

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. )

**PROPOSED FINDINGS, RECOMMENDATIONS, AND ORDER**

These are the proposed findings and recommendations concerning the proposed affiliation between BCBSD, Inc. (which generally is known as Blue Cross Blue Shield of Delaware) and Highmark Inc. (the “Affiliation”) that I, as Hearing Officer, am making to the Delaware Insurance Commissioner (“Commissioner”). I collectively refer to BCBSD and Highmark as the “Applicants.” Other abbreviations are as shown. As I discuss fully herein, I have found that, with the inclusion of certain additional conditions designed to protect the reserves and financial condition of BCBSD and to promote a continuation of local autonomy and community involvement, among other ends, the proposed Affiliation meets the standards and requirements set forth in Title 18, Sections 5003, 6310, and 6311 of the Delaware Code. I therefore recommend that the Commissioner approve the Affiliation and include in her Order the conditions as set out in detail in Appendix A.

**PROCEDURAL HISTORY**

On August 19, 2010, BCBSD and Highmark signed a Business Affiliation Agreement (“Affiliation Agreement”). (Appendix B, Docket Index,<sup>1</sup> Tab 1, Ex. 1). Under the terms of Affiliation Agreement, Highmark would gain control of BCBSD and become the only

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<sup>1</sup> I use the Docket Index (attached hereto as Appendix B) to cite to the public docket for this proceeding, available at <http://www.delawareinsurance.gov/departments/bcbs/bcbs.shtml>.

entity (albeit through BCBSD) able to use the “Blue Cross” and “Blue Shield” marks in Delaware (“Blue mark” or the “marks”). In exchange, Highmark would guarantee all of BCBSD’s claims and would provide administrative, corporate, and strategic support to BCBSD. (*Id.* at Ex. 1, § 2.1). On October 7, 2010, Highmark filed an Affiliation Statement with the Delaware Department of Insurance (“DOI”), which triggered the DOI’s obligation to evaluate the proposed Affiliation pursuant to Title 18, Chapter 3 of the Delaware Code. 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. (Appendix B, Docket Index, Tab 2, Pre-Hearing Order, ¶ 1). The purpose of the public hearing was for the Hearing Officer to determine whether the Commissioner should approve the proposed Affiliation, based on the statutory criteria found in 18 *Del. C.* § 5003(d)(1) (“Section 5003”) (*Id.* at Pre-Hearing Order, ¶ 8). In a November 4, 2010 Order, the Commissioner appointed me as Hearing Officer in this matter. (Appendix B, Docket Index, Tab 3).

The parties to the proceeding are Highmark, BCBSD, the DOI, and the Department of Justice (“DOJ”). (Appendix B, Docket Index, Tab 2, Pre-Hearing Order, ¶¶ 3-4). Jo Ann Fields, M.D., applied for party status in the proceeding, and in a January 18, 2011 oral ruling and in a subsequent written order issued on January 25, 2011, I determined that Dr. Fields did not meet the criteria for becoming a party to these proceedings. (*See* Appendix B, Docket Index, Tab 21, Jan. 25, 2011 Order; Appendix B, Docket Index, Tab 17, Transcript from Jan. 18, 2011 Public Hearing. *See also* Appendix B, Docket Index, Tab 2, Pre-Hearing Order, ¶ 4).

Both the DOI and the DOJ retained independent advisors to assist them in their analysis of the proposed Affiliation. The DOI retained Morris, Nichols, Arsht & Tunnell LLP as

its legal advisor, Blackstone Advisory Partners L.P. (“Blackstone”) as its financial advisor, and KPMG LLP (“KPMG”) as its information technology advisor. The DOJ retained Dewey & LeBoeuf LLP as its legal advisor and Grace Global Capital, LLC as its financial advisor.

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 JX 14, Conversion Letter at 1).<sup>2</sup> Under the Affiliation Agreement, the Attorney General’s declaration gave Highmark the contractual option to terminate the Affiliation Agreement. (See Appendix B, Docket Index, Tab 1, Ex. 1, Affiliation Agreement §§ 6.3, 10.1(e); see also *id.* Appendix A, “Highmark Materially Burdensome Condition” (iv)). Highmark, however, did not exercise its right to terminate.

