it last? Does the next administrator come in and change it?' And [the reorganized HCFA] lasted until [1991, when a Medicaid bureau was set up within HCFA]. That's phenomenal—that's 12 years or so of the history of a governmental entity. And from a public policy point of view, HCFA is still the major tool used by succeeding administrations to leverage the financing and delivery of the entire health care system.

After leaving the federal government, Schaeffer moved back into the private sector ("I was broke, dead broke," he says), but looked back on his time at HCFA with fondness:

> HCFA was tremendous fun. I worked seven days a week, and I just loved it. ... [It] was fun because I was younger, and I really thought we were going to change the face of American health care. I mean, this was not just big stuff, it was good stuff.

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After HCFA, Schaeffer moved into the nonprofit private sector, first as executive vice president and chief operating officer at the Student Loan Marketing Association and then as president of Group Health, Inc., one of the largest health maintenance organizations in the Midwest. While at GHI, which was headquartered in Minneapolis, he created a "hybrid plan" that combined features of HMO care and conventional fee-for-service insurance reimbursement. Such mixed health insurance packages, Schaeffer told *Business Week* in January 1986, were "a harbinger of what will happen nationally." When he moved on to his next job, as president and chief executive officer of Blue Cross of California (BCC) the following month, he was in a position to help fulfill his own prophecy. Before introducing such innovative schemes, however, he concluded he would have to "reinvent" the floundering health insurance giant from the ground up.

Background: An Ailing "Blue"

Schaeffer took up his post at BCC at a time when health insurers as a whole were reeling from record losses, brought on by sharp rises in medical costs and heavy expenses associated with starting up HMOs.[8] Many major insurance companies were reporting significant red ink, but none were hit harder than the 77 Blue Cross and Blue Shield companies in the US, whose total losses would amount to at

8 *New York Times*, February 15, 1988, p. D1.

least $1 billion for 1987 alone.[9] While most observers agreed that the "Blues" would, like other health insurers, rebound as higher premiums stimulated a recovery, there was also widespread consensus that more than the normal cyclic losses that afflicted the industry lay at the heart of their financial woes.

Originally formed in the 1930s by groups of hospitals and physicians, in an effort to provide coverage for all who needed it, spread costs, and attract business,[10] Blue Cross and Blue Shield companies had, in the 1980s, increasingly lost their once dominant market share to the competition, especially HMOs. While about 76 million people were still insured under Blue Cross and/or Blue Shield plans in 1988, that figure was some 10 million less than it had been at the start of the decade. Declining membership and deficits in the billions—along with criticisms of its member companies' management practices—had caused the Blue Cross and Blue Shield Association to be "shaken by doubts about its mission," the *New York Times* reported. "Officials of the association ... are grappling with the question of whether to be business-oriented or to continue to emphasize public service."[11]

Such grappling would perhaps be nowhere so painful as at Blue Cross of California, which had lost a total of $150 million over a two-year period. The struggling company had also seen its membership decline, from 3.7 million in 1984 to 2.9 million in 1987, and had lost its position as California's largest health plan to archrival Kaiser Permanente, an HMO.[12] When Schaeffer was appointed CEO, on February 27, 1986, the company was losing about $1 million a week. "We were really in a death spiral," says Schaeffer.

Schaeffer, then 40 years old, was, unusually for BCC, an outside hire. He had won the job after a six-month nationwide search had been conducted to find a replacement for his predecessor, who was retiring. "Blue Cross' bid to regain competitiveness," wrote the *Los Angeles Times*, "began ... when it looked outside its own ranks and hired Schaeffer." For his part, Schaeffer told the paper he had taken the job "because of the challenge of finding a way to control the costs of health care while not restricting its quality. 'That's what attracts me to this business,' he said."[13] The challenge would be a considerable one. What *Business Week* wrote about the "Blues" as a whole applied equally well to Blue Cross of California in particular: "[T]urning around that creaky behemoth will be a monumental task."[14]

Inside BCC

The company that Schaeffer took charge of in March 1986 was in some respects similar to the early HCFA. It was—more avowedly than HCFA—in the health care business, "paying out just the way Medicare did," says Schaeffer, "[in] after-the-fact, cost-based reimbursements." Like HCFA too,

9 The 77 independent Blue Cross and Blue Shield companies were loosely affiliated through a Blue Cross/Blue Shield Association, headquartered in Chicago.

