

SECTION II. A, B, AND C: DOJ'S/APPLICANTS' LANGUAGE

A. The DOJ's Proposed Condition

Attorney General Biden gave a statement on the record at the outset of the public hearing. (Tr. at 11-24). His focus was the surplus of BCBSD and the state tax break BCBSD receives as a result of its not-for-profit status. (Tr. at 12-13). He stated that “[t]he intent of the [DOJ] in reviewing the transaction is not to duplicate . . . the work of the [DOI], but rather to meet [the DOJ’s] own statutory and common law responsibilities.” (Tr. at 14). The Attorney General discussed the change of control in the Affiliation, and its potential for Highmark to divert BCBSD’s reserves to purposes other than those serving Delawareans. (Tr. at 16-19). He requested that the Hearing Officer impose a condition on the Affiliation that establishes a mechanism to guarantee the public’s investment in BCBSD remains in Delaware to be held and protected for the benefit of Delawareans, in an amount no less than \$45 million. (Tr. at 20). Attorney General Biden then discussed his views on how this \$45 million extraction would have a minimal impact on the adequacy of the risk-based capital ratio of BCBSD, given the national average of RBC among Blue plans and given the RBC requirements of the Blue Cross Blue Shield Association and of the National Association of Insurance Commissioners. (Tr. at 21-22). He stated “[t]hat a foundation is not statutorily mandated as it would be in a conversion does not limit . . . the ability of the [DOJ] to find one to be necessary to protect the public interest where control of a not-for-profit in its assets are changing as is the case here” (Tr. at 23).

The DOJ elicited testimony that BCBSD’s status as a not-for-profit, and its related exemption from paying state income taxes, could be characterized as support from, an investment in, or a subsidy of BCBSD by the Delaware public (Tr. at 91); and that by not being

required to pay state income taxes, BCBSD is able to pass along that tax savings to its policyholders and lower premium rates (Tr. at 91-92).

On October 14, 2011, Deputy Attorney General Ian McConnell sent me a letter (“DOJ Oct. 14 Letter”) describing the DOJ’s response to testimony and argument at the public hearing concerning the DOJ’s proposed condition. In his letter, Mr. McConnell reiterated Attorney General Biden’s opposition to the proposed Affiliation and his position that these proceedings are an appropriate forum for consideration of his proposed condition that a fund be established to serve Delaware’s unmet health needs, given the Attorney General’s role under the doctrine of *parens patriae* and the language of the Pre-Hearing Order and Delaware’s Administrative Procedures Act. (DOJ Oct. 14 Letter at 1-2).

Mr. McConnell also based the Attorney General’s position on the protection that Section 6311 itself provides for the reserves of BCBSD, as well as my own statements on the record that Section 6311 on its face allows for the imposition of other conditions. (*Id.* at 2). He wrote that the Attorney General’s proposed condition “is essential to ensure that the public’s subsidy of BCBSD will be preserved and protected for Delawareans after control of the assets has been shifted outside of Delaware.” (*Id.* at 3). He also wrote that Section 6311 “does not specify that the exclusive use of the funds preserved is to be for purposes related to BCBSD’s insurance business . . . nor even that the funds preserved be maintained within BCBSD.” (*Id.*).

Mr. McConnell concluded with a discussion of the way in which the DOJ’s expert report (which I excluded from the record in a pre-hearing ruling) reached a proposed extraction of the \$45-million figure from the BCBSD reserves, and of the ways in which this extraction would impact BCBSD’s RBC ratio, particularly if the payout of the \$45 million occurred via installments over time (*Id.* at 4).

B. The Applicants' Response

At the close of the second day of the public hearing, David Swayze, counsel for BCBSD, spoke in response to the Attorney General's statement at the beginning of the proceeding. Mr. Swayze stated that:

the provisions of 6311(b) make clear that the purpose of the conditions . . . [is to] protect the reserves and surplus of the company. . . . You cannot characterize the removal of twenty-five percent of [BCBSD's] surplus as a protection. I think that any condition which does other than protect those reserves is not consistent with 6311(b) and, therefore, not consistent with Chapter 50.