Subsequent to the Attorney General declaring that the Conversion Act applied to the Affiliation, the General Assembly enacted Senate Bill 146 (“S.B. 146”), which 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 not-for-profit entities. (See 78 *Del. Laws* c. 109 § 1 (2011)). On June 29, 2011 the Delaware General Assembly passed S.B. 146. On July 12, 2011, Governor Jack Markell signed S.B. 146 into law. (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. 18 *Del. C.* § 6311(b). These conditions are intended “to preserve that amount, determined in accordance with Delaware law, that

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<sup>2</sup> References to Joint Hearing Exhibits will be cited as (JX \_\_\_\_).

constitutes the surplus or reserves of [a] health service corporation.” (*Id.*). For example, under S.B. 146, the DOI 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 DOI must assess the commercial reasonableness of the proposed expenditure or transfer. (18 *Del. C.* § 6311(b)(2)). S.B. 146 also 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)(3)).

On June 15, 2011, the General Assembly also passed Senate Bill 56 (“S.B. 56”), codified at 18 *Del. C.* § 6310 (“Section 6310”). S.B. 56 prohibits the Commissioner from approving the proposed Affiliation “unless the [A]ffiliation will result in [BCBSD] offering an insurance plan with the same benefits and eligibility criteria as the Delaware program created under 16 *Del. C.* § 9909(j) [the Delaware Healthy Children Program].” The Governor signed S.B. 56 into law on June 27, 2011.

In accordance with the provisions of the Pre-Hearing Order, as well as those of Title 29, Chapter 101 and Title 18, Chapter 3 of the Delaware Code, I held a public hearing from October 5 to October 7, 2011 in the DOI’s Dover office. During the hearing, the parties presented testimony and members of the public gave comments, all of which are part of the record of the proceeding. (Tr. at 27-28).<sup>3</sup> Six witnesses testified on behalf of the Applicants: Timothy J. Constantine (President and Chief Executive Officer, BCBSD); Scott Fad (Senior Vice

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<sup>3</sup> References to the transcript of the October 5-7, 2011 hearing will be cited as (Tr. at \_\_\_\_).

President of Operations, BCBSD); James Hynek (Vice President, Chief Financial Officer, and Treasurer, BCBSD); Karen L. Hanlon (Senior Vice President for Financial Planning and Analysis, Highmark); Kenneth B. Gebhard (Vice President, Cost Management and Analysis, Highmark); and J. Fred Earley, II (President, Highmark West Virginia). David S. Swayze and Michael W. Teichman of Parkowski, Guerke & Swayze, P.A. appeared as counsel for BCBSD. Frederick K. Campbell and S. Doak Foster of Mitchell, Williams, Selig, Gates & Woodyard, P.L.L.C. and Mona A. Parikh of Buchanan Ingersoll & Rooney PC appeared as counsel for Highmark.

The Honorable Joseph R. Biden III, Attorney General of Delaware, made a public statement at the opening of the hearing, which was entered into the record. Ian R. McConnel and Meredith Stewart Tweedie, Deputy Attorneys General, and Cynthia R. Shoss of Dewey & LeBoeuf LLP appeared on behalf of the DOJ. The DOJ did not offer direct testimony at the hearing.

The DOI presented the testimony of three witnesses at the hearing: Martin Alderson Smith (Senior Managing Director, Blackstone); Kenneth Jackson (Senior Director, KPMG); and Linda Sizemore (Director of Company Regulation, Delaware Department of Insurance). Michael Houghton and Leslie A. Polizoti of Morris, Nichols, Arsht & Tunnell LLP appeared as Special Counsel for the DOI.

Presenting testimony as permitted by Paragraph 5 of the Pre-Hearing Order were the following members of the public: James Lafferty (Executive Director, Mental Health Association in Delaware); Joanne Hasse (Former Board Member, Delaware Health Information Network); Mitch Crane; Vincent White; and Jo Ann Fields, M.D.

In addition to the testimony presented during the public hearing, I accepted into the record over one hundred exhibits proffered by the parties, consisting of thousands of pages of documentary evidence, and numerous letters from members of the public.

