BEFORE THE INSURANCE COMMISSIONER
FOR THE STATE OF DELAWARE

In Re: The proposed affiliation of	)	
BCBSD, INC., doing business as	)	Docket No. 1509-10
Blue Cross Blue Shield of Delaware,	)	
with HIGHMARK INC.	)	

PRE-HEARING MEMORANDUM OF THE DELAWARE DEPARTMENT OF INSURANCE

MORRIS, NICHOLS, ARSHT & TUNNELL LLP
Michael Houghton (#2179)
Leslie A. Polizoti (#4299)
Ryan D. Stottmann (#5237)
Brenda R. Mayrack (#5253)
Bryan Townsend (#5538)
1201 N. Market Street
P.O. Box 1347
Wilmington, DE 19899-1347
(302) 658-9200
Attorneys for the
Delaware Department of Insurance

September 21, 2011

TABLE OF CONTENTS

TABLE OF CONTENTS (Continued)

TABLE OF AUTHORITIES

Page(s)

OTHER AUTHORITIES

RULES AND STATUTES

TABLE OF AUTHORITIES (Continued)

Page(s)

INTRODUCTION

BCBSD, Inc. ("BCBSD"), generally known as Blue Cross Blue Shield of Delaware, and Highmark Inc. ("Highmark"), a non-profit corporation that operates as a hospital plan and a professional health services plan in Pennsylvania, propose to affiliate pursuant to several negotiated contracts whereby Highmark would gain control of BCBSD and become the only entity able to use the "Blue Cross" and "Blue Shield" marks in Delaware, in exchange for guaranteeing all of BCBSD's claims and providing administrative, corporate, and strategic support to BCBSD ("the Affiliation"). The decision of the BCBSD Board of Directors to enter into a strategic partnership with Highmark, and of Highmark to file an Affiliation Statement with the Department, requires the Delaware Insurance Commissioner to evaluate the proposed Affiliation pursuant to Title 18, Chapter 3 of the Delaware Code.

The Department of Insurance (the "Department") is charged with determining whether the proposed Affiliation complies with certain statutory criteria requiring consideration of issues of fundamental importance to Delaware policyholders and the public interest. The application of these criteria to the proposed Affiliation has caused the Department to focus particularly on whether the Affiliation protects BCBSD's significant reserves, keeps meaningful local control of BCBSD in Delaware, does not provide BCBSD executives with "golden parachutes" or other financial incentives to enter into the Affiliation, and allows BCBSD to stand on its own if the Commissioner approves the proposed Affiliation and there is a later disaffiliation.

Under the terms of the proposed Affiliation, BCBSD will continue to exist as a separate, not-for-profit Delaware non-stock corporation, and Highmark will become the sole member of BCBSD. BCBSD will continue to be subject to the Commissioner's general regulatory authority. Highmark will become the sole Delaware licensee of the Blue Cross Blue Shield Association[1] ("BCBSA"), entitling Highmark to use the "Blue" names and service marks in Delaware ("Blue marks" or the "marks"). In exchange for becoming BCBSA's sole Delaware licensee, Highmark will guarantee—to the full extent of Highmark's assets—all of BCBSD's contractual and financial obligations to BCBSD customers. In order for Highmark to become the primary licensee, and according to certain BCBSA guidelines, BCBSD must become a "controlled affiliate" of Highmark. Becoming a "controlled affiliate" requires BCBSD to give a specified amount of control to Highmark, including the ability to elect a majority of BCBSD's Board of Directors, control BCBSD's governance structure, and exercise control over BCBSD's policy and operations. (*See* Ex. 1, BCBSA Guidelines). The Affiliation is not, however, the same as a merger. BCBSD will still remain a standalone company, and many aspects of the Affiliation attempt to preserve BCBSD's autonomy and local presence. For example, while BCBSD will receive administrative, corporate, and strategic support from Highmark, and will migrate to Highmark's technology systems, BCBSD will still remain locally-managed for such "market-facing" functions as sales and distribution; provider relations and provider contracting; and community affairs, and will be assisted by Highmark in connection with, for example, product development and marketing, member and provider service, claims, billing, and enrollment. The Affiliation does not give Highmark the right or ability to use or control BCBSD's reserves, and the Department seeks to impose conditions that will prevent Highmark from having any behind-the-scenes ability to do so.

---

[1] The Blue Cross Blue Shield Association is "a national federation of 39 independent, community-based and locally operated Blue Cross and Blue Shield companies." BLUE CROSS BLUE SHIELD ASSOCIATION, http://www.bcbs.com/about (last visited Sept. 14, 2011).

With the assistance of legal, financial, and technology advisors, the Department has analyzed the Affiliation and applied the statutory criteria in 18 *Del. C.* § 5003(d)(1). The Department has had experienced reviewing and approving—and dismantling—a BCBSD affiliation in the past, namely the affiliation with CareFirst, Inc. ("CareFirst") initially approved in 2000 ("CareFirst Affiliation"). In no small measure due to the experience of the CareFirst Affiliation, the steps taken to protect Delaware's interest in that transaction, and the challenges in unraveling that arrangement, the Department has applied special scrutiny to the proposed service and support costs that Highmark will charge BCBSD, the executive compensation agreements of BCBSD executives, and the means of unwinding the Affiliation (if necessary) and of returning the Blue marks to BCBSD. The Department has also considered the impact the Affiliation is likely to have on employment as well as continued involvement with the community in Delaware by BCBSD, as well as the protections in place designed to maintain BCBSD's local control.

Although the Department concludes that the Affiliation should be approved, the Department's conclusion—informed by the Department's history with affiliations—is expressly contingent on acceptance of the conditions the Department here recommends, as well as others it continues to discuss and develop with the parties. These conditions are critical to assuring Department oversight of the assumption of control of one of Delaware's largest not-for-profits—and Delaware's largest non-investor-owned health insurer—by an out-of-state company not subject to the direct oversight of Delaware regulators charged with protecting Delaware interests. Without conditions relating to, among other things, prior Department review and approval of costs allocation and related items, unwinding the Affiliation if key commitments are not satisfied, assured levels of service to Delaware consumers, and best efforts undertaking by Highmark to return the marks to BCBSD upon disaffiliation, the Department cannot support the proposed transaction. With these conditions, the Department believes the risks and complications of foreign control of Delaware's largest not-for-profit domestic insurer are adequately controlled and the Delaware public protected and benefited.

Moreover, while neither jobs nor commitments to community organizations are criteria for the Department's review of this application under Chapter 50 of Title 18, the Department has been, and continues to be, in discussions with the Applicants encouraging them to make significant commitments relating to employment as well as continued financial commitments to community organizations subsequent to any affiliation. Some of these commitments are stated here as conditions only because the Department understands the Applicants have voluntarily agreed to them, and it is, therefore, useful to memorialize them in this manner. Whether other such voluntary commitments will be made is unclear, but the Department is continuing to encourage commitments which will be of substantial value to the State and its citizens.

This memorandum presents the Department's analysis of the Affiliation, including a description of conditions which the Department will request that the Commissioner impose on the Affiliation. Subject to the Commissioner imposing these conditions, the Department recommends approval of the Affiliation.

PROCEDURAL HISTORY

On August 19, 2010, BCBSD and Highmark (collectively, the "Applicants") signed a Business Affiliation Agreement ("Affiliation Agreement"). On October 7, 2010, Highmark filed an Affiliation Statement with the Department.[2] The Affiliation Statement seeks

---

[2] Highmark amended its filing on five occasions: January 14, 2011 (to complete its application to the Department by providing biographical information of its directors and executive officers, and BCBSD's financial pro formas); March 14, 2011 (to update

the Department's approval for BCBSD to affiliate with Highmark. BCBSD is a nonprofit health service corporation in the State of Delaware. BCBSD is governed by 18 *Del. C.* § 6301 *et seq.* and is subject to the general regulatory authority of the Delaware Insurance Commissioner (the "Commissioner") under 18 *Del. C.* § 301 *et seq*. Given the Commissioner's regulatory authority over BCBSD, Highmark seeks the Commissioner's review and approval of the proposed transaction ("Affiliation") and the Commissioner's finding that the Affiliation fulfills the requirements of 18 *Del. C.* § 5003(d)(1) ("Section 5003").

The Commissioner entered an order on October 20, 2010 (the "Pre-Hearing Order"), indicating that the Commissioner would conduct an inquiry pursuant to 18 *Del. C.* § 317 and would appoint a Hearing Officer to conduct a public hearing. (Pre-Hearing Order, ¶ 1). In a November 4, 2010 Order, the Commissioner appointed The Honorable Battle R. Robinson as Hearing Officer.

The original parties to the proceeding were Highmark, BCBSD, the Department of Insurance, and the Department of Justice. (*See, e.g.*, Pre-Hearing Order, ¶ 3-4). Although one individual sought party status, in a January 18, 2011 oral ruling and in a subsequent written order issued on January 25, 2011, the Hearing Officer determined that this individual did not meet the criteria for becoming a party. (*See* Jan. 25, 2011 Order; Transcript from Jan. 18, 2011 Public Hearing. *See also* Pre-Hearing Order, ¶ 4). Specifically, the individual did not have a pecuniary interest in the proceedings beyond her interests as a policyholder, and the Hearing Officer

BCBSD's pro formas); March 24, 2011 (to update its financial statements and those of certain affiliates); July 19, 2011 (to update biographical information); and August 29, 2011 (to update biographical information, to update BCBSD's pro formas, and to provide recent financial statements). Pursuant to a February 23, 2011 order from the Hearing Officer, the BCBSD financial pro formas and certain biographical information are designated as "Confidential," and redacted versions of these documents have been posted on the Department's website. (*See* Feb. 23, 2011 Order).

determined that the individual's overall interests would be adequately protected by the Department, which is a party to the proceeding, and by the Attorney General's "*parens patriae*" role and party status in the proceeding, and from the Section 5003 statutory criteria the Commissioner must consider when determining whether to approve the proposed Affiliation. (*See* Jan. 25, 2011 Order; Transcript from Jan. 18, 2011 Public Hearing.).

From January 2011 through September 2011, the Department conducted discovery of the Applicants, including requesting documents from the Applicants related to a broad set of topics.[3] These topics included but were not limited to: (i) the development of BCBSD's financial pro formas; (ii) BCBSD studies on its information technology ("IT") needs; (iii) BCBSD's strategic review process; (iv) plans for migration and integration of BCBSD systems onto Highmark systems; (v) negotiations of the Affiliation between BCBSD and Highmark; (vi) records of BCBSD and Highmark's due diligence and integration plans; (vii) BCBSD executive compensation; (viii) plans for BCBSD's future operations; and (ix) the impact of the proposed Affiliation on BCBSD policyholders and on stakeholders and the Delaware community more broadly, including pricing, provider relations, and customer relations. (*See, e.g.*, Jan. 21, 2011 Request to BCBSD; Jan. 21, 2011 Request to Highmark).

The Department retained three advisors to assist with its review of the proposed Affiliation. The Department's legal advisor is Morris, Nichols, Arsht & Tunnell LLP. Blackstone Advisory Partners L.P. ("Blackstone") was engaged as the Department's financial advisor to conduct an analysis of potential financial and economic impacts of the proposed Affiliation, including elements of the statutory criteria found in 18 *Del. C.* § 5003(d)(1). The

---

3 The Department's January 21, 2011 document requests to BCBSD and Highmark are available at: http://www.delawareinsurance.gov/departments/bcbs/bcbs.shtml.

Department also chose KPMG LLP ("KPMG") as its information technology advisor to assist the Department with analyzing the recommendations of BCBSD consultants concerning BCBSD's technology needs—which are directly related to BCBSD's capabilities, and thus the level at which it may serve its customers and come into compliance with certain federally-mandated capabilities improvements—and with evaluating potential resolutions to BCBSD's technology challenges.

Since the beginning of 2011, the Department and its counsel and advisors communicated and met extensively with the Applicants, as well as with the Delaware public, various stakeholders in the Delaware community, and a Highmark affiliate in West Virginia. For example, the Department held a series of public information sessions in Georgetown, Delaware on May 16, in Dover, Delaware on May 17, and in Wilmington, Delaware on May 19, 2011, respectively.[4] At each public information session, representatives of Highmark and BCBSD explained the Affiliation, including the reasons why BCBSD is seeking a strategic partner and the reasons why Highmark is BCBSD's chosen partner. Immediately after the Applicants' presentations, the Department invited members of the public to make statements or ask questions. The Department's responses and the Applicants' responses to those questions have been available on the Department's website since the end of June. (*See* Joint Response of BCBSD, Inc. and Highmark Inc. to Public Information Session Questions).

On May 31, 2011, the Delaware Attorney General declared that the Affiliation would constitute a not-for-profit healthcare conversion transaction under the Not-for-profit Healthcare Conversion Act, 29 *Del. C.* § 2531(1)(c) (the "Conversion Act"). (*See* Ex. 2,

---

4 Each session was transcribed, and the Department posted transcripts on the Department's website (http://www.delawareinsurance.gov/departments/bcbs/bcbs.shtml).