I'd ask for that reason that no condition be considered which has the effect [of] basically making the [BCBSD] reserves sort of a piñata and asking the [DOI] or the Commissioner [] to swing the stick in hopes of raining down a portion of that reserve on some purpose or for some purpose that does not relate to the protection of the company and its policyholders as is found at 6311(b)(4), which is the standard, I think, that is imposed by that statute.

For those reasons, Your Honor, we would request that there be no consideration of a condition such as that interposed by the Department of Justice with respect to the withdrawal of reserves of [BCBSD] for a purpose other than the protection of the policyholders and the company.

(Tr. at 606-608).

Tim Constantine testified that BCBSD is committed to maintaining its charitable role in the Delaware community as an affiliate of Highmark. (Tr. at 83-85). He also testified that BCBSD intends to continue with contributions to the Delaware Community Foundation (which began in 2008) in lieu of paying state taxes, as well as to continue with making community contributions of \$750,000 each year at least through 2015. (Tr. at 97-98). With respect to the Delaware Community Foundation, Mr. Constantine explained that BCBSD established a donor-advised fund at the Delaware Community Foundation, a nonprofit organization that manages and administers charitable funds throughout Delaware. This fund,

known as Blue Prints For The Community, was created to help address issues faced by Delaware's uninsured and underserved populations, as well as healthcare disparities throughout the state. (Tr. at 83-84). As for BCBSD's other community-support initiatives, Mr. Constantine explained that \$750,000 of BCBSD's community contributions go to a program called Working Well Together, which aims to make healthcare more affordable and accessible, to improve the quality and safety of patient care, to respond to the increasing diversity of BCBSD's members, and to support organizations that address health-related issues within the community. (Tr. at 84-85). Mr. Constantine testified that, particularly given the experience of BCBSD's RBC ratio dropping from over 1000 percent to 730 percent during the market downturn of 2008, it would be difficult to memorialize in perpetuity a commitment to maintain certain levels of community contributions. (Tr. at 118-119).

In that vein, James Hynek of BCBSD testified that the purpose of BCBSD's reserves is to fund capital enhancements and to protect against catastrophic events or market downturns, given that BCBSD is a not-for-profit and cannot raise capital via the capital markets. (Tr. at 176-177). He testified that BCBSD would be subject to close monitoring by the Blue Cross Blue Shield Association or the National Association of Insurance Commissioners if BCBSD's reserves were to approach certain minimum levels established by those organizations, respectively. (Tr. at 174-175). Mr. Hynek also testified that BCBSD had Milliman, an independent consultant actuary, examine BCBSD's RBC and prepare a report, which ultimately recommended a target RBC ratio range of 950 percent to 1,200 percent for BCBSD during normal circumstances. (Tr. at 175; JX 74 at 49). Mr. Hynek confirmed that BCBSD's RBC ratio is currently within that targeted range. (Tr. at 176). He also stated that Highmark's

guaranty to pay all BCBSD claims would not influence the calculation of BCBSD's RBC ratio, under the calculation used by the NAIC. (Tr. at 185).

Karen Hanlon of Highmark testified that “[t]he Affiliation will not interfere with BCBSD’s ongoing community support[] and charitable activity commitments [and that] Highmark will work with BCBSD to develop programs that leverage the lessons learned by both parties in community and charitable initiatives.” (Tr. at 222). She testified that “the BCBSD board of directors would approve charitable contributions subsequent to the Affiliation” closing. (Tr. at 230; *see also id.* at 233). Ms. Hanlon also testified that she would expect to discuss the details of the Highmark Foundation’s charitable presence in Delaware after the closing of the Affiliation. (Tr. at 240).

C. DOI’s Response

The DOI indicated in its pre-hearing memorandum its belief that, although requiring commitments to community organizations is not part of the criteria for the DOI’s review of the proposed Affiliation, the DOI had been, and continued to be, supportive of any measures taken by the Applicants to make continued financial commitments to community organizations subsequent to any affiliation. (Appendix B, Docket Index, Tab 61 at 4).