Notice of the public hearing was published in *The News Journal* and *The Delaware State News* from September 10 to 14, 2011. (JX 62-63).

The record in this proceeding—which was kept open after the public hearing to receive additional joint exhibits from the parties, as well as letters and other comments from interested members of the public—closed on October 14, 2011. Pursuant to Paragraph 11 of the Pre-Hearing Order, I am required to recommend to the Commissioner my summary of the evidence, findings of fact, conclusions of law, and decision, along with any proposed conditions to which my recommended decision is subject.

## BACKGROUND

### I. BACKGROUND OF THE APPLICANTS

BCBSD is a Delaware non-stock, nonprofit health service corporation. (Tr. at 55-56). Under various corporate names, BCBSD has continuously operated in Delaware since 1935. (*Id.*). Its headquarters are in Wilmington. (Appendix B, Docket Index, Tab 1, Affiliation Statement at 2). 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 Blue Cross Blue Shield Association<sup>4</sup> (“BCBSA”) licensee in Delaware and, thus, is the only entity licensed by the BCBSA to market health insurance using the Blue names and trademarks throughout Delaware. (*Id.*; *see also* Tr. at 54-55). Among the significant health insurers in Delaware, BCBSD is the only insurer that is locally-controlled. (BX 115).<sup>5</sup> As of December 31, 2010, BCBSD serves approximately 394,000 subscribers (Tr. at 54-55), has a total of \$171 million in reserves, and has a risk-based capital<sup>6</sup> ratio of 1,056 percent (*see* Appendix B, Docket Index, Tab 55, Aug. 31, 2011 BCBSD Pro Formas at 5; BX 32, 43). Currently, BCBSD’s reserves are approximately \$180 million. (Tr. at 95). BCBSD’s 2010

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<sup>4</sup> 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 Oct. 14, 2011).

<sup>5</sup> Citations to (BX \_\_\_) are to Blackstone’s Report on the Proposed Affiliation between Blue Cross Blue Shield of Delaware and Highmark Inc., dated September 16, 2011. (See Appendix B, Docket Index, Tab 57).

<sup>6</sup> As Mr. Alderson Smith testified, in this context, risk-based capital, or “RBC,” represents an insurer’s capital base for paying customer claims; in other words, the amount of money needed for an insurer to pay its claims. (Tr. at 358-359). RBC is calculated according to a particular formula. (*Id.*). An insurer’s “RBC ratio” is a frequently-used metric in the insurance industry to indicate the financial strength of an insurer and is intended to capture the risks posed to the insurer. (*Id.*). 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. (*Id.*).

revenues totaled approximately \$550.1 million. (See JX 16, BCBSD Pro Forma Comparative Output; BX 32). Since 2008, in lieu of paying state corporate income taxes, BCBSD has made contributions to the Delaware Community Foundation; in 2010 this amount was \$1.6 million. (See JX 17, BCBSD Affiliation Forecast at 3 (labeled as “Community Related Expense – Part 2”). BCBSD currently employs approximately 620 individuals. (BX 32).

Highmark is a Pennsylvania nonprofit corporation authorized by the Pennsylvania Insurance Department (“PID”) to operate a hospital plan and a professional health services plan in Pennsylvania. (Appendix B, Docket Index, Tab 1, Affiliation Statement at 5; Tr. at 189-190). Highmark is one of four Blue plans in Pennsylvania, and provides traditional fee-for-service health care insurance coverage to groups and individuals in addition to providing administrative services for self-insured groups. (Appendix B, Docket Index, Tab 1, Affiliation Statement at 5; Tr. at 190-191). Highmark provides professional health services coverage in conjunction with hospital coverage provided by other Pennsylvania Blues. (Tr. at 190-191). 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. (Appendix B, Docket Index, Tab 1, Affiliation Statement at 5-6; Tr. at 192-193). In addition, Highmark has a number of affiliated insurers and dental and vision care affiliates. (Appendix B, Docket Index, Tab 1, Affiliation Statement at 6; Tr. at 193-194). As of December 31, 2010, Highmark serves a total of 4.8 million subscribers (Tr. at 191), has a total of \$3.7 billion in reserves (Tr. at 212-213), and has a risk-based capital level of 692 percent (see JX 19, Highmark Corporate Profile; JX 20, Highmark 2010 Annual Statement at 3; BX 5, 30). Its 2010 revenues totaled approximately \$14.6 billion. (See JX 19, Highmark Corporate Profile). Highmark employs approximately 19,500 individuals. (*Id.*).