Conversion Letter at 1). The Attorney General's declaration triggered a contractual right by Highmark to terminate the Affiliation Agreement and abandon any potential partnership with BCBSD. (*See* Affiliation Agreement §§ 6.3, 10.1(e); *see also id.* Appendix A, "Highmark Materially Burdensome Condition" (iv)).

Subsequent to the Attorney General applying the Conversion Act to the Affiliation of BCBSD and Highmark, both of which are non-profit entities, the General Assembly enacted Senate Bill 146 ("S.B. 146") to "clarif[y] the General Assembly's [original] intent" of protecting not-for-profit assets from moving to the for-profit sector. (*See* 74 *Del. Laws* c.298 (2004)). (*See* Ex. 3, Synopsis to Delaware Senate Bill 146). Specifically, S.B. 146 revised 29 *Del. C.* § 2531(1)(c) to change the definition of 'conversion' such that the Conversion Act does not apply to a control-related transaction between two non-profit entities. (*See* 78 *Del. Laws* c.109 § 1 (2011)). On June 29, 2011 the Delaware General Assembly passed S.B. 146, which the Governor signed into law on July 12, 2011. (*See* 78 *Del. Laws* c.109 (2011)).

S.B. 146 requires that the Commissioner place certain conditions on any transaction in which a health service corporation such as BCBSD becomes controlled by another entity, even if that entity also is a not-for-profit entity. (78 *Del. Laws* c.109 § 2 (2011)). These conditions are intended "to preserve that amount, determined in accordance with Delaware law, that constitutes the surplus or reserves of [a] health service corporation." (*Id.*). Under S.B. 146, the Department must review and approve any individual expenditure or transfer of funds, or coordinated series of expenditures or transfers of funds, by BCBSD in excess of $500,000 to Highmark or any affiliate of Highmark. When undertaking this review, the Department must assess the commercial reasonableness of the proposed expenditure or transfer. (18 *Del. C.* § 6311(b)(2)). S.B. 146 further provides that a majority of the BCBSD Board of Directors must consist of persons who are not employed by BCBSD or any BCBSD affiliates, and who are residents of Delaware and have been residents of Delaware for at least five years prior to their appointments. (18 *Del. C.* § 6311(b)(4)).

In the weeks following the enactment of S.B. 146, the Department and its advisors continued discovery and completed their analysis of the Affiliation. On September 6, 2011, the parties exchanged the reports of their advisors, in anticipation of a public hearing on October 5, 6, and 7, 2011. The Department submits this memorandum to provide a summary of the analysis, arguments, and recommendations the Department intends to present at the public hearing.

STATEMENT OF FACTS

I. BACKGROUND OF THE APPLICANTS

A. BCBSD, Inc.

BCBSD is a Delaware non-stock corporation authorized as a nonprofit health service corporation in Delaware. (Affiliation Statement at 2). Under various corporate names, BCBSD has continuously operated in Delaware since 1935. (*Id.*). Its headquarters are in Wilmington. (*Id.*). BCBSD provides various types of health insurance coverage and non-insured health plan administrative services to individuals, groups, and governmental entities in Delaware. (*Id.*). BCBSD is the primary BCBSA licensee in Delaware, and thus is the only entity licensed by BCBSA to market health insurance using the Blue names and trademarks throughout Delaware. (*Id.*). Among the significant health insurers in Delaware, BCBSD is the only insurer that is locally-controlled. (BX 115).[5] As of December 31, 2010, BCBSD serves

---

5 Citations to (BX ___) are to the Report on the Proposed Affiliation between Blue Cross Blue Shield of Delaware and Highmark Inc., dated September 16, 2011, which Blackstone drafted in its role as advisor to the Department.

approximately 394,000 subscribers, has a total of $171 million in reserves, and has a risk-based capital[6] level of 1,056 percent. (*See* Aug. 31, 2011 BCBSD Pro Formas at 5; BX 32, 43). Its 2010 revenues totaled approximately $550.1 million. (*See* Ex. 4, BCBSD Pro Forma Comparative Output; BX 32). In lieu of state taxes, BCBSD pays 8.7 percent of pre-tax income to the Delaware Community Foundation, and in 2010 this amount was $1.6 million. (*See* Ex. 5, BCBSD Affiliation Forecast at 3 (labeled as "Community Related Expense – Part 2")). BCBSD employs 620 individuals. (BX 32).

As a nonprofit health service corporation, BCBSD is subject to certain requirements under the Delaware Insurance Code. These requirements would continue to govern BCBSD after the Affiliation. For example, BCBSD must submit proposed rate increases to the Department (18 *Del. C.* § 6306), file an annual report with the Department (18 *Del. C.* § 6307(a)), and open its books and records to an examiner appointed by the Commissioner (18 *Del. C.* § 6307(b)).

B. Highmark Inc.

Highmark is a Pennsylvania nonprofit corporation authorized by the Pennsylvania Insurance Department to operate a hospital plan and a professional health services plan in Pennsylvania. (Affiliation Statement at 5). Highmark is one of four "Blue" plans in Pennsylvania, and provides traditional fee-for-service health care insurance coverage to groups

---

6 In this context, risk-based capital, or "RBC," represents an insurer's capital base for paying customer claims. RBC is calculated according to a particular formula. An insurer's "RBC ratio" is a frequently-used metric in the insurance industry to indicate the financial strength of an insurer. An RBC ratio is intended to capture the risks posed to the insurer. The RBC ratio is equal to the total capital of the insurer divided by the insurer's risk-based capital. For example, an insurer with a 300% RBC ratio has capital equal to three times the insurer's risk-based capital. Although the RBC ratio is not a perfect measure of an insurer's ability to pay customer claims, generally speaking, the higher an insurer's RBC ratio, the stronger an insurer's financial position.

and individuals in addition to providing administrative services for self-insured groups. (*Id.*). Highmark provides professional health services coverage in conjunction with hospital coverage provided by other Pennsylvania Blues. (*Id.*). Further, through subsidiaries, Highmark offers health maintenance organization coverage to various groups, Medicare-related coverage to groups and individuals, and small-group coverage to small businesses. (*Id.* at 5-6). In addition, Highmark has a number of affiliated insurers and dental and vision care affiliates. (*Id.* at 6).

Highmark also has a controlled affiliate in West Virginia. Highmark West Virginia, formerly Mountain State Blue Cross Blue Shield, initially affiliated with Highmark in 1999, at which time Highmark provided the West Virginia entity with financing, as well as use of Highmark's systems and support. (BX 107). In 2004, the companies completed a "closer affiliation," which involved the West Virginia entity's migration onto Highmark's information technology platform and increased Highmark's control over the West Virginia entity. (*Id.*) Finally, in 2009, the companies more fully integrated, whereby Highmark West Virginia's operational and financial "back office" functions now report directly to their counterparts at Highmark while Highmark West Virginia maintains relative autonomy for market-facing functions in West Virginia. (*Id.*).

The arrangements contemplated by the 2004 "closer affiliation" and subsequent full integration in 2009 in West Virginia are similar to the proposed Affiliation between BCBSD and Highmark. (Affiliation Agreement at 6-7). Since 2004, Highmark West Virginia has operated with an IT system integrated with Highmark's platform yet has continued to exercise market-focused decision-making authority. (BX 106). Since its initial relationship with Highmark in 1999, Highmark West Virginia's reserves, risk-based capital ratio, and membership levels have increased significantly. (*See* Ex. 6, Highmark West Virginia Affiliation – Update at

2; BX 108). In an interview with the Department and its advisors, the Highmark West Virginia President described how his company has maintained several forms of local control and success even while integrating with, reporting to, and receiving guidance from, Highmark. (BX 109). The West Virginia Department of Insurance reported that no significant complaints related to the loss of local autonomy have been received from market participants or customers since Highmark West Virginia's full integration with Highmark in 2009. (*Id.*).

As of December 31, 2010, Highmark serves a total of 4.8 million subscribers, has a total of $3.7 billion in reserves, and has a risk-based capital level of 692 percent. (*See* Ex. 7, Highmark Corporate Profile; Ex. 8, Highmark 2010 Annual Statement at 3; BX 5, 30). Its 2010 revenues totaled approximately $14.6 billion. (*See* Ex. 7, Highmark Corporate Profile). Highmark employs approximately 19,500 individuals. (*Id.*).

As of the date of this memorandum, Highmark is in negotiations to affiliate with West Penn Allegheny Health System ("West Penn"), which includes five hospitals and other facilities in the Pittsburgh region. (BX 64). The transaction currently is expected to involve a total commitment by Highmark of $475 million over four years. (*Id.*; *see also* Ex. 9, Article – Highmark-WestPenn Transaction). REDACTED

(*See generally* BX 64).

II. BACKGROUND TO THE PROPOSED AFFILIATION

On December 23, 1998, BCBSD entered into a business affiliation agreement with CareFirst, a not-for-profit Maryland corporation, which was approved by then-

Commissioner Donna Lee Williams on March 20, 2000. (*See* Ex. 10, March 20, 2000 Affiliation Order).

In 2004, however, Commissioner Williams ordered a conditional termination of the CareFirst Affiliation, after concluding that the 2000 Affiliation Order had been violated when the Maryland General Assembly passed legislation that had "the practical effect of altering the corporate governance of CareFirst and BCBSD and impinging upon the ability of the [Delaware] Insurance Commissioner to maintain supervisory authority over BCBSD for the benefit of the residents of the State of Delaware." (*See* Ex. 11, June 30, 2004 Decision and Amended Order at 19).[7] Commissioner Williams permitted BCBSD and CareFirst to continue a relationship on a contractual basis, if they submitted proposed contracts and agreements to the Department for the Department's review and approval. (*Id.* at 20). In 2006, then-Commissioner Matthew Denn issued an order that terminated the CareFirst Affiliation due to insufficiency in the submission of documentation and evidence. (*See* Ex. 12, Aug. 23, 2006 Order at 9).

The BCBSD Board of Directors, with the assistance of consultants Lou Pavia and Robert C. Cole and internal and external legal advisors, then began a process to identify other potential strategic partners. (*See* Ex. 13, BCBSD Board Minutes Dec. 1, 2006 at 1-2; Ex. 14, BCBSD Board Minutes Feb. 7, 2007 at 4). Throughout 2007, BCBSD explored its need for a strategic partner and invited several potential partners, including REDACTED and Highmark, to submit proposals. (*See, e.g.*, Ex. 15, CareCompanion Mar. 7, 2007 BCBSD Strategy Session II; Ex. 16, July 7, 2007 Email from T.Constantine; Ex. 17, Highmark Sep. 14,

---

[7] The Department's prior experience with the CareFirst disaffiliation—and the serious threat which those circumstances posed to Delaware consumers and the Delaware community at large—has, as noted previously, significantly colored the Department's view of the protections and conditions required in this proposed Affiliation.

2007 Response to BCBSD Partnership Memo). For more than a year thereafter, BCBSD examined potential partners, and in January 2009, the BCBSD Board decided to enter into exclusive negotiations with REDACTED for a partnership that would result in BCBSD becoming a for-profit entity. (*See* Ex. 18, Jan. 9, 2009 Letter from BCBSD Affiliation Partner Evaluation Team at 4; Ex. 19, BCBSD Board Minutes Jan. 14, 2009 at 2). By August 2009, however, BCBSD had decided REDACTED valuation of BCBSD was too low and that BCBSD would explore Highmark as a strategic partner. (*See, e.g.*, Ex. 20, Aug. 25, 2009 Letter from T.Constantine to REDACTED Ex. 21, Aug. 25, 2009 Letter from T.Constantine to Highmark).

In December 2009, the BCBSD Board determined that Highmark was the most favorable strategic partner for BCBSD and authorized management to negotiate an affiliation with Highmark (*See* Ex. 22, BCBSD Board Minutes Dec. 3, 2009 at 2; Ex. 23, CareCompanion Dec. 3, 2009 Presentation – Strategic Partnership Considerations). After the completion of due diligence and the negotiation of terms over the first seven months of 2010, the BCBSD Board approved the proposed Affiliation. (*See* Ex. 24, BCBSD Board Minutes July 21, 2010 at 9). As described by BCBSD CEO Timothy Constantine, BCBSD selected Highmark as a strategic partner for several reasons, including the ability of BCBSD to remain a not-for-profit Delaware company following BCBSD's affiliation with Highmark; Highmark's success in working with other Blue companies; Highmark's advanced IT platforms; Highmark's broad and innovative mix of health care products and services; and Highmark's respect for local working relationships. (*See* Transcript of May 16, 2011 Public Hearing at 34:24-41:2).

III. SUMMARY OF THE TERMS OF THE PROPOSED AFFILIATION

The Affiliation is governed by several agreements, including the Affiliation Agreement, an Administrative Services Agreement, a Line of Credit Agreement, and amendments to BCBSD's Certificate of Incorporation and to BCBSD's Bylaws. If the transaction is approved, the Affiliation Agreement governs how BCBSD and Highmark will affiliate generally. The Administrative Services Agreement ("ASA") controls the ways in which BCBSD and Highmark will integrate their IT systems and operations, as well as the services Highmark will provide to BCBSD as part of that integration. The Line of Credit Agreement ("LOC Agreement") governs the terms of the financing that Highmark is offering to BCBSD in connection with the integration of IT systems. The amended BCBSD Certificate of Incorporation and BCBSD Bylaws establish the governance structure through which Highmark will be the sole member of BCBSD.