10 *New York Times*, April, 2, 1989, p. 24.

11 *Ibid.*

12 *Los Angeles Times*, February 16, 1988, p. 9A; *New York Times*, February 15, 1988, p. D1.

13 *Los Angeles Times*, February 16, 1988, p. 9A.

14 *Business Week*, February 15, 1988, p. 32.

it essentially consisted of two separate, unintegrated units coexisting uneasily, and inefficiently, under the same organizational umbrella. Established in 1938, BCC had originally been two separate, independent companies—Blue Cross of Northern California and Blue Cross of Southern California. When the two firms merged in 1982, to form Blue Cross of California, "the weakest guy of the two," says Schaeffer, "was put in charge. He could not make key decisions." Consequently, BCC had a northern and a southern headquarters, in Oakland and Woodland Hills, each with its own personnel, payroll, and other administrative systems. In the degree of its lack of integration, BCC actually outstripped HCFA. "At least with HCFA," Schaeffer points out, "we had the discipline of a regular annual budget and appropriations process. You knew where people were." Not so, he found, at BCC: "I can remember asking where people worked, and it took about three weeks [to figure it out]. They brought in these charts, and [they] just didn't make any sense."

BCC was considerably larger than HCFA: some 6,500 employees in 1986—a "bloated work force," wrote the *Los Angeles Times*, that had not experienced layoffs in over 30 years. Not surprisingly, many of these employees—particularly those in the management ranks—were unenthusiastic about Schaeffer's appointment. "When I moved to Blue Cross," he recalls, "it was not a very happy homecoming. These people were quite upset that somebody who was not 'Blue' was running it, number one. Number two, I had a pretty lousy reputation in the Blue Cross/Blue Shield world because I was the guy at HCFA who told them that they were too expensive and there were too many of them. ... I can remember speaking at the Blue Cross/Blue Shield Association meeting in Washington and telling them that they were dinosaurs. ... So they weren't too happy to see me coming."

First Moves

In some respects, Schaeffer's first steps at BCC resembled those he had taken at HCFA. He planned to integrate the company's northern and southern units, consolidating the two headquarters in the Woodland Hills offices and, at the same time, completely restructuring their operations. As he had done with HCFA, he spent considerable time upfront working on a "conceptual framework—mission, goals, strategies," and created an internal publication—this time, the "President's Report"—to articulate and explain that framework.

But there were stark differences as well. With BCC hemorrhaging millions of dollars, Schaeffer's most immediate concern, he recalls, was "to control administrative costs." While he tried to do this to some degree by selling off some of BCC's assets, the chief means of control at his disposal were layoffs. At HCFA, Schaeffer reflects, "we couldn't lay anybody off because it was government. At Blue Cross, it was survival." Starting in the summer of 1986 and continuing over the next two years, Schaeffer trimmed back BCC's workforce from 6,500 to about 3,500. Between layoffs and attrition, there was massive turnover. By the end of the decade, he estimates, only about 2,000 of the employees he inherited were still at the company. "It was a terrible, terrible experience," he says.

Not all of it was purely negative, however. Schaeffer found much of the senior staff at BCC "ragingly incompetent. ... I've never seen a bunch of more self-centered, self-satisfied people. I'd go around and ask people, 'What business are we in?' And I assumed they would say, 'Insurance.' They never said that. They said they were in the business of being Blue Cross. Well, there's no market for being Blue Cross." Using techniques not available to him at HCFA, he "separated" most of them from the company—by buying people out, helping them find jobs, or dismissing them outright. "In nine months," he says, "there was nobody left of the senior officers I inherited. Nobody. They were all gone." Meanwhile, Schaeffer hired outside consultants and "dealt with them almost exclusively after about the first six months [at BCC]. And we did all these things ourselves—made all the plans and then implemented them across the company."