At the hearing, Martin Alderson Smith of Blackstone testified about charitable giving being an “entirely worthy cause[]” but that, in his view, charitable giving is not a factor of the DOI’s review of the proposed Affiliation under Section 5003. (Tr. at 430). Mr. Alderson Smith testified that Blackstone’s examination based on the Section 5003 criteria did not specifically focus on preserving any type of public benefit asset for any potential conversion in the future. (Tr. at 402). He testified that, rather, Blackstone focused on ensuring that BCBSD’s reserves remained intact in the future, so that there would be different disaffiliation options if it were appropriate for BCBSD to disaffiliate from Highmark. (*Id.*). He expressed his view that

community contributions would be under the purview of the BCBSD board, but that ultimately the primary job of the DOI as part of its review of the Affiliation is to ensure that BCBSD policyholders are fully protected. (Tr. at 406-407). Mr. Alderson Smith specified that Blackstone considered in its analysis “all insurance-buying people in the State plus all of the policyholders in BCBSD, and then to the broader extent, to the public interest.” (Tr. at 425). He further indicated that Blackstone analyzed the public interest under the language of Section 5003, and because Blackstone did not find that the Affiliation was not in the public interest, no further analysis was necessary. (Tr. at 429-430; *see also* 18 *Del. C.* § 5003(d)(1)(d) (“The Commissioner shall approve any merger or other acquisition of control . . . unless, after a public hearing thereon, the Commissioner finds that...[t]he plans or proposals which [Highmark] has [for BCBSD] are unfair and unreasonable to policyholders of the insurer and not in the public interest.”)).

Mr. Alderson Smith further testified that he believes Section 6311 is designed to preserve the surplus or reserves of BCBSD, and that there is no additional language in Section 6311 that relates to a broader public benefit or public interest, as the DOJ appears to be seeking. (Tr. at 451-452). He testified that it is also his understanding that Section 6311 affords the Commissioner the ability to use additional steps to preserve the reserves for the benefit of BCBSD and its subscribers, and that there is nothing in Section 6311 that relates to a preservation of reserves or assets to meet Delaware’s unmet health needs. (Tr. at 452-453).

Linda Sizemore of the DOI testified that as a regulator, her primary concern is the protection of the policyholders’ interests, and that she could not sanction moving a \$45 million lump sum from BCBSD’s reserves to a charitable fund. (Tr. at 567-568). She clarified that although a condition relating to community contributions would be outside the statutory purview

of the DOI under Section 5003, she believed it would be appropriate to memorialize any voluntary commitments made by BCBSD or Highmark. (Tr. at 563-567).

Ms. Sizemore further testified that one of the DOI's primary concerns is to prevent Highmark from causing any inappropriate transfer of funds from BCBSD to Highmark or any improper assessment of expenses against BCBSD, which, if not kept in check, could drain BCBSD's reserves to the detriment of policyholders. (Tr. at 531). Ms. Sizemore testified that she believes that the General Assembly shared this concern, as evidenced by the passage of S.B. 146. (*Id.*). She testified that the statutorily-mandated conditions, along with the conditions proposed by the DOI and agreed to by the Applicants, "will effectively prevent Highmark from taking any of BCBSD's reserves to the detriment of Delaware's policyholders." (Tr. at 534).

Both Mr. Alderson Smith and Ms. Sizemore testified about their views on the purpose and usefulness of BCBSD's reserves during the Affiliation with Highmark to protect current and future BCBSD policyholders and the entire insurance-buying public. Mr. Alderson Smith testified that "[BCBSD's] maintenance of strong reserves will be an important element in retaining flexibility in the event of a disaffiliation from Highmark as [BCBSD] is likely to have fewer strategic options available if its reserves are insufficient for it to operate on a standalone basis." (Tr. at 362). He noted that Highmark's claims guaranty would become void in the event of a disaffiliation, which is likely to be a time when BCBSD is already under significant financial pressure. (Tr. at 441-442). He also testified that BCBSD having its own reserves is much more important from a regulatory perspective than a guaranty from Highmark; "It's a lot easier to seize assets, seize RBC, seize reserves located in [] Delaware that have been ring-fenced for the people of Delaware than trying to chase down a guaranty from some distant organization in Pittsburgh." (Tr. at 413). Given BCBSD's earlier disaffiliation from CareFirst,

he testified that “[i]t is a real possibility that in the future there may be the necessity for a disaffiliation and we wouldn’t want to make that a non-option by pulling reserves out [now] and, thereby, potentially weakening [BCBSD], and weakening what is effectively reserves, paying ability and to allow [BCBSD] to thrive and prosper in this market.” (Tr. at 416).