A. Affiliation Agreement

BCBSD and Highmark entered into the Affiliation Agreement on August 19, 2010. The Affiliation Agreement describes the steps, promises, business operations, and documents necessary to finalize and formalize the new relationship between BCBSD and Highmark. (Affiliation Agreement Arts. III-VI). Although the Department has analyzed the entirety of the Affiliation Agreement, there are three provisions of the Affiliation Agreement that are particularly relevant to the Department's review:

BCBSD's Right to Withdraw from the Affiliation. If certain "triggering events" occur, the independent directors (*i.e.*, those directors that are neither employees of BCBSD nor of Highmark) can require Highmark to withdraw from its position as sole member of BCBSD and to consent to BCBSD re-acquiring the license to the registered names and marks owned by BCBSA. (*Id.* § 7.8(a)). These triggering events include, for example, Highmark: (i) converting to a for-profit Pennsylvania corporation; (ii) admitting in writing its inability to pay its debts as they become due; (iii) becoming insolvent or seeking protection from creditors; (iv) losing, despite appeal, its status as the primary licensee of the Blue marks in Delaware or Pennsylvania; or (v) experiencing a change in Pennsylvania law that deprives the Highmark Board of Directors from being able to select its own members or that results in a third party having decision-making authority over the management, operations, or assets of Highmark. (Bylaws § 13.1). The list does not include, however, certain other material adverse developments, such as: Highmark materially failing to perform any of its obligations under the Affiliation Agreement, the ASA, or the LOC; Highmark becoming the subject of a delinquency proceeding pursuant to Pennsylvania law; Highmark's risk-based capital levels falling below a certain level; or Highmark entering into and receiving approval for a transaction involving a conversion or change-of-control.

Once there is a triggering event, BCBSD can only withdraw from the Affiliation, however, if BCBSD completes all of the following: (i) pays any funds owed to Highmark under the LOC Agreement, ASA, or other credit facility formed on BCBSD's behalf; (ii) releases Highmark from any liabilities made on behalf of BCBSD and reimburses Highmark for any payments Highmark made related thereto; (iii) obtains the Department's approval of Highmark's withdrawal; (iv) obtains BCBSA's approval for BCBSD to reestablish itself as the primary licensee of the Blue marks in Delaware; (v) pays any BCBSA fees associated with reacquiring the Blue marks or has any fees against Highmark waived; and (vi) surrenders to Highmark the right to use the name "Highmark." (Affiliation Agreement § 7.8(c)). Further, once BCBSD receives notice from Highmark that a triggering event has occurred, the independent BCBSD directors have only sixty days to decide whether to complete these requirements and withdraw from the Affiliation. (Bylaws § 13.1).

Employment and Community—The Public Interest. After the closing of the Affiliation transaction, BCBSD and Highmark have agreed to maintain BCBSD's Delaware headquarters, as well as to maintain certain BCBSD employment levels in Delaware and to create new employment opportunities in Delaware. (Affiliation Agreement § 7.4). Highmark has made additional commitments regarding employment in Delaware, including assuring that full-time employment levels in Delaware (of both BCBSD employees and Delaware-based Highmark employees) will not decrease during the eighteen-month integration process; BCBSD employees whose positions are eliminated due to the Affiliation will be given first priority for new positions that are created in Delaware; and Highmark will make good-faith efforts to locate additional full-time employment positions in Delaware as Highmark's business opportunities arise.[8] (*See* Ex. 25, Pre-Hearing Joint Comprehensive Statement of BCBSD, Inc. and Highmark Inc., at 8). As previously stated, since already agreed to by Highmark, these commitments are noted herein as conditions to the Affiliation.

Employee Benefits. Highmark and BCBSD have agreed that, if the Affiliation is approved, BCBSD will not reduce or eliminate any grandfathered benefits under BCBSD employment agreements or employee benefit plans, unless required to do so by law or if the plan already allows for such modification. (Affiliation Agreement § 7.5(a)). Further, for a period of two years post-closing, BCBSD will not negatively modify its benefit plans for existing BCBSD employees, unless required to do so by law or unless a majority of the BCBSD Board (including one independent director) approves such a change. (*Id.* § 7.5(b)). After the second year,

---

[8] Highmark's commitments do not relate to the specific types of jobs that will remain or come to Delaware, and, as currently proposed, if there is a significant decrease in BCBSD's enrollment or market share during the implementation period that results in lost jobs, Highmark is not responsible to replace such lost jobs.

Highmark may change the BCBSD benefit plans to create plans covering Highmark and BCBSD employees collectively, but Highmark must take into account an employee's years of service with BCBSD when calculating service for purposes of vesting and eligibility in the new plans. (*Id.*). Any such change cannot leave a BCBSD employee with a less generous plan than the plan for a similarly-situated Highmark employee, unless the original BCBSD plan provided the same benefit at a lower level compared to the Highmark plan. (*Id.*). Further, after the second year (or before that time, with a majority board vote including one independent director), Highmark can elect to maintain separate and parallel plans for Highmark and BCBSD employees subject to the equality requirements already discussed above. (*Id.*).

B. Administrative Services Agreement

BCBSD has indicated that a key aspect of the Affiliation is for BCBSD to be able to take advantage of Highmark's capabilities and services. The ASA provides a detailed, though not exhaustive, list of the services Highmark will provide to BCBSD. (ASA Art. I(A)). These include but are not limited to executive management, financial administration, payroll, human resource relations, computer and data processing, marketing and sales, pharmacy and prescription drugs, customer service, enrollment and membership, claims adjudication and administration, grievances and complaints, and provider relations. (*Id.*). BCBSD and Highmark have been working together to plan the integration of each company's respective systems. (*Id.* Art. I(B)).

BCBSD will reimburse Highmark for the "fair and reasonable allocable share of the total actual cost" to Highmark of providing these administrative services, but without provision for profit. (*Id.* Art. II(A)). This share "shall be determined in accordance with

Highmark's established cost accounting practices as in effect from time to time." (*Id.*). As explained by the Applicants:

> While BCBSD will begin aligning its cost allocation methodologies with Highmark's at the time of Affiliation, the rollout of inter-company allocations for ongoing services will largely follow the operational integration of the two companies. . . .
>
> Highmark's cost allocation framework [ ], which will be used by both Highmark and BCBSD post-affiliation, differentiates between costs originating in the Home Office and those originating in the Business Segments. Home Office refers to functions or activities responsible for managing or serving two or more Business Segments. . . .
>
> Home Office expenses largely consist of either centralized service functions, *e.g.* Information Technology or staff management of certain activities that benefit either the entire enterprise or multiple, though not necessarily all, business segments, *e.g.* Corporate Finance. The first step of the methodology for allocating Home Office expenses is to allocate centralized service functions to segments on the basis of the service furnished to or received by each segment. Allocation of centralized service expenses is followed by the allocation of staff management functions which are first allocated based on specific activities provided in support of an identifiable business segment. When this isn't possible due to the nature of the activity, residual Home Office expenses are allocated using a methodology reflective of the beneficial or causal relationship between such expenses and the receiving segments. . . .
>
> [C]ommon cost allocation methodologies in place at both Highmark and BCBSD will determine the inter-company charges between the companies. All intercompany charges will be at actual cost without provision for profit consistent with the terms of the Administrative Service Agreement.

(Ex. 26, Joint Response of BCBSD, Inc. and Highmark Inc. to Delaware Department of Justice Questions Dated August 23, 2011, at 4-5).

BCBSD has the right to review Highmark's records relating to Highmark's cost of providing these services to BCBSD. (ASA Art. II(C)). Both BCBSD and Highmark must maintain their books, records, and accounts so as to be able to verify the details of the services

Highmark is providing and to verify the reasonableness of the amounts Highmark is charging to BCBSD. (*Id.* Art. IV).[9]

The ASA will terminate if certain events occur, including but not limited to if: (i) Highmark ceases to be the sole member of BCBSD with the power to elect or appoint BCBSD's Board of Directors; (ii) BCBSD ceases to be Highmark's "controlled affiliate" under BCBSA guidelines; or (iii) BCBSD defaults under the LOC Agreement and does not cure its default within thirty days. (*See id.* Art. III(B)). If the ASA terminates because of (i) or (ii) above, BCBSD can request that Highmark continue to provide services for a maximum of two years. (*Id.* Art.III(C)). If that situation arises, BCBSD must compensate Highmark on the "allocable share" model described above plus an additional 8 percent. (*Id.*). Although these certain events serve as bases for termination, after the first year of the Affiliation the ASA can be terminated by BCBSD or Highmark for no reason, if 180 days' notice is given. (*See id.* Art. III(A)). If any disputes arise under the ASA, the Highmark CEO and BCBSD President will attempt to resolve them, followed by the BCBSD Board of Directors and then (upon request of the independent directors) by the Highmark Board of Directors. (*Id.* Art. VII(A)).

C. Line of Credit Agreement

As part of the Affiliation, BCBSD must transition to Highmark's systems, which is expected to cost between $35 million and $37 million. (BX 78, KPMG 35).[10] To assist BCBSD with this cost, Highmark is extending a $45 million line of credit, as set forth in the

---

9 The Commissioner also has authority to examine the books and records. (*See* 18 *Del. C.* §§ 317, 318, 6311(a)). A condition crafted by the Department will assure the Department's appropriate access to and review of this and other relevant information is being requested.

10 Citations to (KPMG ___) are to the Project Delaware Report, dated September 2011, which KPMG drafted in its role as advisor to the Department.

LOC Agreement. (LOC § 1). BCBSD, at its option, may only use these funds for the payment of costs associated with the systems conversion and integration with Highmark. (*Id.* § 6). The interest rate of this line of credit is the lesser of the one-month LIBOR rate plus 350 basis points, or the United States Prime rate. (*Id.* § 2(a)). BCBSD has until the seventh-year anniversary of the LOC Agreement to repay all principal and accrued interest. (*Id.* § 2(d)(i)). BCBSD may prepay without penalty. (*Id.* § 3).

Certain events will cause an early termination of the LOC Agreement. One such event is a default, which includes but is not limited to BCBSD's: (i) failure to make a payment due under the LOC; (ii) failure to perform any obligations under the LOC; (iii) becoming the subject of a delinquency proceeding under the Delaware Insurance Code or a summary order of the Commissioner; (iv) admitting in writing its inability to pay its debts as they become due; or (v) becoming insolvent or seeking protection from creditors. (*Id.* § 7(b)). Another such event involves a change of control, which is defined broadly to include a number of corporate transactions involving any change in who controls the management, operations, or assets of BCBSD. (*Id.* § 7(a)). If a default or a change of control occurs, the LOC Agreement automatically terminates and all amounts BCBSD owes to Highmark become due and payable immediately. (*Id.* § 7). There is no provision that gives BCBSD the opportunity to cure an event of default before termination.

D. Amendments to BCBSD's Certificate of Incorporation and Bylaws

Under the new Certificate of Incorporation ("Charter"), BCBSD will change its name to Highmark BCBSD, Inc. (Charter Art. 1). Highmark BCBSD, Inc. ("BCBSD") will remain a non-stock corporation, but Highmark will become its sole member. (*Id.* Arts. 4-5). The BCBSD Board of Directors will have nine members in three different "classes": 4 directors in

Class A (the "Independent Directors"), four directors in Class B, and the President, who also serves as a director ("President Director"). (*Id.* Art. 8(a)). S.B. 146 requires that a majority of the BCBSD Board—5 of 9 directors—must be residents of Delaware.

Class A Directors are independent in the sense that they cannot be directors of Highmark or officers or employees of Highmark or BCBSD. (Bylaws § 5.2(b)). The Bylaws require that the four Class A Directors will have initial terms of 1, 2, 3, and 4 years, respectively. (*Id.*). Such Class A Directors will remain in office until their successors are elected and qualified. (*Id.*). When a new Class A Director is elected, he or she will serve for 3 years. (*Id.*). The initial Class A Directors will be chosen by BCBSD before the closing of the Affiliation. New Class A Directors are nominated by a Nominating Committee, whose members will be the four Class A Directors. (*Id.* § 5.13). If Highmark does not approve of a nominated individual for any reason, the Nominating Committee must nominate an alternate. (*Id.* § 5.2(b)). If Highmark also disapproves of any alternates, and if the board seat has been vacant for a period of more than 60 days, Highmark must propose a list of names to the Nominating Committee for consideration. (*Id.*). Highmark will formally elect the Class A directors to the Board, subject to requirements in the Bylaws. (Charter Art. 8(b)).

The four Class B Directors are chosen by Highmark. For the first three years of the Affiliation, the four Class B Directors must include the Highmark CEO and two other Highmark executive officers who report directly to the Highmark CEO. (Bylaws § 5.2(c)). Highmark has indicated that it will elect Dr. Kenneth R. Melani, Deborah G. Rice, and Nanette P. DeTurk as three of the initial Class B Directors, with the fourth initial Class B Director yet to be determined. (*See* Letter from D. Foster re: Highmark's Supplemental Filing No. 6 to Statement Regarding the Affiliation, Aug. 29, 2011, at 1). Terms of Class B Directors are 1 year in length or until a successor is elected and qualified. (Bylaws § 5.2(c)). Highmark will formally elect the Class B directors to the Board, subject to requirements in the Bylaws. (Charter Art. 8(b)). Highmark may remove a Class B Director at any time for any or no reason. (Bylaws § 5.3).