The layoffs came in big blocks, often involving hundreds of employees at a time. While cutting back on costs remained a central motive for the cuts, they were also done with an eye to rationalizing the organization. There were "huge organizational layers," Schaeffer says, separating key units of the company. "My theory was that those layers were killing us. ... So we got rid of huge blocks of people." For example, "there was a business systems group in between the computer [staff] and the business units. It had 357 people. They were laid off in one day. Just gone. Three floors of the building. It was terribly traumatic, [but] once they were gone, about two or three weeks later everything improved because people talked to each other, not to somebody in between." Over time, Schaeffer reduced the number of layers in the organization from nine to four.

Still, despite such short-term gains, the immediate effects of the layoffs were devastating. There were, says Schaeffer,

> 3,000 people [who were] going to lose their jobs, and maybe 50 of them were responsible for getting us into the trouble we were in. The rest of them were just ... following along. And now they've got to go home and tell [their families] that they're unemployed. That's a heavy price to pay. ... Towards the end, once we got down to the real paring, there were a lot of minority groups, single parents [being let go]. And they had to go for the greater glory of Blue Cross—not quite for the fate of the free world, not quite to help America ... not for the greater glory of the US health care system.

At one point, he adds, he installed management consultants as acting line officers "to do the dirty work, so that when I recruited new people, they wouldn't be tarred by the layoffs.[15]

Transforming BCC

While the rounds of layoffs continued, Schaeffer pressed on with the reorganization of Blue Cross. In his President's Reports, he had articulated two "priorities" for the company for 1986:

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15 Long after BCC had been restored to fiscal health, the memory of the layoffs lingered on. "One of the saddest things," Schaeffer says, was a worker's response to a company meeting he called in 1991 to announce a surprise bonus for all employees. After the meeting, "one of the women came up to me," he recalls, "and said, 'We were very nervous, because we thought we were being called together to be told we were going to be laid off.' ... They still think management is capable of that even though we're doing so well."

establishing "accountability and control," and improving "customer satisfaction." BCC's reputation for customer satisfaction had suffered in recent times. The company had been the subject of numerous consumer complaints and sharp criticism from state insurance regulators and the state attorney general. When Schaeffer first arrived at Blue Cross, *Business Week* reported, "complaints about poor service were so rampant that his secretary stopped announcing [his] name when she answered the phone."[16]

It was the goal of improving this sorry state of affairs that shaped the restructuring that Schaeffer, with the aid of his consultants, envisioned for BCC. Blue Cross, he explains was organized by function:

> [But] if you're in a business that has customers, they don't care how good your functions are, they don't care how good your accounting is, they don't care how good your claims processing is. ... They want whatever product or service they think they're buying. Blue Cross was organized to satisfy the professional standards and goals of the people employed there. But no one was responsible for a product or service. No one was responsible for a customer.

Schaeffer proposed to correct this structural mismatch by organizing the company around "market business units," each responsible for one of BCC's market segments—such as individual accounts, small group accounts, national accounts, etc. "What we tried to do," he explains, "was to build a market-driven organization. We broke it into ... 12 market business units. And the notion was that each market business unit was responsible for all of the functions. They could do whatever they wanted ... but they had a market segment they were accountable for, and they would be evaluated on customer satisfaction." Unlike HCFA, he notes, "which was designed to be a top-down implementer of administration policy, Blue Cross was restructured to become a bottom-up, customer-driven organization."

Schaeffer announced the new organizational scheme in a September 1986 President's Report, warning employees that it was "vital that Blue Cross of California become a market oriented company. ... " Over the next couple of years, he repeated this message again and again, and refined the organizational chart of BCC so that it no longer structurally resembled the company he had inherited.

