

SECTION II. A, B, AND C: DOJ'S 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 on the preferential treatment BCBSD has received as a Delaware not-for-profit, including the state tax exemption BCBSD has received for 75 years 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). He described the DOJ's significant interest in the Affiliation as “due to our role in enforcing state consumer protection laws, protecting not-for-profit or charitable interests, and investigating matters involving the public welfare.” (Tr. at 13).

The Attorney General summarized BCBSD's lobbying to change the Conversion Act following his ruling that the Affiliation constituted a conversion under that Act. He stated that “[BCBSD] successfully lobbied the Delaware General Assembly to change this important law protecting the charitable interests of a Delaware not-for-profit corporation so that the proposed transaction would no longer be a conversion under the Act, and a foundation would no longer be required by law.” (Tr. at 15). Following the change in the law, the DOJ continued its review of the Affiliation pursuant to its common law authority, as affirmed in the Conversion Act, to protect the charitable trusts and assets held for the public benefit in the State. (Tr. at 16). The Attorney General discussed the fact that the Affiliation will result in BCBSD being controlled by Highmark in Pennsylvania and the resulting potential for Highmark to divert BCBSD's reserves, which were created through subsidy by the Delaware public over 75 years, to

purposes other than those serving Delawareans. (Tr. at 16-19). Specifically, Attorney General Biden stated that:

[BCBSD] will become part of Highmark's larger regional corporate effort. This will affect efforts ranging from decisions about Delaware jobs and the treatment of [BCBSD] policyholders, and possible use or other disposition of [BCBSD's] public benefit asset. Given this controlled affiliate relationship, ... there is a present risk that Delawareans' investment in [BCBSD] over the past 76 years may be diverted to other purposes.

(Tr. at 18).

Additionally, Attorney General Biden pointed out that as of the time of the hearing there was as yet no formal agreement between BCBSD and Highmark that would memorialize what is a reasonable cost allocation of expenses as between BCBSD and Highmark.

(Tr. at 19).

Attorney General Biden requested that the Hearing Officer impose a condition on the Affiliation that establishes a mechanism to guarantee that 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 to be administered in an independent foundation. (Tr. at 20). The Attorney General stated:

Consideration of the public's interest must include, and any approval decision must include, and any approval decision must address the disposition, present and potential, of the assets of [BCBSD] that were subsidized by Delawareans for so many years, as well as the assignment of responsibility for the future management in business decisions that may affect the use of those public subsidized assets.

(Tr. at 13-14).

In order to protect the considerable public subsidy of BCBSD, the Attorney General called for a valuation "prior to the closing of the transaction, taking into account the effect of the affiliation, by a valuation expert approved by the [DOJ]". (Tr. at 20).

Attorney General Biden then discussed why using this \$45 million to meet the unmet health needs of Delawareans would have an insignificant impact on the financial ability of BCBSD to pay its policyholders' claims based on the RBC ratio of BCBSD, as compared to the national average of RBC ratios among Blue plans and the RBC requirements of the BCBSA and of the NAIC. (Tr. at 21-22). He stated that "BCBSD has reserves of approximately \$181 million, or more than five times the level the [NAIC] requires, and more than three times the level that the Blue Cross Blue Shield Association requires." (Tr. at 21). He also 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 over its assets are changing as is the case here" (Tr. at 23). The Attorney General explained:

A foundation based on the parameters set forth in 29 Delaware Code, Chapter 2531...would obviously be one way to accomplish the goal of protecting Delaware's public investment in [BCBSD], and I would offer that as the best way....

The Conversion Act requirements for how a foundation must be created, funded, and governed were designed to do an optimal job of protecting the public benefit asset, or assets attributable to the historic public subsidy for a not-for-profit healthcare service corporation entity. They provide an excellent blueprint that has been approved by the Delaware legislature.

The foundation's purpose would be serving the state's unmet health needs and it would be managed by a group of experienced and independent directors. Such a foundation would protect and ensure that the assets accumulated through Delaware's public subsidy of [BCBSD] will be properly supervised, managed, and ultimately...returned to the citizens of this state.