The President Director will remain on the BCBSD Board so long as he or she is the President of BCBSD. (*Id.* § 5.2(d)). The BCBSD Board of Directors will elect the President, who is subject to the approval of Highmark. Upon such election to the presidency, Highmark will formally elect the President Director to the Board, subject to requirements in the Bylaws. (Charter Art. 8(b)). The Class B directors may remove the President at any time, for any or no reason. (Bylaws § 6.2).

A quorum of the Board will consist of a majority of the directors then in office and qualified to act, including at least one Class B Director. (*Id.* § 5.7).

There must be an approval of a majority of the directors, including at least one Class B Director, before BCBSD can engage in certain corporate actions, including: entering into a change-of-control transaction; incurring additional indebtedness other than a maximum of $10 million in the ordinary course of business; and changing any provision in the Charter or Bylaws. (Charter Art. 12(b)-(d)). In order for there to be any change to the numbers of directors or to the different classes of directors, there must be an affirmative approval of a majority of the Class A Directors and a majority of the Class B Directors. (*Id.* Art. 13). Further, Highmark must approve any changes to the Charter. (*Id.* Art. 11). The Department must undertake prior review and give approval of any proposed changes to the Charter. (18 *Del. C.* § 6311(b)(1)).

E. BCBSD Executive Compensation and Non-Executive Transaction-Related Bonuses

BCBSD has seven executives with employment agreements. In 2009 and 2011, BCBSD hired a compensation consultant to compare the terms of these agreements to market; the conclusion was that the compensation of BCBSD's executives is generally below competitive median levels in the industry. (*See* Ex. 27, WatsonWyatt – BCBSD CEO Comp. Assessment at 3; Ex. 28, TowersWatson – BCBSD VP Comp. Assessment at 3).

Neither the BCBSD CEO nor any of the six vice presidents have an employment agreement that includes compensation or bonuses arising from the Affiliation. (BX 69). Each of these executives does have an employment agreement that pre-dates BCBSD's relationship with Highmark or that is identical to such pre-existing agreements. (*See, e.g.*, Ex. 29, REDACTED Employment Agreement; Ex. 30, REDACTED Employment Agreement). In connection with the Affiliation, some agreements were amended to address the tax impacts of the agreements on BCBSD and to clarify that the proposed Affiliation would constitute a change of control under the agreements. (*See, e.g.*, Ex. 30, REDACTED Employment Agreement ¶¶ 28(b), 29-30). Each agreement contains provisions related to the payment of severance benefits upon the occurrence of certain events which were contractually defined prior to the proposed Affiliation. (*See id.* ¶¶ 8, 10). The Affiliation itself does not entitle the executive to severance payments. Rather, there must be some other event (such as an involuntary termination of the executive's employment, a substantial reduction of the executive's duties or compensation, or a significant geographic relocation of the executive's employment post) before the executive is entitled to severance payments based on the remaining length of the employment agreements. (*See id.* ¶ 10(a); Ex. 26, Joint Response of BCBSD, Inc. and Highmark Inc. to Delaware Department of Justice Questions Dated August 23, 2011, at 14-15). If all seven of these executives were to have their employment terminated immediately after the Affiliation, there would be a severance payout of approximately $6 million. (*See* Ex. 31, BCBSD Change of Control – Exec. Comp. Analysis; *see also* Ex. 26, Joint Response of BCBSD, Inc. and Highmark Inc. to Delaware Department of Justice Questions Dated August 23, 2011, at 14-15). As indicated by Highmark, there are no current plans to replace the current officers of BCBSD. (*See* Affiliation Statement at 9; *see also* Ex. 26, Joint Response of BCBSD, Inc. and Highmark Inc. to Delaware Department of Justice Questions Dated August 23, 2011, at 14).

Although there are no Affiliation-related bonuses for BCBSD executives, there are eight BCBSD non-executive employees who will receive bonuses as part of the Affiliation, for the purposes of retaining these employees during the transition period, allowing the employees to focus on job tasks before and during the integration, recognizing the additional efforts and responsibilities of the employees during the transition process, and ensuring that BCBSD continues to operate at a high level during the period of time between the announcement and closing of the Affiliation. (*See* Ex. 32, BCBSD Associate Retention Bonus Info). The BCBSD Board of Directors retained Mercer to assist it in evaluating this Retention Bonus Program. (*See* Ex. 33, Mercer – BCBSD Study). A total of approximately $300,000 is planned for distribution among the eight employees, with part of the bonuses for each employee being paid at closing of the Affiliation and the remaining amounts being paid six months later. (*See* Ex. 34, BCBSD Jan. 26, 2011 Responses to DOJ Request at 11; BX 69). The various amounts of the bonuses range from 25 percent to 30 percent of the employees' respective annual salaries. (BX 69). Eligibility was determined on the basis of employees whom would be difficult to replace before the closing of the Affiliation, who had unique skill sets or institutional knowledge, or who were part of critical operations or strategic functions. (*See* Ex. 32, BCBSD Associate

Retention Bonus Info (describing the specific employment functions of the employees, and explaining the rationale for their selection)).

STATUTORY CRITERIA & STANDARD OF REVIEW

The Commissioner ordered that the public hearing would be "governed generally under the provisions of 29 *Del. C.* § 10101 *et seq.*, except [when those provisions] are in conflict with the provisions of Chapter 3 of Title 18 (*see e.g.*, 18 *Del. C.* § 326)." (Pre-Hearing Order, ¶ 1). The Commissioner specified that in conducting her analysis the Hearing Officer "shall apply the specific criteria for approving or disapproving a change of control of a Delaware domestic insurer found at 18 *Del. C.* § 5003(d)(1)." (Pre-Hearing Order, ¶ 8). As applied to this Affiliation, Section 5003(d)(1) requires the Commissioner to approve the Affiliation unless, after a public hearing, the Commissioner finds that:

> a. After the change of control, the domestic insurer [*i.e.*, BCBSD] . . . would not be able to satisfy the requirements for the issuance of a license to write the line or lines of insurance for which it is presently licensed;
>
> b. The effect of the [Affiliation] would be substantially to lessen competition in insurance in this State or tend to create a monopoly therein…;
>
> c. The financial condition of [the controlling affiliate, *i.e.*, Highmark] is such as might jeopardize the financial stability of [BCBSD], or prejudice the interest of [BCBSD] policyholders;
>
> d. The plans or proposals which [Highmark] has to liquidate [BCBSD], sell [BCBSD's] assets or consolidate or merge it with any person, or to make any other material change in [BCBSD's] business or corporate structure or management, are unfair and unreasonable to policyholders of [BCBSD] and not in the public interest;
>
> e. The competence, experience and integrity of those persons who would control the operation of [BCBSD] are such that it would not be in the interest of policyholders of the insurer and of the public to permit the merger or other acquisition of control; or

> f. The [Affiliation] is likely to be hazardous or prejudicial to the insurance buying public.

Although Section 5003(d)(1), on its face, applies to a change in control of an insurance company holding system, the proposed Affiliation is not such a transaction because BCBSD is not an insurance company holding system under Chapter 50 of the Delaware Insurance Code.[11] The Applicants, however, have agreed to submit the proposed Affiliation to the Commissioner pursuant to Section 5003.

ANALYSIS

Pursuant to its statutory duties under Title 18, Chapter 3 of the Delaware Code to evaluate the proposed Affiliation, the Department has worked with its legal and financial advisors to conduct a thorough analysis of how the Affiliation relates to the statutory criteria in 18 *Del. C.* § 5003(d)(1). As previously noted, the Department is acutely aware of the significance of the proposed Affiliation to Delaware consumers and the Delaware public generally. In undertaking its analysis, the Department has drawn on its experience with the prior BCBSD affiliation with CareFirst, examined the recent statutory protections and policy considerations arising from S.B. 146, and carefully applied the statutory criteria to the facts, all with a view of assuring that the proposed Affiliation is—or can be configured to be—in the best interest of Delaware consumers and Delaware citizens. The results of the Department's analysis are as follows, and will be supported by testimony at the public hearing by Linda Sizemore, the Department's Director of Company Regulation; Martin Alderson Smith, Senior Managing Director of Blackstone; and Kenneth Jackson, Senior Director of KPMG.

[11] BCBSD is, instead, a health service corporation under Chapter 63 of the Insurance Code.

I. FAIRNESS, REASONABLENESS, AND PUBLIC INTEREST OF HIGHMARK'S PLANS FOR BCBSD

Many of the Department's key concerns about the Affiliation are implicated by Standard D of Section 5003(d)(1), which requires the Department to evaluate Highmark's plans or proposals to make material changes in BCBSD's business, corporate structure, or management to determine whether those plans or proposals are unfair and unreasonable to policyholders of BCBSD and not in the public interest.[12] In evaluating the Affiliation under Standard D, the Department, with the assistance of its financial and IT advisors, focused on: (i) changes to BCBSD's capabilities as a result of the Affiliation; (ii) protecting BCBSD's reserves, including by analyzing how and under what circumstances monetary transfers can be made from BCBSD to Highmark; (iii) ensuring BCBSD's ability to withdraw from the Affiliation if necessary; and (iv) ensuring that no BCBSD executives would financially benefit from the Affiliation.

Changes in BCBSD's Capabilities. As part of a strategic planning effort in 2008, BCBSD retained a well-known industry advisor, Deloitte & Touche, to assess BCBSD's operational capabilities. Deloitte identified a number of functional and technology areas in which BCBSD needed improve to meet its strategic goals and address high priority areas of opportunity (for example, reducing its administrative cost structure and increasing the efficiency of its operations). Most of these capabilities gaps related to BCBSD's technology and systems. (*See* Ex. 35, Deloitte 2008 Report; Ex. 36, Deloitte 2010 Report; KPMG 19; BX 97)]. The

[12] A basis for the Commissioner rejecting the proposed Affiliation is that the Commissioner finds that "[t]he plans or proposals which [Highmark] has to liquidate [BCBSD], sell [BCBSD's] assets or consolidate or merge it with any person, or to make any other material change in [BCBSD's] business or corporate structure or management, are unfair and unreasonable to policyholders of [BCBSD] and not in the public interest." (18 *Del. C.* § 5003(d)(1)(d)). Highmark has no plans or proposals to liquidate BCBSD or sell BCBSD's assets or consolidate or merge it with any person. (Affiliation Statement at 9; Ex. 25, Pre-Hearing Joint Comprehensive Statement of BCBSD, Inc. and Highmark Inc. at 5).

Department and its advisors have concluded that the Affiliation will allow BCBSD to address these capability gaps, particularly given the experience Highmark has with various affiliations and administrative service agreements, and the ways in which Highmark offers market-competitive prices for these services. (BX 97-99; KPMG 67).

A primary way that BCBSD will close the capabilities gaps through the Affiliation is by its transition to Highmark's IT platform. BCBSD's core IT system is over twenty years old, which makes the system difficult to maintain and expensive to upgrade. (BX 75). In addition, recent changes to healthcare regulations at the federal level have increased the various IT requirements that health insurers must meet. (*Id.*). One of these changes is the U.S. Government's requirement that the insurance industry move from "ICD-9" to "ICD-10." (KPMG 8). The International Classification of Diseases, or "ICD," is an international coding scheme to classify diseases that is used in over 100 countries. (*Id.*). Insurance providers and payers use ICD codes in connection with, for example, health insurance claim reimbursements. (*Id.*). The United States is the only country operating under ICD-9, the now outdated coding scheme in place before ICD-10. (*Id.*). In order to improve healthcare and help the U.S. healthcare system, the U.S. Government has required a transition from ICD-9 to ICD-10 by October 1, 2013. (*Id.*). This transition is both expensive and complicated.[13]

Combined, these factors have increased both the urgency—and cost—of BCBSD upgrading its IT systems. The Affiliation will enable BCBSD to integrate onto Highmark's IT

[13] A second government mandate is the transition to the HIPAA 5010 standard, which regulates the electronic exchange of health data and is intended to protect consumers, reduce fraud and improve the quality of healthcare. (KPMG 8). The U.S. government has required a move to the new HIPAA standard by January 1, 2012. (*See* Ex. 37, Modifications to the Health Insurance Portability and Accountability Act (HIPAA) Electronic Transaction Standards, 74 Fed. Reg. 3296, 3302 (Jan. 16, 2009) (codified at 48 C.F.R. pt. 162)).

platform over a period of 18 to 24 months, with the costs of doing so governed by the ASA and reviewed by the Department. (*Id.*).