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. (Tr. at 195, 296-297, 302-304; 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. (Tr. at 195, 299-301, 302-304; BX 107). 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. (Tr. at 302-304; BX 107).

## II. BACKGROUND TO THE PROPOSED AFFILIATION

### A. BCBSD's Affiliation With CareFirst And Its Continued Search For A Strategic Partner

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* Tr. at 57; *see also* JX 22, March 20, 2000 Affiliation Order). As Mr. Constantine, President of BCBSD, testified, during that affiliation, CareFirst held the primary BCBSA licenses for Delaware and BCBSD's controlled affiliate license. (Tr. at 57). In 2003 the Maryland General Assembly passed legislation that caused the existing CareFirst board to be removed and, among other things, gave the State of Maryland a material level of control over the future composition of the CareFirst board of directors. (Tr. at 57-58). As a result, in 2004, Commissioner Williams ordered a conditional termination of the CareFirst Affiliation. (Tr. at 58; *see* JX 23, June 30, 2004 Decision and

Amended Order at 19). Thereafter, BCBSD attempted to restructure the affiliation with CareFirst on a contractual basis, but was unsuccessful because of litigation in both Maryland and Delaware. (Tr. at 58). Ultimately the companies disaffiliated in September 2006, and BCBSD has been operating as the primary licensee of the BCBSA in Delaware since that time. (*Id.*; *see* JX 24, Aug. 23, 2006 Order at 9).

Mr. Constantine testified that, following the disaffiliation with CareFirst, “BCBSD’s board of directors and management began an extensive strategic planning process designed to address the challenge of maintaining BCBSD’s strength and stability over the long term.” (Tr. at 59). As a result of the strategic planning process, the BCBSD board “ultimately determined that given the competitive environment in which BCBSD must operate, and the need for systems and capabilities upgrades, the best option for BCBSD was to, again, collaborate with a strong partner.” (Tr. at 60; *see also* JX 25, BCBSD Board Minutes Dec. 1, 2006 at 1-2; JX 26, BCBSD Board Minutes Feb. 7, 2007 at 4).

The BCBSD team identified more than thirty potential partners, and recommended six as best suited to meet BCBSD’s needs. (Tr. at 60-61; *see also* JX 27, CareCompanion Mar. 7, 2007 BCBSD Strategy Session II). Mr. Constantine testified that “[i]n July 2007, each of the six [potential] partners received a Partnership Memorandum requesting a confidential proposal for establishing a long-term strategic partnership.” (Tr. at 61; *see also* JX 28, July 7, 2007 Email from T. Constantine). BCBSD then examined potential partners through the first quarter of 2008, and invited executives of each of the six companies to make presentations to the BCBSD management team to discuss their proposal in more detail. (Tr. at 61). The BCBSD team narrowed the list of potential partners to three companies, which at that time did not include Highmark due to BCBSD’s “concern that Highmark’s then-impending

proposed merger with Independence Blue Cross would affect its ability to focus on an affiliation with BCBSD.” (Tr. at 61-62). In January 2009, the BCBSD board decided to enter into exclusive negotiations with one company for a partnership that would result in BCBSD becoming a for-profit entity. (See JX 30, Jan. 9, 2009 Letter from BCBSD Affiliation Partner Evaluation Team at 4; JX 31, BCBSD Board Minutes Jan. 14, 2009 at 2). By August 2009, however, BCBSD had decided that, based in part on concerns over that company’s valuation of BCBSD, BCBSD would terminate its exclusive negotiations and instead explore Highmark as a strategic partner. (See, e.g., JX 32, Aug. 25, 2009 Letter from T. Constantine; JX 33, Aug. 25, 2009 Letter from T. Constantine to Highmark). By that time, Highmark had terminated plans to partner with Independence Blue Cross. (Tr. at 62).

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 (Tr. at 63; *see also* JX 34, BCBSD Board Minutes Dec. 3, 2009 at 2; JX 35, 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 JX 36, BCBSD Board Minutes July 21, 2010 at 9).