At the same time, Schaeffer worked to change the products Blue Cross of California was offering its customers. "If you went out and asked the customer, even in 1986, 'What's the number one concern?' Well, [the answer would be] 'Health care costs so much.' [At BCC] you had cost-based retrospective reimbursements—fee-for-service insurance. There's no future for it. So we were losing money selling buggy whips." In place of the buggy whips, Schaeffer announced, in a President's Report, that BCC would, as part of a three-year "strategic plan," transform itself into a company that primarily offered "managed care" products. He began with a new HMO and over the next few years

16 *Business Week*, February 15, 1988, p. 32.

added on a "preferred provider organization (PPO)"[17] and an assortment of mixed packages aimed at all segments of the population. In creating these programs, Schaeffer notes, BCC was aided by the relative lack of regulation of the insurance industry in California; in 1982, California became one of the first states where selective contracting was permitted, so that insurers did not "have to pay everybody if they didn't want to." By 1992, less than 15 percent of BCC's business involved fee-for-service insurance—in contrast to more than 85 percent when Schaeffer first took the reins of the company. "We are no longer an insurance company," Schaeffer says. "We are in the business of creating provider networks on a contractual basis. ... We have the largest PPO in America today, the third or fourth largest HMO in California. There are few vestiges of the old Blue Cross."

Reaction

During this period of wrenching change, the most serious resistance Schaeffer faced came, not surprisingly, from workers at BCC. "The major obstacle to the reorganization and the move of Blue Cross [headquarters, from Oakland] was the employees," he says. "And in Oakland, which is a minority group city, they turned it into a racial issue." Laid-off employees in Oakland, who unlike their southern California counterparts were unionized, went to the city council and to the local newspaper, and "accused Blue Cross of racism, and me of racism. ... I'd never been accused of that in my life." As a result, "we got just terrible press in the *Oakland Tribune* ... and of course, that got picked up. That got into the *San Francisco Chronicle* and then all across the state."

Schaeffer countered the barrage of bad press by drawing on lessons he had learned from Eileen Shanahan, assistant secretary for public affairs under Califano: "you've really got to have your press operation under control," and "develop a simple message and beat on it." BCC "didn't have a decent press operation," he recalls, "so we had to hire competent people [and] communicate a consistent message." Thereafter, all layoffs, he says, were "extremely carefully planned out, down to who would tell who what and physically where and when during the day, so that it wouldn't get to the newspaper that day." Employees were told of layoffs in large groups, "so nobody heard from somebody else. They all heard directly." Schaeffer and his staff worked on mock press releases and mock interviews with reporters; they drilled managers on what to say to employees who came to talk with them. No one other than Schaeffer or his press officer was allowed to talk with members of the press. The emphasis, says Schaeffer, was "consistent communication. We wanted the story to be thought through before it happened." Still, the press coverage managed to make things unpleasant for him. "For the first two years [at] Blue Cross," he remembers, "not only were we laying off people, and that was ugly, but I was just being pounded by the press all the time for firing black people, firing women, single parents. It was really ugly."

In personal terms as well, Schaeffer found the task of axing hundreds and hundreds of people the most distressing part of his job. Recalling his younger self at HCFA, he says, "I was not real big on

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17 A preferred provider organization establishes a network of physicians and hospitals that agree to offer discounts to subscribers. BCC had actually set up an HMO—Health Net—some years back, but had lost management control of it in 1983.

empathy when I was thirty years old," but at forty, he felt differently. "For the first two-and-a-half years, there were all those layoffs," he remembers. "They were not fun. ... You had the sense that you were indecently interfering with people's lives."