The Department's IT advisor has evaluated the reasonableness of the projected costs for this IT integration and upgrade. (*See* KPMG Report; BX 76-79). At the direction of the Department, KPMG examined three options moving forward for BCBSD and its IT platform: remaining a standalone entity, outsourcing its IT system, and integrating with Highmark's platform via the Affiliation. (KPMG 11-12). KPMG's Report provides the basis for the Department's conclusion that the Affiliation scenario is in the public interest. One significant consideration is cost. The integration costs of IT upgrades under the Affiliation are projected to be between \$35-\$37 million, followed by annual service charges of \$21-\$23 million. (KPMG 11). If BCBSD wishes to remain a competitive standalone entity, it would incur anywhere between \$93-\$150 million in one-time costs, followed by annual costs exceeding \$20 million (KPMG 11). If BCBSD attempts a long-term contractual outsourcing arrangement, one-time costs would likely range from \$30-\$45 million, followed by annual costs of \$30-\$60 million. (KPMG 11).

Another consideration is capability enhancements. BCBSD's migration onto Highmark's platform will eliminate all BCBSD capability gaps and satisfy new federal mandates. (KPMG 16). BCBSD cannot easily or completely achieve these same outcomes as a standalone entity or via outsourcing. (KPMG 13-14). These same outcomes and capability enhancements are not well-suited for outsourcing relationships, given the high strategic value of the enhancements or the low cost-savings potential of outsourcing them. (KPMG 55-60; BX 100-105).

The Affiliation provides for relative ease in implementing IT upgrades for BCBSD, given Highmark's history of successful affiliations and system migrations. (KPMG 12). BCBSD would face significantly more implementation challenges if it remained a standalone entity or outsourced its capabilities needs. (*Id.*). Likewise, the standalone alternative and the outsourcing model do not contribute to BCBSD's ability to fulfill its strategic goals, whereas the Affiliation would, particularly because the Affiliation—unlike the other two options—would help BCBSD gain economies of scale and resources in certain areas and also includes Highmark's expressed commitments to employment levels and ongoing employment opportunities in Delaware. (KPMG 11; BX 110). The only perspective from which the Affiliation is not the preferred option is the process of disentangling IT systems, which would not be a factor in the standalone context and which would involve unwinding a less integrated system in the outsourcing context as compared to the Affiliation. (KPMG 12).

Protecting Reserves. Of paramount importance for the Department is to protect BCBSD's substantial reserves; allowing mechanisms for Highmark to use those reserves in ways that do not benefit Delaware policyholders is plainly not in the public interest. There are certain statutory provisions that prevent Highmark from siphoning BCBSD's reserves. The July 2011 passage of S.B. 146—now codified at 18 *Del. C.* § 6311—requires that a condition be imposed on the proposed Affiliation that mandates review and approval by the Department of any individual expenditure or transfer of funds or coordinated series of expenditures or transfers of funds by BCBSD in excess of $500,000 to Highmark or any Highmark affiliate. S.B. 146 instructs the Department to review and assess the commercial reasonableness of the proposed expenditure or transfer, and requires that the Applicants consent to the Commissioner's standing to seeking relief in the Delaware Court of Chancery to enforce this condition, as well as all other conditions and the terms of the Affiliation. (*See* 18 *Del. C.* § 6311(b)(1), (4); 78 *Del. Laws* c. 109, § 2).

As for profits and dividends, BCBSD is a not-for-profit, non-stock membership corporation. (*See* Charter Art. IV). After the Affiliation, BCBSD will remain a non-profit, non-stock membership corporation, with Highmark as its sole member. (*Id.*). As such, BCBSD has no membership interests (*i.e.*, a member's share of profits and losses or the right to receive distributions of such profits) to be given to Highmark. (*See* 8 *Del. C.* § 114(d)(2)-(3)). Highmark, therefore, cannot share in BCBSD's profits.

Finally, BCBSD has agreed to the Department-imposed condition that it be subject to Delaware's Holding Company Act (Chapter 50 of the Delaware Insurance Code) after the Affiliation. Under the Holding Company Act, any contract, agreement, sale, purchase, exchange, loan, guarantee, investment, transfer, or other transaction between Highmark and BCBSD shall be subject to approval or disapproval of the Commissioner pursuant to a "fair and reasonable" standard. (*See* 18 *Del. C.* § 5005(a)(1)). In other words, all inter-affiliate transactions—transactions between BCBSD and Highmark—must be "fair and reasonable." (*Id.*). This standard applies to fees that Highmark will charge to BCBSD for the various services rendered under the ASA. *Id.* The Department may order BCBSD to produce books, records or other information papers in possession of BCBSD or Highmark that are reasonably necessary to determine whether the Applicants have complied with, among other things, the "fair and reasonable" standard. (*See* 18 *Del. C.* § 5006). If BCBSD fails to produce such information (for example, because such information is not in BCBSD's possession), then the Department may obtain such information from Highmark directly. *Id.*

In addition to analyzing what restrictions applicable statutory provisions impose on transfers between BCBSD and Highmark, the Department has also analyzed what restrictions on transfers are in the Affiliation documents. The Department has concluded that the two primary ways that funds can be transferred from BCBSD to Highmark are: (i) BCBSD's payments to Highmark for BCBSD's integration to Highmark's IT systems (BX 74), and (ii) BCBSD's ongoing payments to Highmark for the administrative services Highmark will provide to BCBSD, (ASA Art. II).[14]

The integration costs of IT upgrades under the Affiliation are projected to be between \$35-\$37 million. (KPMG 11). The \$35 million estimate is a "top down" estimate based on the integration costs associated with West Virginia's affiliation with Highmark. (KPMG 35). The "bottoms-up" estimate prepared by Highmark and BCBSD is approximately \$37 million, with the largest portion of that amount being earmarked for the actual migration of BCBSD to Highmark's systems. (KPMG 35). Based on KPMG's review of the affiliation planning documents, and their experience with other comparable integration projects, they believe that these estimates are reasonable. (KPMG 35).

The second primary way whereby BCBSD may make monetary transfers to Highmark is by compensating Highmark for the services it will provide under the ASA. These services are projected to cost BCBSD \$21.7 million annually by 2015. (*See* Ex. 5, BCBSD Affiliation Forecast at 3 (labeled as "Highmark Support Charges")); BX 80). This amount will account for approximately 14.2% of BCBSD's total non-care operating expenses. (BX 80). The method Highmark will use for determining the costs it charges BCBSD is identical to the method

[14] If BCBSD chooses to draw on the Line of Credit to fund the integration with Highmark, BCBSD will have to make interest payments to Highmark. (LOC § 2). BCBSD has indicated that it does not intend to use the Line of Credit. (BX 82).

Highmark uses for all other subsidiaries and affiliates: BCBSD's share of Highmark's total cost burden. (BX 81; ASA Art. II). As previously discussed, Highmark determines its total cost burden by combining the costs Highmark incurs at the most centralized level with the costs Highmark incurs servicing the business segment in which BCBSD will operate. (*See* Ex. 26, Joint Response of BCBSD, Inc. and Highmark Inc. to Delaware Department of Justice Questions Dated August 23, 2011, at 4-6). Highmark then apportions BCBSD's share of these costs on the basis of "common methodologies and statistics." (*Id.* at 6). The Department will review these costs and allocations on at least an annual basis, although even prior to that review BCBSD's management will be involved in the annual budgeting process and will receive projections of corporate costs that may be charged in the coming years, as well as invoices and monthly reports detailing actual costs charged. (BX 81). As discussed above, there also is a dispute resolution mechanism that would first involve the BCBSD Board and then the Highmark Board, if there are disagreements relating to the amounts charged to BCBSD as compared to the services and benefits received. (ASA Art. VII). Despite contractual provisions regarding cost allocation and representations made by the Applicants as to the fairness of the process, the Department is intent on assuring that the process does not result in an inappropriate assessment of expenses against BCBSD. As to cost allocation in particular, the Department's determination that this standard is satisfied is contingent on the conditions the Department suggests below.

In addition, the Affiliation may increase BCBSD's reserves. The overall financial impact of the Affiliation is reflected in two sets of financial projections BCBSD prepared: one set for the situation in which BCBSD remains a standalone entity and another set for BCBSD affiliating with Highmark. (*See* Ex. 38, BCBSD Standalone Forecast; Ex. 5, BCBSD Affiliation Forecast; BX 84-96). BCBSD projects that by 2015 its reserves would be $53 million lower if

BCBSD were to remain a standalone entity and not enter into the Affiliation. (*See* Ex. 38, BCBSD Standalone Forecast at 6 (Capital & Surplus); Ex. 5, BCBSD Affiliation Forecast at 6 (Capital & Surplus); BX 88). This decrease in reserves is largely due to IT-related depreciation and support expense. (*See* Ex. 38, BCBSD Standalone Forecast at 3 (Capability Enhancements – Depreciation); Ex. 5, BCBSD Affiliation Forecast at 3 (Capability Enhancements – Depreciation); BX 88). Membership and expenses are different under the two alternatives as well. With the Affiliation, BCBSD will gain membership and incur lower expenses as compared to remaining a standalone entity. (*See* Ex. 38, BCBSD Standalone Forecast at 1 (Total Member Months), 3 (Total Operating Expenses); Ex. 5, BCBSD Affiliation Forecast at 1 (Total Member Months), 3 (Total Operating Expenses); *see also* BX 88-93). Another difference is that, by 2015, BCBSD's cash and investments are projected to be valued at $147 million less in the standalone context than under the Affiliation, given projections in the standalone case of decreased operating results, higher capital expenditures, and other negative changes in investing activities and to the balance in assets and liabilities. (*See* Ex. 38, BCBSD Standalone Forecast at 6 (Cash & Short Term Investments, Investments); Ex. 5, BCBSD Affiliation Forecast at 6 (Cash & Short Term Investments, Investments); *see also* BX 94-96).

Disaffiliation Considerations. The proposed Affiliation contemplates changes to BCBSD's governance and corporate structures, and to BCBSD's market presence, which changes involve a level of integration with Highmark that is more complex than BCBSD's previous affiliation with CareFirst. (BX 73). In light of the relationship between BCBSD and CareFirst ending in a disaffiliation, the Department has carefully analyzed the proposed Affiliation for the options it provides to BCBSD in the event of a disaffiliation with Highmark. As discussed above, the Class A directors of BCBSD have the option to disaffiliate from

Highmark only under limited circumstances. If there is a disaffiliation, BCBSD likely would have to disassociate its core administrative and IT functions from those of Highmark. (*Id.*). BCBSD would then have to find an alternative provider of IT services, as well as a provider of other services, or to build its own capabilities to provide those services (*Id.*; *see also* KPMG 42). Such a disaffiliation would likely cost between $40-$55 million, depending on the level of integration between BCBSD and Highmark at the time of the disaffiliation. (KPMG 42) Also as discussed above, BCBSD would have to navigate this capability-building process while faced with having to immediately repay the funds borrowed under the LOC Agreement (if any amounts are outstanding) and to fulfill BCBSA's requirements related to BCBSD reestablishing itself as BCBSA's primary licensee in Delaware. (*Id.*). Given the limited circumstances under which BCBSD could disaffiliate from Highmark, and the immediate pressures that BCBSD would face if it actually needed to disaffiliate, the Department has heightened concerns about the fairness and reasonableness of the Affiliation to BCBSD policyholders, as well as whether the Affiliation is in the public interest, and the Department undertook its review bearing in mind additional governance and financial conditions designed to best protect BCBSD policyholders and Delaware interests. As described below, the Department has proposed conditions to the transaction affecting corporate governance, concerning the events that give rise to BCBSD's right to withdraw from the Affiliation, supporting BCBSD in its decision whether to disaffiliate, and relating to BCBSD's ability to obtain the marks after a disaffiliation—all with the intent of minimizing harm to BCBSD in the event there is a disaffiliation.

BCBSD's Management & Executive Compensation. The Department also scrutinized BCBSD's executive compensation to determine where there were any incentives that would cause BCBSD executives to favor an affiliation with Highmark over other potential strategic partners. Neither Highmark nor BCBSD have offered any BCBSD executives any compensation or bonuses in connection with the Affiliation. As discussed above in the Statement of Facts, Section III.E, "Executive Compensation and Non-Executive Transaction-Related Bonuses Plans," BCBSD's CEO and six vice presidents will remain with BCBSD or Highmark after the Affiliation. (BX 69). Their terms of employment remain essentially unchanged from pre-existing employment agreements that pre-dated the proposed Affiliation.[15] In a worst-case scenario, the total severance payment if all seven executives were terminated immediately, and only under specific circumstances, after the Affiliation closes is approximately $6 million. (*See* Ex. 26, Joint Response of BCBSD, Inc. and Highmark Inc. to Delaware Department of Justice Questions Dated August 23, 2011, at 14-15; BX 69). The executives' agreements do not, however, provide them with any financial payments or incentives for the completion of the Affiliation. (*See* Ex. 34, BCBSD Jan. 26, 2011 Responses to DOJ Request at 10).

As discussed above, there is a total of approximately $300,000 in bonuses planned for distribution to eight non-executive employees who the BCBSD Board have decided are critical to the successful transition involved in the Affiliation. (*Id.*). If the Affiliation closes, these non-executive employees would receive some portion of their bonuses at the closing of the Affiliation and then receive the remaining portion six months later. (*Id.*).