As described by Mr. Constantine, BCBSD selected Highmark as a strategic partner for several reasons, including BCBSD’s belief that “Highmark offers the most practical, efficient, and cost-effective means of ensuring that BCBSD can meet the near-future and long-term needs of its Delaware stakeholders while remaining a viable and robust local presence in the Delaware employer marketplace.” (Tr. at 67-68). Highmark also has a “state-of-the-art and highly capable information technology platform” that is proven and, after BCBSD migrates to it,

will enable BCBSD to meet new federal mandates while saving millions of dollars. (Tr. at 68-69). Further, the Affiliation with Highmark will allow BCBSD to remain a not-for-profit Delaware company, and it follows on Highmark's success in working with other Blue companies. Furthermore, the Affiliation will enable BCBSD to enjoy Highmark's broad and innovative mix of health care products and services and Highmark's respect for local working relationships. (*See also* Appendix B, Docket Index, Tab 40, Transcript of May 16, 2011 Public Hearing at 34:24-41:2).

Blackstone reviewed BCBSD's search for a strategic partner following the disaffiliation from CareFirst in 2006. (Tr. at 394-396). Martin Alderson Smith testified that the BCBSD board's determination regarding the state of BCBSD's strategic position was reasonable and that BCBSD's subsequent search for a new strategic partner was also reasonable. (Tr. at 398-399).

#### B. The Proposed Affiliation with Highmark

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. (Appendix B, Docket Index, Tab 1, Ex. 2, Amended & Restated Certificate of Incorporation, Article Fourth and Fifth). BCBSD has agreed it will continue to be subject to the Commissioner's general regulatory authority. (Appendix A, JX 113A,<sup>7</sup> Condition 31). Highmark will become the sole Delaware licensee of the BCBSA, a status that will entitle Highmark to use the Blue marks in Delaware. (Appendix B, Docket Index, Tab 1, Ex. 1, § 2.1). In exchange for becoming the BCBSA's sole Delaware licensee, Highmark will guarantee—to

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<sup>7</sup> The DOI, BCBSD and Highmark have agreed to a modified set of conditions, attached hereto at Appendix A (JX 113A). A redline showing the changes between JX 113A and JX 113 is attached hereto at Appendix C.

the full extent of Highmark's assets—all of BCBSD's contractual and financial obligations to BCBSD customers. (Appendix B, Docket Index, Tab 1, Affiliation Statement at 3; *see also* JX 13, BCBSA Guidelines at 15).

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* JX 13, BCBSA Guidelines at 7). The Affiliation is not, however, a merger. BCBSD will still remain a standalone company. Further, it appears that many aspects of the Affiliation attempt to preserve BCBSD's autonomy and local presence. For example, although BCBSD will receive administrative, corporate, and strategic support from Highmark pursuant to various contractual agreements, and will migrate to Highmark's technology systems, the Applicants intend for BCBSD to remain locally-managed for such market-facing functions as sales and distribution, provider relations and provider contracting, and community affairs. (Tr. at 67-68; 206-209). Highmark also intends to assist BCBSD with such business functions as product development and marketing, member and provider services, claims, billing, and enrollment. (Tr. at 208-209).

In addition to the Affiliation benefits, as described by Mr. Constantine, noted above, the proposed Affiliation is intended to offer BCBSD and its policyholders the added financial security of being part of a larger, more diversified organization with much greater financial resources, as well as the advantage of access to such an organization's resources and the ability to avoid the negative impact on BCBSD employment that would follow from outsourced back-room operations. (Tr. at 70-71). The proposed Affiliation is also intended to

benefit Highmark, by increasing Highmark’s scale and lowering Highmark’s per-member cost structure. (Tr. at 201). Highmark estimates the full value of this benefit upon full integration at \$18.8 million annually. (*Id.*). The proposed Affiliation also provides Highmark an opportunity to market its various ancillary products in Delaware. (*Id.* at 201-202).

### STANDARDS OF REVIEW

The Commissioner specified that 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).” (Appendix B, Docket Index, Tab 2, 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.

