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October 14, 2011

**Via Email and U.S. Mail**

The Honorable Battle R. Robinson  
104 West Market Street  
Georgetown, DE 19947

***RE: Proposed Affiliation of BCBSD, Inc. ("BCBSD") with Highmark, Inc.  
("Highmark")***

Dear Judge Robinson:

From October 5 through October 7, 2011, a public hearing was held before Your Honor with regard to the proposed affiliation of BCBSD with Highmark (the "Proposed Affiliation"). At the public hearing, the Attorney General of the State of Delaware (the "AG") made a statement to which counsel for BCBSD later responded. These statements related to the condition proposed by the AG (together with his staff, the "Delaware Department of Justice" or the "DOJ") by letter dated October 4, 2011, that BCBSD and Highmark must establish a mechanism to guarantee that the public's investment in BCBSD remains in Delaware to be held and protected for the benefit of Delawareans, specifically, to serve the State's unmet health needs. Counsel for BCBSD had previously responded to the DOJ's proposed condition, articulating basically the same arguments, by letter dated September 28, 2011. We appreciate this opportunity to respond to issues raised by BCBSD's counsel in that letter and at the hearing with regard to the DOJ's proposed condition.

*These proceedings are the appropriate forum for considering the proposed condition.*

On behalf of the people of the State of Delaware, the AG opposes the Proposed Affiliation, which will shift control of BCBSD and the assets built over 75 years of public subsidy, from Delaware to Pennsylvania. The relevance of the DOJ's opposition on behalf of Delawareans can hardly be overstated in proceedings in which control of substantial subsidies made by the public over several decades to a Delaware not-for-profit entity are at issue. Just as Your Honor ruled that it would be inappropriate to exclude the AG from asserting his opposition and advocating for protection of the public's funds at the hearing, it is equally inappropriate to remove from consideration one possible mechanism to protect for Delawareans those publicly subsidized assets of BCBSD.

Pursuant to the Pre-Hearing Order issued by the Delaware Insurance Commissioner (the “Insurance Commissioner”) on October 20, 2010, the Delaware Department of Insurance (the “DOI”), Highmark and BCBSD affirmed that the AG, representing the State in his capacity as *parens patriae*, is a party to these proceedings. The affirmation of this status recognized that the change of control of a Delaware not-for-profit healthcare entity merits a full review from the perspectives of all the stakeholders, including the 70% of Delawareans who are not BCBSD members but who have subsidized BCBSD,<sup>1</sup> and that the interest of the DOJ in representing the people of the State of Delaware is substantial and should be part of the proceedings. The Administrative Procedures Act, 29 *Del. C.* §§ 10101 *et seq.*, does not limit the suggestions a party may make for the hearing officer’s consideration. Such authorization for parties clearly implies an ability to propose conditions for the hearing officer’s consideration and recommendation to the reviewing agency.

The Pre-Hearing Order does not limit consideration of whether the Insurance Commissioner should approve the Proposed Affiliation to those specific criteria found at 18 *Del. C.* § 5003(d)(1). While the Pre-Hearing Order does reference such criteria as being applicable, they are not the only applicable criteria to a consideration of whether the Insurance Commissioner should approve the Proposed Affiliation. Your Honor stated in your opening remarks at the public hearing on October 5, 2011, that you “must make certain that the proposed affiliation meets the criteria set out in 5003(d)(2) and complies with the statutory conditions of the new Section 6311.”<sup>2</sup> Without limitation as to any other statutory or common law authority, 18 *Del. C.* § 6311 (“Section 6311”) expressly requires the Insurance Commissioner’s consideration of conditions to protect the surplus or reserves of BCBSD and thus consideration in these proceedings of such mechanisms is appropriate and necessary. Your Honor also stated that the conditions that are expressly required by certain subsections of Section 6311 in connection with a change of control of an entity like BCBSD are “without limitation,”<sup>3</sup> indicating that additional conditions beyond those expressly set forth therein may be appropriate. The DOI, for example, has proposed numerous conditions which have been agreed to by BCBSD and Highmark that are outside the strict application of the Section 5003 criteria and those expressly required by Section 6311. The DOJ’s proposed condition, which goes to the protection of the surplus of BCBSD for the benefit of Delawareans who subsidized it, is such a permitted condition.

The appropriateness of the DOJ’s proposed condition in this forum is underscored by the provision in Section 6311 that requires the giving of notice to the AG with regard to activities which must be approved by the Insurance Commissioner, including pursuant to conditions relating to the protection of BCBSD’s reserves and surplus. These notice requirements clearly contemplate the AG’s role and interest in the preservation of

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<sup>1</sup> Timothy J. Constantine testified that BCBSD has an approximately 30% market share in Delaware. Hearing Transcript in the Matter of Proposed Affiliation of BCBSD, Inc. with Highmark, Inc. (October 5, 2011), at p.89. The public subsidy, however, is from all Delawareans.