The Affiliation will also result in some BCBSD corporate departments and professionals reporting to their corresponding Highmark departments and professionals, such as

---

15 Earlier analyses performed by an executive compensation consultant of BCBSD in 2009 and 2011 concluded that, in general, the compensation of BCBSD's executives is below competitive median levels in the industry. (See Ex. 28, TowersWatson – BCBSD VP Comp. Assessment; Ex. 27, WatsonWyatt – BCBSD CEO Comp. Assessment).

in the areas of operations and finance. (BX 70-71). The BCBSD President will, however, have relative autonomy when making the kinds of decisions that relate to interacting with BCBSD customers and the Delaware public. (BX 70). Corporate budgets will be determined at Highmark, but the BCBSD President and certain BCBSD personnel will have input into Highmark's budget-planning process. (*Id.*).

Employment Levels. Another crucial anticipated impact of the Affiliation relates to employment levels in Delaware. Although Highmark is contractually obligated, under the Affiliation Agreement, to use commercially reasonable efforts to maintain employment levels in Delaware that are proportionate to those employment levels in other Highmark service areas, BCBSD employment levels are likely to decline as a result of the Affiliation. (Affiliation Agreement § 7.4; BX 72). This is particularly true in the longer term, because Highmark's commitment to specific employment levels relates to the time immediately after the completion of the Affiliation integration. (*See* Ex. 25, Pre-Hearing Joint Comprehensive Statement of BCBSD, Inc. and Highmark Inc. at 8). Three areas of employment in particular—finance, operations, and IT—are likely to involve transfers of BCBSD positions to Delaware-based Highmark positions. (BX 72). Highmark's laudable goal of making BCBSD more competitive by promoting greater efficiency for BCBSD creates a tension with efforts to preserve employment levels in Delaware. (*Id.*). As previously noted, Highmark has made certain commitments regarding maintaining certain employment levels for certain periods of time, providing first priority to displaced BCBSD employees for new positions created in Delaware, as well as others, which the Department recognizes as in the interest of the Delaware public and, having been voluntarily agreed to by the Applicants, are appropriately reflected as conditions.

On the basis of the previous evidence, and contingent upon the approval of the conditions advanced by the Department, the Department does not believe the Affiliation is unfair or unreasonable to BCBSD policyholders or against the public interest.

II. HAZARDOUS OR PREJUDICIAL TO THE INSURANCE BUYING PUBLIC

Standard "F" of the criteria in Section 5003 concerns whether the Affiliation is likely to be hazardous or prejudicial to the insurance buying public.[16] The Department and its advisors focused on an assessing BCBSD's current market position and the impact of the Affiliation on that position; reviewing BCBSD's search for a strategic partner and the decision of BCBSD's Board of Directors in connection therewith; and the Delaware public's feedback concerning the Affiliation. (BX 113).

BCBSD's Current Market Position. BCBSD is the dominant locally-based insurer in the Delaware health insurance market. (BX 115). BCBSD provides services to approximately 33 percent of all Delawareans. (*Id.*). Various stakeholders in the Delaware market—including members, providers, employers, brokers, and community members—generally are highly satisfied with BCBSD. (BX 114). These include such specific stakeholders as Christiana Care Health System, the Medical Society of Delaware, and Nanticoke Memorial Hospital. (*See, e.g.*, Ex. 39, Statement of Support from the Medical Society of Delaware; BX 124-27). BCBSD faces significant challenges, however. The Delaware market is limited in size, which thus limits the potential for BCBSD to expand its subscriber base. (BX 114). Further, maintaining its high satisfaction rates among diverse stakeholders will require BCBSD to

16 A basis for the Commissioner rejecting the proposed Affiliation is that the Commissioner finds that "[t]he [Affiliation] is likely to be hazardous or prejudicial to the insurance buying public." (18 *Del. C.* § 5003(d)(1)(f)).

continue capital spending and to modernize. (*Id.*). This capital spending may require BCBSD to seek to raise premiums, which would impact stakeholder satisfaction. (*Id.*). Additionally, any modernization program likely would result in a temporary decrease in BCBSD's service performance during the transition period. (*Id.*). Another source of pressure is the uncertainty regarding healthcare legislation at the federal level, and BCBSD's ability as a small organization to respond quickly and competitively to that legislation. (*Id.*). Finally, BCBSD's small size and lean business model limits the resources BCBSD is able to devote to developing new products, improving its data management, and addressing other capability enhancement necessary for BCBSD to continue its successful performance and service. (*Id.*). Accordingly, while BCBSD is in a favorable position within the Delaware insurance market, BCBSD faces significant challenges as a standalone entity. (*Id.*).

BCBSD's Search for a Strategic Partner. Over the course of approximately three years following its 2006 disaffiliation from CareFirst, BCBSD completed a strategic review of its long-term options and needs. (BX 117; *see generally* BX 118-122). BCBSD had several reasons to enter into a relationship with a strategic partner. (BX 123). Chief among them is the continued consolidation occurring in the healthcare industry nationwide, driven in part by the need for larger scale to achieve improvement in technology and gains in capabilities. (*Id.*). BCBSD's competitors in the Delaware market are large, national conglomerates with significant resources. (*Id.*). With the CareFirst Affiliation, BCBSD had already experienced the benefits of having an affiliation with a larger Blue organization when competing in an increasingly consolidated marketplace. (*Id.*).

BCBSD, however, did not want to enter into a short-term relationship and then soon afterwards undertake another search for a long-term partner. (*Id.*). Instead, BCBSD sought to find the appropriate long-term partnership now, one that enables BCBSD to remain a non-profit corporation and able to fulfill the social mission of a non-profit, yet also to retain local decision-making authority in Delaware. (*Id.*). BCBSD has identified Highmark as the long-term partner that enables BCBSD to meet these requirements.

Public Feedback on the Proposed Affiliation. The Department and its financial advisor compiled public comments received prior to and during the May 2011 public information sessions and spoke with market participants during the weeks after those sessions. (BX 124). Of highest priority were these stakeholders' views on the following: BCBSD's performance and capabilities relative to its competitors; the importance of having a large non-profit health insurance provider in Delaware; the importance of BCBSD being locally-managed; experiences during any prior interactions with Highmark; and the Affiliation's potential impact on competition in the Delaware health insurance market. (BX 113, 124). From these public information sessions and stakeholder meetings, the Department and its financial advisor identified the reactions of various Delaware stakeholders to the proposed Affiliation. (BX 125-127; *see also* Ex. 39, Statement of Support from the Medical Society of Delaware). The primary concern of BCBSD's customers and the broader insurance-buying public is BCBSD's ability to maintain a strong local presence and local decision-making authority. (BX 128). Generally, the Department believes that the terms and likely impacts of the Affiliation address these concerns, along with the other concerns expressed by these stakeholders, subject to the conditions that the Department would impose. (*See* BX 125-27).

On the basis of BCBSD's current market position and unique role in Delaware, its reasons for and thorough deliberation in seeking a strategic partner, and the Department's conclusion that the terms of the Affiliation comport with the priorities and preferences of insurance-buying public and other stakeholders in Delaware, the Department does not believe the Affiliation is likely to be hazardous or prejudicial to the insurance-buying public, subject to the conditions the Department proposes below.

III. STRENGTH OF HIGHMARK'S FINANCIAL CONDITION

Standard "C" of Section 5003 requires evaluating the financial condition of Highmark to determine whether it might jeopardize the financial stability of BCBSD or prejudice the interest of BCBSD policyholders.[17]

BCBSD and Highmark will remain separate legal entities under the terms of the proposed Affiliation, and BCBSD will not be responsible for paying any of Highmark's liabilities. (BX 58). Highmark's financial condition, however, is important to the Commissioner's decision whether to approve the Affiliation because it influences Highmark's ability to fulfill its own obligations under the terms of the Affiliation Agreement and ASA, including its provision of administrative and corporate services to BCBSD. (*Id.*). For example, a financially weakened Highmark could jeopardize the financial stability of BCBSD or prejudice BCBSD policyholders. (*See id.*). The Department's analysis, therefore, focused on three issues: Highmark's financial condition, BCBSD's reserves (because maintaining strong reserve levels will help BCBSD retain local control while affiliated and would better position BCBSD in the event of a disaffiliation), and the potential impact of a large commercial transaction proposed by Highmark in western Pennsylvania.

---

17 A basis for the Commissioner rejecting the proposed Affiliation is that the Commissioner finds that "[t]he financial condition of [the controlling affiliate, *i.e.*, Highmark] is such as might jeopardize the financial stability of [BCBSD], or prejudice the interest of [BCBSD] policyholders." (18 *Del. C.* § 5003(d)(1)(c)).

Highmark's Financial Condition. Not only does BCBSD have no direct exposure to Highmark's liabilities, but Highmark's financial condition is sufficiently strong that BCBSD does not appear to be at risk by affiliating with Highmark and relying on Highmark for administrative services. Highmark's risk-based capital ratio is approximately 692%, which exceeds the average ratio of 478% among a sample of large, publicly traded health insurers. (BX 59; *see* Footnote 6 for an explanation of risk-based capital ratios; *see also* Ex. 25, Pre-Hearing Joint Comprehensive Statement of BCBSD, Inc. and Highmark Inc. at 4 (noting financial strength of Highmark)). This figure indicates the above-average strength of Highmark's position in the market, as it relates to the ability to satisfy liabilities even in the face of a market downturn or other adverse development. Further, Highmark anticipates steady growth in the coming years, as well as growth in its investment portfolio and in investment income. (BX 60).

BCBSD's Reserves. The Department and its advisors also analyzed BCBSD's reserves, because of their view that maintaining strong reserve levels will help BCBSD retain local autonomy while affiliated with Highmark and will better position BCBSD in the event it were to withdraw from the Affiliation. (BX 61). BCBSD's risk-based capital ratio of 1,056% is much higher than the average of 867% among a sample of similarly-sized health insurance carriers from across the United States. (BX 62). It also is significantly higher than the BCBSA's minimum requirements of 200% and the BCBSA's 375% threshold for monitoring. (BX 63). Based on advice from Milliman, an advisor retained by BCBSD, BCBSD seeks to maintain a risk-based capital ratio that significantly exceeds minimum requirements, given that small non-profit health insurers face greater concentrations of business risks and fewer capital-raising options as compared to their for-profit competitors. (*Id.*). BCBSD projects that the Affiliation will first result in a slight decrease in BCBSD's risk-based capital ratio (to 994% in 2013), but that the ratio will increase to 1,063% by 2015. (*See* Aug. 31, 2011 BCBSD Pro Formas at 5).

Highmark's Proposed Affiliation with West Penn Allegheny Health System. In June 2011, Highmark proposed to affiliate with the West Penn. (BX 64; Ex. 9, Article – Highmark-WestPenn Transaction). West Penn is a non-profit provider organization that operates five hospitals in the Pittsburgh region. (BX 64). The details of the transactions are not yet finalized, and Highmark has not yet made a regulatory filing with the Pennsylvania Insurance Department. (*See id.*). Preliminary financial terms indicate, however, a commitment from Highmark in the amount of $475 million to West Penn. (Ex. 9, Article – Highmark-WestPenn Transaction). This amount includes a combination of grants and loans. (BX 64). REDACTED

REDACTED

(*Id.*; BX 59).

On the basis of Highmark's current and projected financial condition, the information provided by Highmark concerning the West Penn transaction, and BCBSD's current and projected reserves, as well as the proposed corporate structure of Highmark, the Department does not believe that the financial condition of Highmark is such as might jeopardize the financial stability of BCBSD—with certain caveats. In order to assure Highmark's maintenance of adequate risk-based capital levels, to assure the Department can verify Highmark's financial condition, and to assure BCBSD has no direct exposure to any liabilities or operating losses in Highmark's provider chain, the Department's determination that this standard has been satisfied is subject to certain conditions, discussed below

IV. COMPETENCE, EXPERIENCE, AND INTEGRITY

For its analysis of whether the Affiliation satisfies Standard E,[18] the Department has reviewed the biographies, credentials, and records of the 21 board members and 11 executive officers of Highmark. The Department has focused on the education, employment history, experience, and professional licensing of these individuals, as well as answers to questions relating to any fraud, dishonesty, civil actions, and bankruptcy associated with companies for which these individuals have worked or served as directors. The Department is in the process of completing an additional inquiry with Highmark.

[18] A basis for the Commissioner rejecting the proposed Affiliation is that the Commissioner finds that "[t]he competence, experience and integrity of those persons who would control the operation of the insurer are such that it would not be in the interest of policyholders of the insurer and of the public to permit the merger or other acquisition of control." (18 *Del. C.* § 5003(d)(1)(e)).

Highmark has chosen three of its four Class B Directors: Dr. Kenneth R. Melani, Deborah G. Rice, and Nanette P. DeTurk. (*See* Letter from D. Foster re: Highmark's Supplemental Filing No. 6 to Statement Regarding the Affiliation, Aug. 29, 2011, at 1). Dr. Melani, Ms. Rice, and Ms. DeTurk are executives in a highly-regulated industry, whose qualifications have also been reviewed by other state departments of insurance. Dr. Melani has been an executive of health care entities for more than twenty years and is or has been a director of nearly thirty entities in the health or health insurance fields. (*See* Ex. 40, Melani Biographical). Deborah Rice has been a senior executive at Highmark for nearly three years and an employee of the company for nearly thirty years, and is or has been a director of thirteen entities in the health or health insurance fields. (*See* Ex. 41, Rice Biographical). Nanette DeTurk has been an executive or manager of health care entities for more than twenty years and is or has been a director of more than fifty entities in the health or health insurance fields. (*See* Ex. 42, DeTurk Biographical).