Following entry of the Pre-Hearing Order, as mentioned above, S.B. 56 and 146 were signed into law. Codified in part at 18 *Del. C.* § 6311, S.B. 146 requires that the Affiliation be governed under the provisions of Chapter 50 of Title 18 of the Delaware Code “and shall be subject to conditions that ensure compliance with this section.” 18 *Del. C.* § 6311(a). Subsection (b) of Section 6311 requires the Commissioner to “place conditions upon any approval of the change of control intended to preserve that amount, determined in accordance with Delaware law, that constitutes the surplus or reserves of the health service corporation.” 18 *Del. C.* § 6311(b). The statutorily-required conditions set forth in Section 6311 are identified as Conditions Nos. 1-6 of Joint Exhibit 113A. In my analysis of the Section 5003 statutory criteria, I have also taken into account this statutory mandate in Section 6311 to ensure that there are conditions in place that will preserve BCBSD’s reserves. Furthermore, the statutorily-required condition created by S.B. 56, which is codified at 18 *Del. C.* § 6310, is identified as Condition No. 38 of Joint Exhibit 113A.

#### SUMMARY OF THE EVIDENCE

The evidence in this matter consists of the sworn testimony of nine witnesses; 134 joint exhibits offered into evidence by the Applicants and the DOI; the public docket, which is available on the DOI’s website;<sup>8</sup> oral comments from the public; and written submissions from the public which were entered into the hearing record. (Tr. at 27-28).

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<sup>8</sup> <http://www.delawareinsurance.gov/departments/bcbs/bcbs.shtml>.

I. SECTION 5003 CRITERIA

The facts as adduced at the public hearing and from the hearing record are summarized in the context of the specific criteria set out in 18 *Del. C.* § 5003(d)(1) as follows.

- A. After the closing of the Affiliation, will BCBSD be able to satisfy the requirements for the issuance of a license to write the line or lines of insurance for which BCBSD is presently licensed? (18 *Del. C.* § 5003(d)(1)(a)).

Tim Constantine of BCBSD testified that BCBSD is regulated as a health service corporation under Chapter 63 of the Delaware Insurance Code and, because BCBSD was in existence prior to the adoption of Chapter 63, BCBSD is not required to hold a certificate of authority. (Tr. at 55). Martin Alderson Smith of Blackstone testified that, post-closing, BCBSD will remain a health service corporation and will remain able to write the same lines of insurance as it writes now, also without having to acquire a certificate of authority from the DOI. (Tr. at 345). Linda Sizemore of the DOI confirmed this, testifying that the proposed Affiliation “does not involve a change to [BCBSD’s] corporate identity, its status as a health service corporation under Chapter 63 of the Delaware Insurance Code, or its ability to satisfy all applicable licensing standards.” (Tr. at 521-522). Mr. Alderson Smith testified that “Blackstone also verified that Highmark’s Delaware-based subsidiaries will meet the capital balance requirements for the satisfaction of their licensing requirements as domestic insurers in the State of Delaware.” (Tr. at 346). No testimony or other evidence was presented disputing Mr. Alderson Smith’s or Ms. Sizemore’s testimony.

- B. Will the Affiliation substantially lessen competition in insurance in the State or tend to create a monopoly therein? (18 *Del. C.* § 5003(d)(1)(b)).

Mr. Alderson Smith of Blackstone testified that an examination of data from the National Association of Insurance Commissioners (the “NAIC”) shows that BCBSD and