While he was feeling pressure from below, there was pressure coming from above as well, but with little direction. The situation, he says, was "quite similar to HCFA, in fact, even more so—I had a clear-cut goal but I didn't have any direct supervision. [Board members] made it very clear they wanted Blue Cross to recover quickly, but they expected me to figure out how to do it." The company was governed by an 18-member board (plus Schaeffer), none of whom (with the exception of Schaeffer) were BCC employees or insurance experts. Schaeffer met with the board periodically—once a month at the height of BCC's fiscal woes—but, he notes, board members were, necessarily, observers. "What's an outside board going to do?" he asks. " ... In a time of crisis like we had at Blue Cross, there's not much a board can do, and frankly, there's not much an outside group of people can do. You need a top-down decisionmaker, because in some cases, it matters less what you do than that you do something." In a crisis situation, he continues, a board's real task is to hire and fire the CEO. "That's basically it. When you're in that much trouble, you've just got to go with it." The BCC board had evidently reached the same conclusion. "I was just running [BCC]," Schaeffer says, "because everybody thought the place was going to go down."

Results

By 1992, it was clear that BCC would not, in fact, "go down." After a couple of more years of diminishing red ink, the company reported a net gain in 1989. Two years later, Schaeffer could report profits of more than $13 million per month. On a variety of measures, BCC compared favorably with its competitors, Blue or non-Blue, in the health insurance industry. And while most other Blue Cross/Blue Shield organizations had also begun showing profits, by 1991 BCC was, says Schaeffer, the "most profitable and fastest growing" Blue plan in the country—as well as the most profitable and fastest growing health plan in California. Moreover, while other BC/BS plans showed signs of cyclic leveling off in 1991, BCC's net gain and enrollment continued to rise.

Prosperity brought the obvious rewards—announcements of bonuses instead of layoffs, good press, elevated status (Schaeffer was named chairman of the BCC board of directors in 1989). It also provided Schaeffer the opportunity to expand his and his company's horizons. The goal of his first two years at Blue Cross, he reflects, was "basically survival"; of the second two, "to build financial strength"; of the third two, "growth with profitability." In this most recent period, Schaeffer also envisioned a stronger voice for BCC in public policy. In his periodic reports—now called the "Chairman's Report"—he began to include in the company's "corporate goals" the aim of "provid[ing] leadership in developing private insurance solutions to public policy concerns." As part of that goal, he launched a "Fill the Gaps" program in 1991, with the aim of developing "innovative, affordable insurance for underserved groups" and "advocating and participating in broader public policy initiatives" on health insurance. The program reflected Schaeffer's belief that "we're in a position to do things today [to remedy the nation's health insurance crisis]. That's my focus—let's do things today, as opposed to 'let's build a plan that will go into effect in '94, be fully operational in '98, and then we'll have a conference in 2002 about why it doesn't work.' I guess I'm an incrementalist, or a 'let's-fix-it-now' advocate."

With this mission in mind, Schaeffer and his company had become "much more active in the public policy arena than anybody else in health insurance." The goal, he reflects, "is oddly enough coming out to be the same as we had at HCFA, which is trying to leverage the ... health care system," in this case in California. Schaeffer believed the policy solution to the health insurance problem was more likely to surface on the state than on the national level and, he says, "we're [i.e., BCC] now a major player in California, so we can influence state policy." Musing on the private sector's role in public policy, he adds:

> You have standing in government by virtue of [being] the administrator of HCFA. They've got to deal with you. To have standing in policy development [when you're] in the private sector, you either have to represent a whole lot of people or you have to be so strong and powerful that they can't do it without you. You can't make health policy in California without Blue Cross because we're too big—you can't go around us. ... I came to California to do good and to do well, to change the California health care system and get paid for it. As it turned out, I spent four years rebuilding a company for financial reasons only. And it really turns out that in the private sector, first you have to do well before you can do good.

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Reflections

Looking back on his experience in the public and private sectors, and in particular at HCFA and BCC, Schaeffer sees a number of similarities in the tasks he faced in both organizations, but some vast differences in the terms under which he could do his job. "Within the parameters of a private company," he says, "you have much greater control. You sort of own and control a certain field of action. Within those parameters, you have tremendous leeway. At the government level, it's a much broader canvas, but there are many more constituencies that you have to deal with, and nobody is in complete control."