Based on the biographical information provided by Highmark, the research the Department has conducted into the background records of the directors and executive officers of Highmark, and the conversations the Department has had with its counterparts in other jurisdictions, the Department to date has no reason to conclude that the leadership and management of Highmark and the appointment of Dr. Melani, Ms. Rice, and Ms. DeTurk to the Board of Directors of the post-Affiliation entity is contrary to the interest of BCBSD policyholders or to the public interest, or that Dr. Melani, Ms. Rice, and Ms. DeTurk have ever been charged or convicted of criminal misconduct or ever have been found to have committed any fraud, misrepresentation, malfeasance, or gross negligence, whether in a civil or criminal proceeding. The Department will conduct the same thorough review of the fourth person

Highmark proposes to appoint as a Class B Director and will complete its follow-up analysis with Highmark, in order to make a final determination as to whether the Affiliation satisfies the criteria of Standard E.

V. IMPACTS ON COMPETITION

Standard B involves a determination of whether the effect of the Affiliation would be substantially to lessen competition or tend to create a monopoly in Delaware.[19] Specifically, the Commissioner must apply quantitative standards relating to the market shares of BCBSD and Highmark and to recent trends towards increased concentration in the market, as set forth in 18 *Del. C.* § 5003A(d)(2). (*See* 18 *Del. C.* § 5003(d)(1)(b)(1); *see also* BX 51). If certain quantitative criteria are met, then there is *prima facie* evidence that the competitive standard has been violated. (*See* 18 *Del. C.* § 5003A(d)(2)(a)). Even if such *prima facie* evidence exists, the Affiliation may nonetheless satisfy the overall standard if there is other substantial evidence that suggests that the Affiliation will not have an anti-competitive effect. (*See* 18 *Del. C.* § 5003A(d)(2)(d)). These factors include, but are not limited to market shares, volatility of ranking market leaders, number of competitors, concentration, trend of concentration in the industry, and ease of entry and exit into and out of the market. (*Id.*).

Based on an analysis of data collected by the NAIC and provided to the Department, there are two insurance categories in which BCBSD and Highmark currently compete in Delaware: Stop-Loss and Dental. (BX 52). Because of the way that insurers report Stop-Loss business to the NAIC, it is impossible to isolate what percentage of an insurer's

---

19 A basis for the Commissioner rejecting the proposed Affiliation is that the Commissioner finds that "[t]he effect of the [Affiliation] would be substantially to lessen competition in insurance in this State or tend to create a monopoly therein." (18 *Del. C.* § 5003(d)(1)(b)).

market share comes from Stop-Loss premiums versus from other health or accident insurance premiums. However, even assuming that 100% of Highmark's health insurance premiums in Delaware were written in the category of Stop-Loss—which is not, in fact, the case—Highmark's market share in the category is less than 1 percent, and thus there is no *prima facie* violation of the market-share or increasing-trend standards. (BX 52-53).

In the Dental category, however, both BCBSD and Highmark have higher market shares: 11.1 percent for BCBSD, and 5.8 percent for Highmark. (BX 54). The high market concentration of the four largest insurers, when considered along with the specific market shares of BCBSD and Highmark, results in a *prima facie* violation of the competitive standards. (*Id.*). Notwithstanding, the Department does not believe that the Affiliation will have an anti-competitive effect. Because more than 81 percent of Highmark's Delaware dental customers receive their dental insurance from employers based outside of the Delaware, Highmark's market share of the active Delaware dental market likely is below 1 percent. (BX 55). Thus, the Affiliation will not have an anti-competitive effect on pricing in the Delaware market. (*Id.*). Moreover, any increase in Highmark's presence in the Delaware dental market may actually help to provide a competitive counterbalance to Delta Dental, which has a 65.9 percent market share and is by far the largest dental insurer in Delaware. (*Id.*; *see also* Ex. 25, Pre-Hearing Joint Comprehensive Statement of BCBSD, Inc. and Highmark Inc. at 2-3 (discussing competitiveness in Delaware dental market)).

On the basis of the relevant standards and this analysis, the Department does not see evidence of the Affiliation having an anti-competitive effect in the Stop-Loss or Dental markets. The Department is concerned, however, about the potential for anti-competitive effects arising through certain types of product offerings and pricings. The Applicants intend to offer ancillary health insurance products beyond BCBSD's current core products. Such an offering may cause a negative impact on consumers if ancillary products introduced into the Delaware market by Highmark are bundled with core health products in which BCBSD enjoys a strong market position. In the Delaware market, BCBSD currently enjoys very strong positions for several core products. Competition in the markets for ancillary products could be impeded if customers who seek to purchase core products offered by BCBSD can buy those BCBSD products if and only if the customers agree to buy ancillary Highmark products for which neither Highmark nor BCBSD currently has strong market positions or if BCBSD engages in anti-competitive pricing in certain circumstances. As a consequence, and as noted below, the Department qualifies its determination that this standard is satisfied on certain conditions being imposed to address these concerns.

VI. BCBSD'S AND HIGHMARK'S SATISFACTION OF STATUTORY LICENSING REQUIREMENTS

Standard A requires an evaluation of whether BCBSD will be able to satisfy the requirements to continue writing the lines of insurance that it does today.[20] Because BCBSD was already engaged in business as a health service corporation on November 1, 1968, BCBSD is not required to obtain a certificate of authority from the Department, or a "license" for the purposes of Standard A of Section 5003(d)(1)(a). (*See* 18 *Del. C.* § 6304(a); Charter ¶ 1; Ex. 25, Pre-Hearing Joint Comprehensive Statement of BCBSD, Inc. and Highmark Inc. at 1-2). Following the closing of the Affiliation, BCBSD will remain a health service corporation because it will remain a "a nonprofit corporation, without capital stock, organized under the laws

[20] A basis for the Commissioner rejecting the proposed Affiliation is that the Commissioner finds that "[a]fter the change of control, the domestic insurer [*i.e.*, BCBSD] . . . would not be able to satisfy the requirements for the issuance of a license to write the line or lines of insurance for which it is presently licensed." (18 *Del. C.* § 5003(d)(1)(a)).

of this State for the purpose of establishing, maintaining and operating plans to provide hospital, physicians or related health services, or indemnity therefore, for such persons as become members or subscribers of any plan of such corporation." (18 *Del. C.* § 6302; *see also* Charter Arts. 3-4; Ex. 25, Pre-Hearing Joint Comprehensive Statement of BCBSD, Inc. and Highmark Inc. at 2). Therefore, BCBSD will continue to have the ability after the Affiliation to write the same lines of insurance as it did before the Affiliation. The Department has also verified that Highmark's Delaware-based subsidiaries meet the capital balance requirements essential to the satisfaction of their licensing requirements. (BX 48). Accordingly, the Department believes that the proposed Affiliation would not violate Standard A.

THE DEPARTMENT'S PROPOSED CONDITIONS

The foregoing analysis identified certain aspects of the proposed Affiliation that do not fully satisfy the statutory criteria under 18 *Del. C.* § 5003(d)(1). Consequently, the Department recommends the Commissioner impose certain conditions. Certain other voluntary commitments regarding prospective employment, as well as potential agreements regarding community contributions, should simply be—as noted above, memorialized as conditions agreed to by the Applicants. Those specifically identified below are not all inclusive—there are ongoing discussions with the Applicants regarding additional or alternative conditions in each category addressed. The conditions discussed below represent the Department's current position regarding conditions, which may change based on additional information provided by, or discussions with, the Applicants.

Protection of Reserves. Pursuant to the creation of 18 *Del. C.* § 6311 (the statute created by S.B. 146), the Commissioner is required to place certain conditions on the proposed

Affiliation, which conditions are intended to preserve the remaining surplus or reserves of BCBSD:

- Review and approval by the Department of any individual expenditure or transfer of funds or coordinated series of expenditures or transfers of funds by the post-affiliation BCBSD in excess of $500,000 to Highmark or any Highmark affiliate, which review and approval shall assess the commercial reasonableness of the proposed expenditure or transfer.

- Recognition of, and consent to, the ability of the Insurance Commissioner to seek appropriate relief from the Court of Chancery or other court of appropriate jurisdiction to prevent Highmark from improperly using the assets of the post-affiliation BCBSD for the benefit of Highmark rather than the benefit of the post-affiliation BCBSD and its subscribers, or otherwise violating the terms of this section, Chapter 50, or any agreement between the post-affiliation BCBSD and Highmark or a Highmark affiliate.

- Review and approval by the Department of any change in the certificate of incorporation of the post-affiliation BCBSD.

- A majority of the board of directors of the post-affiliation BCBSD to consist of persons not employed by the post-affiliation BCBSD or any of its affiliates and who are residents of Delaware and have been so for at least five years prior to appointment.

- Whenever approval must be obtained from the Commissioner for any activity described in this Section [§ 6311], simultaneous notice thereof shall be provided to the Department of Justice.

- If BCBSD is dissolved, BCBSD shall, after the discharge of all obligations, distribute all remaining assets to the foundation created under Section 2533 of Title 29 of the Delaware Code.

Delaware Jobs and Community. The Applicants have voluntarily agreed to certain commitments – here reflected as conditions – related to employment in Delaware:

- **BCBSD and Highmark shall make a commitment to employment in the Delaware community, including: (i) BCBSD's corporate headquarters shall remain in Delaware; (ii) Highmark will assure the total FTE positions in Delaware, including either BCBSD positions or Highmark positions located in Delaware, will be the same after the integration is complete as it was at the start of the integration; (iii) Highmark and BCBSD will give to any BCBSD employees whose positions are eliminated due to the Affiliation the first opportunity to fill any new**

positions that are created by either party in Delaware; and (iv) Highmark and BCBSD will use commercially reasonable efforts to maintain employment levels in Delaware that are proportionate to those in other Highmark geographic service areas.
This commitment by the Applicants seeks to maintain the local presence of BCBSD, both as a Delaware-based company and as an employer of Delawareans. This condition accounts for the employment transitions that may be involved in the Affiliation but assures that employment for Delawareans, including current BCBSD employees, remains a priority for BCBSD.

- **For four years after the effective date of the Affiliation, BCBSD will take such actions as necessary to ensure that there is not a material decrease in the quality of BCBSD's provision of account and broker management, customer service, and provider service to Delaware customers by Delaware-based staff under the immediate supervision of Delaware-based staff, it being understood, however, that additional support may be provided by Highmark or other Highmark affiliates during periods of additional need as deemed to be necessary or appropriate to drive optimum client satisfaction.**
  This condition seeks to promote both the stability of jobs in Delaware and the continuation of the Delaware-focused and locally-accountable service that BCBSD has provided for its policyholders and community stakeholders.

Administrative Services. The Department believes the following conditions related to administrative services will help to ensure that Highmark's financial condition will not jeopardize the financial stability of BCBSD or prejudice the interest of BCBSD policyholders, and will help to ensure that the Affiliation is fair and reasonable to BCBSD policyholders and is in the interest of the Delaware public, and that the Affiliation is not hazardous or prejudicial to the insurance-buying public in Delaware (18 *Del. C.* § 5003(d)(1)(c), (d)(1)(d), and (d)(1)(f)):

- **Prior to closing, BCBSD and Highmark shall file with the Department the cost allocation methodology and formula. In addition, BCBSD will annually file a budget that will identify and describe planned Highmark charges. The Department will annually review and approve the annual budget. BCBSD must seek approval from the Department for any payments that exceed the approved budget by more than $500,000.**
  This condition will help to address the issue of how Highmark apportions costs to BCBSD from Highmark's broader network and will help to prevent any unfair or undue administrative charges being levied on BCBSD by

Highmark as Highmark spreads its administrative costs across the various subsidiaries and affiliates in the Highmark network.

- **The ASA may only be terminated or amended: (i) upon notice by BCBSD, with approval by the Department or (ii) pursuant to Article III.B of the ASA. If the ASA is terminated, the terminating party shall give 180 days prior written notice of termination, which period may be shortened by agreement of Highmark and BCBSD.** (*See* ASA Art. III A).
  This condition clarifies and places a limitation on Highmark's ability to terminate the ASA at will after the first year. Without this condition, Highmark would be able to terminate the ASA—a cornerstone of the Affiliation—for any reason whatsoever after the first year of the Affiliation. While the Department has no specific reason to believe Highmark would opt for such a termination, the Department does believe that a reasonable limit should be placed on Highmark's ability to unilaterally terminate an agreement so critical to the Affiliation.

- **BCBSD and Highmark shall agree on a service level agreement (including service level metrics), and for the first eighteen months BCBSD shall provide quarterly reporting to the Department concerning whether the metrics and other standards in such agreement are met.**
  This condition seeks to promote a smooth, accountable process for technology integration, a concern specifically identified by KPMG (KPMG 37). Given the importance of the IT issue to the future strength of BCBSD and to the current and future health of BCBSD policyholders, the Department believes it is important that the Applicants be required to provide the Department with regular progress reports over the first eighteen months of the Affiliation.