Highmark currently compete only in the Stop-Loss and Dental segments of the Delaware health insurance market. (Tr. at 348). In analyzing this competition, Blackstone applied the quantitative standards set forth in Section 5003A(d)(2) of the Delaware Insurance Code. (Tr. at 347). Mr. Alderson Smith testified that Blackstone was only able to apply the quantitative standards to the Dental segment, because complete and consistent data with respect to the Delaware health insurance Stop-Loss market is not available. (Tr. at 348-349). Insurers report stop-loss premiums to the NAIC using different and inconsistent categories that are not exclusive to stop-loss premiums. (Tr. at 348-349). As a secondary measurement for the Stop-Loss segment, Blackstone applied a conservative calculation of a broader set of insurance activities for Highmark. (Tr. at 349-350). Specifically, Highmark reports total 2010 health insurance premiums written in Delaware (for all categories of health insurance, including Stop-Loss and Dental) in two NAIC categories: “comprehensive health” and “life, accident and health.” (Tr. at 349-350). BCBSD and several of its primary competitors in Delaware report all of their health insurance premiums in the “comprehensive health” category. (Tr. at 349-350). Although not an apples-to-apples comparison, comparing Highmark’s total insurance premium to the total premiums reported in the “comprehensive health” category indicates that Highmark would have a 0.8 percent market share of the NAIC category that is most closely aligned with the overall market for health insurance in Delaware. (Tr. at 349-350). Given that even this conservative calculation resulted in a market share for Highmark of 0.8 percent, whereas the prima facie standards require a market share of 1 percent or more, Mr. Alderson Smith testified that “Blackstone does not view the effect of the Affiliation on the Stop-Loss market as having any sort of anticompetitive effect in Delaware.” (Tr. at 351).

Mr. Alderson Smith testified that in the Dental segment, however, the data indicated there is prima facie evidence of the Affiliation having an anticompetitive effect, per the statutory standards, because BCBSD and Highmark have 11.1 percent and 5.8 percent share of the Dental market, respectively. (Tr. at 351-352). To evaluate the potential anti-competitive effect, Blackstone also considered additional factors, pursuant to statute, including: the actual impact of BCBSD's pricing decisions on Highmark's dental subsidiaries in Delaware (and, thus, Highmark's actual relevant market share in Delaware); the possible effect of the Affiliation providing a counterbalance to Delta Dental, which currently dominates the Dental market in Delaware, holding a market share of more than 73 percent; and the fact that Highmark plans to offer dental plans in Delaware that would compare more favorably to the product offerings of Delta Dental than do the current BCBSD dental products. (Tr. at 352-354). Mr. Alderson Smith concluded that "Blackstone believes that these factors, taken together, may lead to increases in competitive pressures in the Delaware dental market." (Tr. at 354).

Mr. Alderson Smith also testified that "a potential negative impact to customers could result from the bundling of ancillary Highmark products, such as dental and vision insurance, with [BCBSD's] core health products." (Tr. at 354-355). He explained a mechanism by which this bundling could negatively impact insurance consumers, and noted that "[p]rohibiting the bundling of ancillary products with core health products could limit the ability of Highmark and [BCBSD] to engage in activities that may lessen [ ] competition in ancillary product markets." (Tr. at 355-356).

Ms. Sizemore confirmed the results of Blackstone's analysis. (Tr. at 522-523). She testified that the DOI is concerned about the potential negative impacts of bundling—such as consumers being required to buy secondary products in order to obtain BCBSD's core health

products—and that the DOI proposes a condition against improper bundling of products or services. (Tr. at 523-524). Specifically, the agreed-upon condition states:

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.

(Appendix A, JX 113A, Condition No. 30).

No testimony or other evidence was presented disputing Mr. Alderson Smith's or Ms. Sizemore's testimony.

C. Will the financial condition of Highmark jeopardize the financial stability of BCBSD, or prejudice the interests of BCBSD policyholders? (18 *Del. C.* § 5003(d)(1)(c)).

Mr. Alderson Smith testified that Blackstone's review of this standard focused on three issues: (1) the likelihood that Highmark would have sufficient financial strength to remain a dependable source of services for BCBSD; (2) BCBSD's reserves and the likelihood that BCBSD will need to rely on Highmark for support in paying BCBSD's claims; and (3) the potential impact of Highmark's proposed affiliation with West Penn Allegheny Health System on Highmark's overall financial stability. (Tr. at 357-358).

Mr. Alderson Smith testified that Highmark's RBC ratio is higher than the median ratio found in a sample of large publicly traded health insurers, and that the company projects that its investment portfolio and reserves will grow in the coming years. (Tr. at 359-360). Karen Hanlon of Highmark testified that Highmark has an A rating from both A.M. Best and Standard & Poor's. (Tr. at 212). She also testified that as of December 31st, 2010, Highmark had over \$3.7 billion in surplus and its net income for 2010 was over \$281 million. (Tr. at 212-213). As of December 31st, 2010, Highmark's RBC was at the higher end of the range defined as "sufficient" by PID, Highmark's primary regulator. (*Id.*). As of June 30, 2011, Highmark's quarterly financial statements reflected that Highmark had over \$4 billion in surplus and that its net income was over \$138.5 million. (*Id.*).