In exerting control, Schaeffer believes, private sector managers had the "luxury" of a bottom line, as a tool to set goals and measure achievement. "I think the overwhelming problem [in government] is the lack of an endgame that's reducible to objective criteria," Schaeffer says. As a result, employees at agencies like HCFA could "connect themselves only with very intermediate processes," which tended to be far removed from the ultimate purpose of the task in hand. Managers in the public sector, he adds, resorted to tactics that at least gave the illusion of objective criteria, but there were drawbacks: "The management way is to break [the organization] down into smaller units. You can assign a task, you can monitor, but the tasks undertaken are so far away from the end result of the program that staff lose sight of what they're about."

The urgency of a bottom line, moreover, helped shape consensus on goals and a course of action. Despite the far more wrenching changes at BCC than at HCFA, Schaeffer found it a more straightforward matter to proceed with reorganization and innovation at the former. "At Blue Cross it was much easier," he says. "[We were saying] 'We want to stop losing money. We want to lower our costs. We've got to be profitable.' ... People all say, 'Yeah, profits, assets, growth, all good.' You don't have to persuade people it's necessary. Try to persuade people what's good about HCFA." In the public sector, with its many constituencies, "You're fighting a war on multiple fronts. What makes sense on one front ... is a loss on another front. ... So it's harder to get people to coalesce around some objective definition of success."

Schaeffer also found more agreement in the private sector about the value of change. At HCFA, he says, "we did more in a short period of time than most people do in a lifetime, in terms of change. ... I'm proud of what I did in government, but maybe there are fifty people outside of government who understand what happened and feel it was worth it. ... In the private sector, [change] is highly valued. ... The private sector is real simple. You take a company that's losing $1 million a week, you make it into a company that's making $4 million a week, and a lot of people want to talk to you."

The shared goals and values in the private sector made it easier for Schaeffer to win the support of his governing board. "A board of directors in a for-profit company," he points out, "has a very defined role and a very defined self-interest, and that is to maximize value for shareholders. It's a little tougher at a [nonprofit like BCC], but the board has clear obligations to the policyholders and to the company." The private sector board's analogy in government—Congress—on the other hand, "acts in two totally different ways"—when it votes and when it deals with individual constituents. The results are often contradictory and frequently maddening to a government manager seeking to implement the laws passed by Congress. "I used to get thousands of letters [from members of Congress] about problems people had with Medicare," Schaeffer recalls. "You know, 'I want old Mrs. Smith to get her heart transplant. Now I may be against advanced technology, and as a matter of fact I voted against it, but back in my home town, Mrs. Smith gets her heart transplant, dammit, because she votes for me.'" Schaeffer encapsulates the difference as he experienced it in two rhetorical questions: "Is my board united behind me at Blue Cross? Absolutely. Is the Congress united behind me at HCFA? Never. Never."

Still, for all its drawbacks and frustrations, Schaeffer thinks that "eventually I'd like to get back to government." He has no illusions about how hard that might be after his years of success in the private sector. "My observation," he says, "is that career business people going into government self-destruct." He explains:

> When you're young and naive and inexperienced, everything seems possible. You work 24 hours a day and you really think

> you're making a difference. Today, if I went back and had to go through some of this bullshit after the experience I've had ... now I know how silly some of this stuff was. ... Because I was so young, I didn't realize it was silly. It didn't bother me to go up to the Social Security [Administration], be told I couldn't have the floor [to move HCFA to]; to hire my own [moving] truck, fill out the forms—we did all that stuff ourselves. Today, I'd say, "What kind of baloney is this?"

Nonetheless, working in the public sector has its attractions, at least for Schaeffer. He sums up his feelings this way:

> I really liked my experience in Washington because in the realm where I functioned I was relatively unencumbered, and probably the only guy who was more impatient than Califano was me. ... I got tired of negative media. I got very tired of those green sheets everyday; I had to get up at dawn and read those things and find out where [we] were in trouble. ... In California, I get tired of narrow financial goals. ... One [arena] is narrow, yet you're in control and you can measure results. The other is broader, but you can't control it. There are all these constituencies. But it's much more challenging. It's much more interesting stuff.