- **There shall be a cap on integration costs (which are those listed on page 35 of the KPMG Report), and any integration costs in excess of $42 million are to be paid or absorbed by Highmark.**
  This condition seeks to address the Department's concerns that the Affiliation, as proposed, does not provide for any kind of maximum cost for the technology upgrades and integration onto Highmark's platform. Without a limit on integration costs, and with significant control from Highmark over how high those costs may go, BCBSD and its policyholders and community stakeholders may be at risk of potentially higher transition expenses charged to BCBSD.

- **After a disaffiliation, Highmark must continue the ASA for 3 years, at cost plus 2% until the later of (a) the end of year 1 or (b) the return of the Marks to BCBSD; during year 2 at cost plus 4% until the later of (a) the end of year 2 or (b) the return of the Marks to BCBSD; and during year 3 at cost plus 6% until the later of (a) the end of year 3 or (b) the return of the marks to BCBSD. (*See* ASA Art. III C.) Highmark also agrees to use**

"best efforts" to assist with BCBSD's transition away from Highmark. In addition, Highmark must continue to abide by these obligations in the event of any termination of the ASA (not just the ones currently specified in Art. III C.).
This condition seeks to promote the continued provision of administrative services for BCBSD from Highmark after a disaffiliation, as BCBSD examines its alternatives.

Corporate Governance. The Department believes the following conditions related to corporate governance will help to ensure the Affiliation is fair and reasonable to BCBSD policyholders and is in the interest of the Delaware public, and that the Affiliation is not hazardous or prejudicial to the insurance-buying public in Delaware (18 *Del. C.* § 5003(d)(1)(d) and (d)(1)(f)):

- **Quorum of the post-affiliation BCBSD Board requires a majority of the directors then in office and qualified to act, which majority must include at least one Class A director and at least one Class B director; provided however, in the event a quorum cannot be reached with regard to two consecutive, properly-called meetings of the Board due to no member of the Class A directors being present at either meeting or no member of the Class B directors being present at either meeting, this quorum requirement will not apply to the next properly called meeting thereafter.** (*See* Bylaws § 5.7).
  This condition seeks to promote local control and input by requiring that at least one Class A (independent) Director of BCBSD must be present before the BCBSD Board can conduct business.

- **After the initial term of each Class A director, the immediate successor to each initial Class A director shall be nominated by the Nominating Committee, such nomination to be in the sole discretion of the Nominating Committee, and shall be elected by Highmark. Following the election of the immediate successor to each Class A director, each subsequent Class A director shall be nominated and elected as set forth in the Bylaws.** (*See* Bylaws § 5.2(b)).
  This condition seeks to promote stability in the integration process by providing the initial Class A Directors the opportunity to elect their own successors for one term. Extending the ability of the initial Class A Directors to select their successors should promote a smooth integration process.

- **Highmark cannot unreasonably withhold its election of a nominated Class A Director, and Highmark shall give BCBSD in writing**

Highmark's reason for withholding any such election. (*See* Bylaws § 5.2(b)).

This condition aims to prevent a situation in which there is gridlock between the Class A Directors and Highmark regarding the selection of new Class A Directors. Each new Class A Director will be nominated by his or her fellow Class A Directors, all of whom together will provide an independent voice on the Board. Highmark, however, must formally approve each nomination and then elect each Director. As currently written, the proposed BCBSD governance documents require only that Highmark approve or disapprove of a nomination in a timely fashion. (*See id.*). The Department recommends that the Commissioner also prohibit Highmark from unreasonably withholding its approval of the nominees.[21]

Disaffiliation. The Department believes the following conditions related to any future disaffiliation will help to ensure that Highmark's financial condition will not jeopardize the financial stability of BCBSD or prejudice the interest of BCBSD policyholders, and to ensure that the Affiliation is fair and reasonable to BCBSD policyholders and is in the interest of the Delaware public, and that the Affiliation is not hazardous or prejudicial to the insurance-buying public in Delaware (18 *Del. C.* § 5003(d)(1)(c), (d)(1)(d), and (d)(1)(f)):

- **Triggering Events giving rise to the Class A directors' ability to withdraw BCBSD from the affiliation (withdrawal being permitted, not required, upon a Triggering Event) include those Triggering Events listed in Bylaws § 13.1, and the following:**

    - **Highmark materially fails to perform its obligations under any of the agreements (allowing for cure period);**

    - **Highmark becomes the subject of a delinquency proceeding pursuant to Pennsylvania law (including, but not limited to, a proceeding involving the rehabilitation or liquidation of Highmark);**

    - **Highmark's risk-based capital ratio falls below 425%; or**

---

21 As to other governance conditions, note that, pursuant to 18 *Del. C.* § 6311, the Department must review and approve any change in the certificate of incorporation of BCBSD, and a majority of the board of directors of BCBSD must consist of persons not employed by BCBSD or any of its affiliates and who are residents of Delaware for at least five years.

- **A 'Form A' or similar regulatory filing by Highmark of a conversion or change-of-control is approved by the regulator with which it is filed.**

This condition expands the options for the BCBSD Class A Directors, so that they have the choice to disaffiliate for important reasons not currently in the proposed Affiliation documents. The Department has concluded that the options as proposed in the Affiliation documents are too narrow to provide BCBSD with the important and necessary protections and flexibility to disaffiliate from Highmark if Highmark enters into certain transactions which introduce significant risk to BCBSD and BCBSD policyholders.

- **Notice of the Class A Directors' intent to disaffiliate shall be provided to the Department when such notice is provided to Highmark. In addition, prior to implementing any disaffiliation, the party seeking disaffiliation must submit to the Department for approval a plan discussing the impact of the disaffiliation on Delaware policyholders and the manner in which current levels of coverage for such policyholders will be maintained.**

  These conditions are intended to ensure Department approval and oversight regarding any planned disaffiliation. Any disaffiliation has the potential to be disruptive to BCBSD's ability to provide services to its policyholders, and Department oversight of such a disaffiliation plan is necessary to ensure that policyholders and Delaware interests are protected.

- **Upon receiving notice of a Triggering Event, the current 60-day period in which the Class A directors must choose whether to authorize a disaffiliation under Article XIII of the Bylaws shall be extended to a total of 180 days. During this time, BCBSD shall have reasonable access to, and the cooperation of, Highmark's resources including, but not limited to:**

  (i) Highmark's provision of material information (subject to an appropriate confidentiality agreement) on BCBSD costs and operations that may be available only at Highmark or through Highmark employees; and

  (ii) BCBSD's access to certain Highmark employees for purposes of conducting due diligence meetings and interviews.

This condition extends the period in which the Class A directors must choose whether to disaffiliate and requires Highmark to provide the information and support as is customary during divestiture of a material operating segment of a company, including but not limited to key information. The Department believes that without this condition, the informational and resource asymmetries between Highmark and BCBSD may be so high that the Class A Directors will have no meaningful option of disaffiliation, even when disaffiliation would be in the best interests of BCBSD, its policyholders, and the broader Delaware community.

- **Highmark shall use all best efforts to facilitate the return of the marks to BCBSD following a disaffiliation, including, but not limited to, jointly requesting with BCBSD that BCBSA grant BCBSD the right to use the marks in Delaware without BCBSA issuing a request for proposals or undertaking a similar process.** (*See* Affiliation Agreement § 7.8).
  This condition seeks to promote BCBSD having sufficient resources and a more meaningful opportunity to regain the BCBSA marks in the event of a disaffiliation. Without this condition, BCBSD may have no meaningful possibility of regaining the marks, which are critical to its identity and success as a health insurer and contributor in the Delaware community.

Line of Credit. The Department believes the following conditions related to the LOC Agreement will help to ensure that: (i) Highmark's financial condition will not jeopardize the financial stability of BCBSD or prejudice the interest of BCBSD policyholders; (ii) the Affiliation is fair and reasonable to BCBSD policyholders and is in the interest of the Delaware public; and (iii) the Affiliation is not hazardous or prejudicial to the insurance-buying public in Delaware (18 *Del. C.* § 5003(d)(1)(c), (d)(1)(d), and (d)(1)(f)):

- **BCBSD shall have three years following termination of the LOC Agreement (including because of a disaffiliation) in which to repay the funds BCBSD has borrowed under the line of credit.** (*See* Affiliation Agreement § 7.8(c)(i)).
  This condition will help to address the Department's concerns that any requirement of immediate repayment of the funds will serve to preclude BCBSD from being able to disaffiliate or would precariously weaken BCBSD immediately following a disaffiliation.

- **Highmark may only terminate the LOC Agreement upon an Event of Default if the default is material and is uncured for 60 days.** (*See* LOC Agreement § 7).
  This condition places a limitation on Highmark's ability to terminate the LOC Agreement for an immaterial default and gives BCBSD the ability to cure any default. The Department has no specific reason to believe Highmark will seek to terminate the LOC Agreement for a non-material reason, but the Department does believe it is nonetheless important that a standard of

materiality is present in this Affiliation, given the potential harm to BCBSD of Highmark's termination of the LOC Agreement.

- **Section 5(b) of the LOC Agreement shall be modified to state: "…grant to any person any mortgage, lien, security interest or other encumbrance on any assets of BCBSD unless (i) Highmark has given prior written consent or (ii) such mortgage, lien, etc. is subordinate to any security interest held by Highmark."**
  This condition introduces flexibility allowing for outcomes beneficial to both Applicants, which has been welcomed by both parties and which alleviates an unintended rigidity in the LOC Agreement as initially proposed.

Competition. The Department believes the following condition related to competition will help to ensure that: (i) the effect of the Affiliation would not substantially lessen competition in insurance in Delaware or tend to create a monopoly in Delaware; (ii) the Affiliation is fair and reasonable to BCBSD policyholders and is in the interest of the Delaware public; and (iii) the Affiliation is not hazardous or prejudicial to the insurance-buying public in Delaware (18 *Del. C.* § 5003(d)(1)(b), (d)(1)(d), and (d)(1)(f)). In particular, the condition will help to minimize any anti-competitive effects from the bundling of health insurance products, whether because BCBSD core products and Highmark ancillary products are offered only in conjunction with one another or because the pricing of such products hampers competitive outcomes in the marketplace:

- **During the term of the Affiliation, neither BCBSD nor Highmark shall:**

  - **Condition the sale of a Pharmacy Product or Core Health Product (defined as a Preferred Provider Organization, Exclusive Provider Organization, Traditional Indemnity, Comprehensive Major Medical, Point of Service, Health Maintenance Organization, Managed Care Organization, Medigap, or Medicare Carve-out product offered for sale by BCBSD or Highmark in Delaware on stand-alone basis) on the purchase of any Ancillary Product (meaning a Dental, Vision, Group Disability, or Group Life product offered for sale by BCBSD or Highmark in Delaware on a stand-alone basis); provided, however that this condition shall not apply to any**

bundling of products or services pursuant to state or federal law, or

- **Discount the price of any Core Health Product on the condition of the purchase of any Ancillary Product in the Delaware market.**

Jurisdiction and Miscellaneous. The Department believes the following conditions related to jurisdiction will help to ensure that the Affiliation satisfies all statutory criteria under 18 *Del. C.* § 5003(d)(1):

- **BCBSD agrees that it is governed by and shall comply with 18 *Del. C.* Ch. 50 (Insurance Holding Company System Registration) and 18 *Del. C.* Ch. 63 (Health Service Corporations) and is subject to the general supervisory authority of the Delaware Department of Insurance, including the "target exam" or "market conduct exam" authority of 18 *Del. C.* § 318 *et seq*.**

- **Highmark agrees that it is governed by and shall comply with 18 *Del. C.* Ch. 50, not as a registered insurer, but insofar as those provisions apply to an affiliate of, and controlling person as to, a registered insurer (*i.e.*, BCBSD). Further, Highmark, though not a registered insurer governed by Chapter 3 of Title 18, agrees that it will provide, upon the Department of Insurance's request and consistent with the provisions of 18 *Del. C.* §§ 318, 320 and 322, all such books, records, or other information in its possession and make available such individuals, for interviews, as the Department of Insurance deems necessary for the Department of Insurance to assure compliance with and enforcing conditions imposed on or commitments made by Highmark in this application.**

- **BCBSD and Highmark shall continue to be subject to the jurisdiction of the Department for the purpose of implementing and enforcing the terms of these conditions, and BCBSD and Highmark continue to be jointly and severally liable for reasonable expenses incurred by the Department for consultants in connection therewith.**

- **The additional reporting obligations required in these conditions, which are in addition to those required by the Delaware Code, including those contained in Chapter 50 of Title 18, will remain in effect for four (4) years, unless it is determined by the Department that an extension of reporting is appropriate.**

CONCLUSION

For the foregoing reasons, and subject to the imposition of the conditions outlined above, the Department recommends approval of the proposed Affiliation.

MORRIS, NICHOLS, ARSHT & TUNNELL LLP

Michael Houghton (#2179)
Leslie A. Polizoti (#4299)
Ryan D. Stottmann (#5237)
Brenda R. Mayrack (#5253)
Bryan Townsend (#5538)
1201 N. Market Street
P.O. Box 1347
Wilmington, DE 19899-1347
(302) 658-9200
Attorneys for the
Delaware Department of Insurance

September 21, 2011

4501526