<sup>2</sup> Judge Robinson, *id.*, at p.7.

<sup>3</sup> *Id.*

BCBSD's surplus and reserves from his perspective as the protector of the publicly subsidized assets included in such surplus and reserves.

The DOJ's proposed condition is thus squarely within the statutory criteria applicable to Your Honor's review of the Proposed Affiliation.

*The proposed condition is appropriate in the context of a change of control of a Delaware not-for-profit healthcare entity.*

As explained in greater detail in the Pre-Hearing Memorandum of the DOJ, the condition proposed by the DOJ is essential to ensure that the public's subsidy of BCBSD will be preserved and protected for Delawareans after control of the assets has been shifted outside of Delaware. This protection is not only the responsibility of the DOJ on behalf of Delawareans but is contemplated by the conditions required to be imposed by the Insurance Commissioner under Section 6311(b), as discussed above. If such assets are to be protected, the funds cannot remain subject to the control of BCBSD once BCBSD becomes controlled by Highmark. The only way to truly safeguard these funds for Delawareans in fulfillment of their original purpose is to place them in a Delaware foundation or similar mechanism which will use them solely for the public benefit of the citizens of Delaware.

*Section 6311(b) does not limit the preservation of surplus or reserves to maintaining all such funds available for use in the health service corporation's insurance business.*

Section 6311(b) requires the Insurance Commissioner to impose conditions to preserve the surplus or reserves of BCBSD. It does not specify that the exclusive use of the funds preserved is to be for purposes related to BCBSD's insurance business, as asserted by BCBSD, nor even that the funds preserved must be maintained within BCBSD. BCBSD has requested that the withdrawal of reserves "for a purpose other than the protection of the policyholders and the company" not be considered. As affirmed by provisions in the Not-for-profit Healthcare Conversion Act, 29 *Del. C.* §§ 2530 *et seq.*, however, at least some portion of such reserves constitutes the "public benefit asset" of BCBSD attributable to seven decades of subsidies by all Delawareans, not just the 30% who are policyholders. The DOJ's proposed condition serves to protect a portion of the reserves for the unmet health needs of members of the public who subsidized the accumulation of the reserves.

Counsel for the DOI introduced testimony at the hearing about the possible future need of the company in the event of a "Doomsday Scenario" for the reserves the DOJ seeks to protect. Such testimony directly questioned the prudence of setting aside the \$45 million amount proposed by the DOJ as a minimum.<sup>4</sup> Accordingly, we view a response at this time to be appropriate, separate and apart from testimony that would be provided

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<sup>4</sup> DOI's counsel, Hearing Transcript in the Matter of Proposed Affiliation of BCBSD, Inc. with Highmark, Inc. (October 6, 2011), at p.448.

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in a subsequent valuation hearing. The minimum amount of \$45 million for a foundation that the DOJ has proposed as a condition is based on calculations performed by Grace Global Capital, LLC ("GGC") using very conservative assumptions. GGC used the excess capital methodology in arriving at this amount; the alternative valuation approach would be the tax regression methodology, which would have resulted in a substantially higher amount based on the tax and other benefits BCBSD enjoyed by virtue of its not-for-profit status in Delaware. Indeed, the excess capital methodology with different assumptions could also result in a substantially higher amount. The excess capital methodology produces an estimate of the amount of public subsidy that exceeds BCBSD's actual business needs, taking into account the proposed affiliation with Highmark and, among other things, the Highmark guaranty of claims, the \$45 million line of credit available to BCBSD, and BCBSD's access to the Highmark information technology systems and administrative services.

BCBSD's ability to continue to pay its members would not be impaired by contributing this amount to a foundation. BCBSD's Risk-Based Capital ("RBC") of 1,056% is ranked the eighth highest in comparison to the 33 not-for-profit Blue plans in the country. After reducing the surplus by \$45 million to satisfy the DOJ's condition, the resulting RBC percentage of 778% would still be substantially in excess of regulatory and the Blue Cross Blue Shield Association minimums, and BCBSD would retain a material level of capital and surplus, plus the Highmark guaranty, as a cushion against future contingencies. Moreover, the DOJ would be willing to consider some flexibility in terms of a funding schedule and a suspension of payments in the event of financial distress. It should be noted that BCBSD's ability to fund the \$45 million is not entirely dependent on the company's annual income, but should also be viewed in the context of the entire extremely strong balance sheet, including the company's surplus as well as the Highmark line of credit and guaranty. Furthermore, if \$45 million were paid in equal installments over time (e.g., 5 years), the impact on the company's RBC percentage would verge on immaterial with the resulting RBC estimated to be 1,000%.

For all these reasons, the DOJ submits that these proceedings are an appropriate forum for consideration of the DOJ's proposed condition, and requests that Your Honor so find and, further, that Your Honor recommend imposition of the DOJ's condition on Highmark and BCBSD.

Respectfully submitted,



Ian R. McConnel

cc: See attached service list (by email only)

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