Mr. Alderson Smith outlined a “worst case scenario” financial calculation of what could happen to BCBSD’s reserves in the event of a disaffiliation, assuming the negative impact of poor market conditions on BCBSD’s reserves followed by the IT costs to BCBSD of disaffiliating from Highmark and then reaffiliating with another partner. (Tr. at 444-447). He testified that following these events, BCBSD’s reserves could stand at \$65 million to \$80 million, and that this amount could be even lower (\$20 million to \$35 million) if \$45 million had been extracted as a condition of this Affiliation. (Tr. at 447-449). He concluded that “it would be very difficult to see [BCBSD] as a viable company with reserves as that low.” (Tr. at 449).

Linda Sizemore testified that “[t]he disaffiliation between [BCBSD] and CareFirst demonstrated that affiliations sometimes need to be unwound and that planning for a potential disaffiliation is essential to ensuring that policyholders are protected.” (Tr. at 517). She outlined calculations similar to those of Mr. Alderson Smith, and concluded that BCBSD could end up with an RBC ratio as low as 124 percent, assuming \$45 million has been removed from BCBSD to establish a fund. (Tr. at 568-573). She further testified that this RBC ratio would be “[v]ery close to authorized control level, where we would want to take over [BCBSD].” (Tr. at 573). Ms. Sizemore also testified that although these calculations suggest a very costly and negative situation for BCBSD in the event of a disaffiliation, these risks are outweighed by the benefits to BCBSD of engaging in what Ms. Sizemore has every hope and confidence will be a good Affiliation with Highmark. (Tr. at 574).

Mr. Alderson Smith testified that Blackstone does not think “there is necessarily an overabundance of reserves [but that BCBSD] is a well-capitalized company, but [] a little company operating in a small market.” (Tr. at 414). Mr. Alderson Smith testified that only an actuarial study, and not testimony in these proceedings, should form the basis of reaching a conclusion that BCBSD does or does not have excessive reserves. (Tr. at 411). He noted, however, that the 2005 Milliman actuarial study commissioned by CareFirst for BCBSD recommended an RBC ratio level of 950 percent to 1200 percent. (Tr. at 412). In addition, he noted, as Ms. Hanlon discussed in her testimony, that the Pennsylvania Insurance Department requires Pennsylvania’s smallest Blue plans to present a plan to reduce surplus if RBC ratios exceed 950 percent. (Tr. at 411; *see also* Tr. at 228; JX 133 at 37). Considering the PID requirements and the 2005 study, he testified that “based on a sort of professional organization of specialists having produced a study that would indicate a range of appropriate RBC ratios, I think that that is clearly the right set of ratios for [BCBSD] operating in this state.” (Tr. at 458-459). Mr. Alderson Smith added that several small, non-publicly traded health insurers have RBC ratio levels higher than BCBSD’s. (Tr. at 467; BX 62).

Linda Sizemore testified that her review of the PID requirements indicates a trend based on membership levels and surplus values that would indicate a target RBC ratio range for BCBSD of 950 percent to 1200 percent if Pennsylvania had a Blue plan as small as BCBSD. (Tr. at 577-582).

BCBSD has since the close of the record submitted its version of a proposed condition (attached hereto as Appendix F) with respect to a charitable contribution commitment to the DOJ and DOI. **[THE DOJ AND APPLICANTS WILL PROVIDE ADDITIONAL**

**SPECIFIC LANGUAGE REGARDING THE PROPOSED COMMUNITY
CONTRIBUTION CONDITION WHEN SUCH LANGUAGE IS FINALIZED.]**