(Tr. 22-23).

Under cross-examination by the DOJ, Tim Constantine of BCBSD agreed that BCBSD's status as a not-for-profit, and its related exemption from paying state income taxes

over 75 years, can be characterized as an investment in, or a subsidy of, BCBSD by the Delaware public (Tr. at 91). Further, Mr. Constantine testified that while theoretically BCBSD could pass along that tax savings to its policyholders in lower premium rates (Tr. at 91-92), he does not believe there is a significant difference between the premiums of for-profit companies and BCBSD (Tr. at 91-92). Mr. Constantine also confirmed on cross-examination that an additional benefit to BCBSD has been the public's positive perception of the company due to BCBSD's status as a Delaware not-for-profit. (Tr. at 93)..

On October 14, 2011, Deputy Attorney General Ian McConnell sent me a letter ("DOJ Oct. 14 Letter") constituting the DOJ's response to an earlier letter from David Swayze, BCBSD's counsel, and to Mr. Swayze's 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 provided support for the DOJ's position that these proceedings are an appropriate forum for consideration of the DOJ's proposed condition to the Affiliation that a fund be established to serve Delaware's unmet health needs. (DOJ Oct. 14 Letter at 1-2). Mr. McConnell noted that whereas only approximately 30% of Delawareans are insured by BCBSD, all Delawareans have contributed to the public subsidy of BCBSD over 75 years. (DOJ Oct. 14 Letter at 2).

Mr. McConnell also cited as support for the Attorney General's position that Section 6311 requires that conditions be imposed to preserve the amount of the reserves of BCBSD, as well as my own statements on the record that Section 6311 on its face allows for the imposition of additional 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 reached the \$45-million figure as a minimum amount for the proposed foundation as well as why the DOJ believes that, based on what would still be a very high RBC ratio, BCBSD’s financial stability would not be compromised by such a contribution, particularly if the payout of the \$45 million were to occur via installments over time during which BCBSD’s reserves are expected to continue to increase. (Id. at 4).

B. The Applicants’ Response

At the close of the second day of the public hearing, David Swayze, counsel for BCBSD, presented BCBSD’s argument against the Attorney General’s proposed condition. Mr. Swayze argued 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.

(Tr. at 607).

The Applicants proffered testimony by Tim Constantine that BCBSD is committed to maintaining its charitable role in the Delaware community as an affiliate of Highmark. (Tr. at 83-85). Mr. Constantine 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 BluePrints For The Community (“BluePrints”), 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; see also footnote 7 above). Mr. Constantine testified on cross-examination by the DOJ that BCBSD’s contributions to BluePrints have been a voluntary outgrowth, not legally enforceable, of the deliberations of the Health Service Corporation Task Force established by the legislature. (Tr. at 99-100). As for BCBSD’s other community-support/corporate-citizenship initiatives, Mr. Constantine testified that BCBSD also contributes approximately \$750,000 to community causes through a program called Working Well Together. (Tr. at 84-85). Mr. Constantine acknowledged on cross-examination by the DOJ that subsequent to the Affiliation, both the community and the BluePrints contributions will be subject to Highmark’s approval during the annual budgeting process. (Tr. at 98-99). Mr. Constantine testified that, particularly given the experience of BCBSD’s RBC ratio dropping from over 1000 percent to 730 percent during the financial crisis of 2008, he thought it would be difficult to memorialize in perpetuity a commitment to maintain certain levels of community contributions. (Tr. at 118-119). I note that Mr. McConnel stated in the DOJ Oct. 14 Letter that the DOJ would be willing to consider a suspension of payments in the event of financial distress. (DOJ Oct. 14 Letter at 4).

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). For example, the threshold for the BCBSA is 375%. 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.¹ (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). Mr. Alderson Smith later testified that the Milliman report did not envision a guaranty such as the one Highmark will be providing to BCBSD, however. (Tr. at 458).