Leonard D. Schaeffer
Chairman & CEO
Blue Cross of California

■ Leonard D. Schaeffer has been **Chairman of the Board of Directors of Blue Cross of California** since 1989. He also serves as **Chief Executive Officer**, a position he has held since 1986. Schaeffer directs the largest health insurance organization in California, serving more than 5 million people. With over $1 billion in assets, Blue Cross annually administers approximately $8 billion in benefits and is staffed by 3,500 employees in 13 offices throughout the State.

■ Schaeffer joined Blue Cross of California after serving as **President of Group Health, Inc.** GHI, one of the largest health maintenance organizations in the Midwest, introduced the concept of comprehensive, prepaid health care to the Twin Cities area and provided services in 29 GHI medical centers.

■ Schaeffer was formerly **Executive Vice President and Chief Operating Officer of the Student Loan Marketing Association**, a $4.6 billion financial institution.

■ Previously, Schaeffer was the **Administrator** of the **Health Care Financing Administration** (HCFA) in the U.S. Department of Health and Human Services. HCFA includes the federal Medicare, Medicaid, Peer Review Organization (PRO), licensure and certification, and quality control programs. In fiscal year 1980, HCFA financed health care services for 46 million beneficiaries through 400,000 health care providers. At that time HCFA's budget was $48.5 billion, including 5,000 federal employees and 85,000 full-time equivalents employed by private carriers, fiscal intermediaries, and state and local governments.

■ As **Health, Education and Welfare's (HEW) Assistant Secretary for Management and Budget**, Schaeffer was responsible for the Department's budget ($194 billion in 1980), financial management, organizational control, automated systems, and facilities management.

■ Before joining HEW, Schaeffer was **Vice President of Citibank, N.A.**, responsible for business planning and financial management for the Services Management Group.

■ He also served as **Director of the Bureau of the Budget for the State of Illinois**, where he developed and executed the State's $10 billion annual budget and was responsible for state cash and debt management. Schaeffer also headed the **Illinois Planning Office** and was **Chairman of the Illinois Capital Development Board**, where he oversaw all state construction activities.

Blue Cross
of California

■ Earlier, Schaeffer had been **Deputy Director for Management, Illinois Department of Mental Health and Developmental Disabilities**, where he was responsible for financial and management functions for this 20,000 person, $400 million-a-year organization which operated 28 hospitals and more than 100 community programs.

■ Schaeffer was previously **Chief Operating Officer** of a private investment banking firm. Before that, he was a **management consultant for Arthur Andersen & Company**, where he specialized in design and implementation of large computerized management and financial information systems.

■ Schaeffer is active on the boards of numerous business, philanthropical, and professional organizations.

■ A native of Evanston, Illinois, he is a graduate of Princeton University. Schaeffer and his wife, the former Pamela Sidford, have two children.

Awards and Affiliations

U.S. Congressional Prospective Payment Assessment Commission (ProPAC): Member

International Fellow: King's Fund College, London, England

PEW Health Professions Commission: Member of the Commission

National Health Foundation: Member, Board of Trustees

Managed Healthcare: Member, Editorial Advisory Board

University of Southern California, School of Public Administration: Member, Board of Councilors

Town Hall of California: Member, Board of Governors

The Music Center (Los Angeles): Cabinet Chairman

The Cultural Foundation (Woodland Hills): Member, Board of Directors

Valley Industry and Commerce Association: Member, Board of Directors

Blue Cross and Blue Shield Association: Member, Board of Directors and Executive Committee

Distinguished Public Service Award: U.S. Department of Health, Education and Welfare

Corporate Social Responsibility Award: Hispanic Medical Students Scholarship Program, University of California

Citation for Outstanding Service: American Academy of Pediatrics

Kellogg Fellow: W.K. Kellogg Foundation

1990 Human Relations Award: San Fernando Valley Interfaith Council