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). It should be noted, however, that the BCBSD board of directors will be controlled by Highmark. (See JX 13, BCBSA Guidelines at 7; Appendix C, Docket Index, Tab 1, Ex. 3, BCBSD Amended Bylaws Art. V; Tr. at 112-113). Ms. Hanlon also testified that she would expect to discuss the possibility of whether and how the Highmark

¹ CareFirst previously commissioned Milliman to produce a report on BCBSD's statutory surplus needs as well as optimal target range. The report was delivered dated May 13, 2005. It concluded that targeting an RBC of 950-1200% for BCBSD would be reasonable and appropriate under normal operating circumstances. (Milliman Report at 55).

Foundation might establish a charitable presence in Delaware after the closing of the Affiliation, as it has done in West Virginia. (Tr. at 240). There are no conditions mandating this, however.

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 C, 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 for the DOI 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).

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 beyond the preservation of the surplus or reserves. (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). I note, however, that Mr. Alderson Smith is not a lawyer. See also discussion above regarding the fact that although the Blackstone report concluded that conditions addressing BCBSD's community initiative commitments in Delaware would be appropriate, none are included in Appendix A. (BX 111; Tr. at 403).

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). I note that Mr. McConnell has indicated that the DOJ would be willing to consider, in addition to the possibility of a suspension of payments in the event of financial distress noted above, some flexibility in terms of a funding schedule. (DOJ Oct. 14 Letter at 4).

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). I note that Ms. Sizemore also is not a lawyer.

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 also testified on cross-examination by the DOJ as to the unlikelihood of BCBSD ever remaining a standalone entity following a disaffiliation. (Tr. at 415). 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). I later asked the Applicants whether they had considered funding an escrow account to be used to immunize BCBSD against the possible effects of a future disaffiliation, and they replied that they had not. (Tr. at 470-471).

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 that the 2005 Milliman actuarial study commissioned by BCBSD recommended an RBC ratio level of 950 percent to 1200 percent for BCBSD as a stand-alone company. (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 three small, non-publicly traded health insurers have RBC ratio levels higher than BCBSD's. (Tr. at 467; BX 62).

Linda Sizemore testified that she believes based on her review of the PID requirements that the PID would expect a target RBC ratio range of 950 percent to 1200 percent if Pennsylvania had a Blue plan as small as BCBSD. (Tr. at 577-582).

After the record closed, BCBSD submitted a proposed condition with respect to the public subsidy protection mechanism to the DOJ (on October 19, 2011) and thereafter a revised version of that proposed condition (on October 27, 2011), and the DOJ has met with BCBSD to discuss the latter proposal. The DOJ has reported that its preliminary response to the October 27, 2011 proposal is that the proposal is inadequate in that it: (i) claims credit toward the DOJ's minimum \$45 million funding requirement for amounts already committed or at least reflected on BCBSD's pro formas, thereby effectively reducing the minimum substantially downward from \$45 million; (ii) claims credit toward the DOJ's minimum \$45 million funding requirement for amounts that would not be contributed for up to ten years, which due to the time

value of money would provide substantially less value than if contributions were made upon closing of the transaction, thereby further reducing the minimum downward from \$45 million; (iii) ignores the requirement for a valuation, and my determination that a subsequent hearing would be appropriate with respect to methodology and structure for any funding mechanism; (iv) is insufficient in terms of the aggregate amount proposed given BCBSD's substantial surplus relative to its peers and the requirements of the BSBSA and the NAIC, its significant public subsidy over 75 years, and the reported "millions" in savings to be realized as a result of the Affiliation; (v) allows payments to be suspended if BCBSD's RBC level drops below a target range that is far higher than that of many healthy Blue plans, *including Highmark*, and which would be based on an actuarial study completed in 2005; (vi) allows payments to be suspended at the discretion of the DOI even if BCBSD does not drop below that already high target RBC range; (vii) allows all commitments to be discharged in the event of a disaffiliation from Highmark, including BCBSD's current informal commitment to make contributions to the Delaware Community Fund in the amount of Delaware state corporate income taxes that would have been due in those years; and (ix) inadequately shifts from BCBSD the control of the mechanism by retaining it within the BluePrints program or distributing funds to other recipients rather than creating a structure similar to the one contemplated by the Conversion Act. (DOJ Oct. 28 Letter at 1).