Mr. Alderson Smith testified that, regardless of Highmark's financial strength, it is also important for BCBSD to have sufficiently strong reserves, so as to "comparatively strengthen [BCBSD's] relative ability to maintain local operational decision-making as a result of decreased potential dependence on Highmark for financial stability." (Tr. at 362). He concluded that "[BCBSD's] current reserve levels are such that it is unlikely that [BCBSD] would need to rely upon Highmark to honor [BCBSD's] claims in the near future." (Tr. at 365). Mr. Alderson Smith also testified that BCBSD's maintenance of strong reserves will be an important element in BCBSD retaining flexibility in the event of a disaffiliation from Highmark, because BCBSD is likely to have fewer strategic options available if its reserves are insufficient for BCBSD to operate on a stand-alone basis. (Tr. at 361-362).

Mr. Alderson Smith also testified about the potential impact of Highmark's proposed affiliation with West Penn Allegheny Health System ("West Penn"), which includes five hospitals and other facilities in the Pittsburgh region. (BX 64). The transaction is currently

expected to involve a total commitment by Highmark of at least \$475 million over four years. (*Id.*). The terms of the affiliation have not yet been finalized, but when they are, Highmark will make a separate regulatory filing with the DOI for its review. (Tr. at 362-363). Mr. Alderson Smith testified that, under a worst-case scenario involving a loss of Highmark's total potential financial commitment to West Penn, Highmark estimates that its RBC ratio could fall approximately 60 to 115 percent, which would still result in Highmark's RBC ratio being above the median ratio found in a sample of large publicly traded health insurers. (Tr. at 363-364). He noted that BCBSD will not have direct exposure to any liabilities or potential operating losses from the West Penn Allegheny affiliation, and that Highmark has pledged not to pass operating costs on to BCBSD from that affiliation. (Tr. at 364). The DOI has proposed a condition preventing Highmark from directly or indirectly passing any up-front or ongoing costs associated with the West Penn Allegheny transaction on to BCBSD. (Tr. at 526; Appendix A, JX 113A, Condition No. 35).

- D. Does Highmark have any plans or proposals to liquidate BCBSD, sell BCBSD's assets, or consolidate or merge BCBSD with any person, or to make a material change in BCBSD's business or corporate structure or management, which are unfair and unreasonable to BCBSD policyholders and not in the public interest? (18 *Del. C.* § 5003(d)(1)(d)).

Karen Hanlon of Highmark testified that "Highmark has no plans or proposals to liquidate BCBSD, sell its assets or consolidate or merge it with any other person or entity." (Tr. at 213). Following the Affiliation, BCBSD will remain a Delaware not-for-profit corporation and a separate entity from Highmark and any Highmark affiliate. (Tr. at 214). Ms. Hanlon also testified that "Highmark has no current plans to replace the current officers of BCBSD as a result of the Affiliation." (Tr. at 214-215). She also stated that "Highmark has no plans or intentions

to gain access to BCBSD’s assets or to transfer any of BCBSD’s assets to Highmark or any subsidiary or affiliate of Highmark.” (Tr. at 222). Ms. Hanlon was not aware of any plans for Highmark to convert to a for-profit entity. (Tr. at 251). Highmark has agreed to a condition memorializing these statements, specifically that “Highmark has no plans or proposals to liquidate [BCBSD] or sell [BCBSD’s] assets or consolidate or merge it with any person or entity.” (Appendix A, JX 113A, Condition No. 37).

This testimony from Highmark notwithstanding, Ms. Sizemore of the DOI testified that “many of the [DOI’s] concerns about the Affiliation are implicated by Standard D.” (Tr. at 528). Testimony related to Standard D, as expressed throughout the public hearing, fell into several categories, discussed below.

1. Changes in BCBSD Business Operations and Governance

**Changes in BCBSD Operations.** Karen Hanlon of Highmark testified that, immediately following the closing of the Affiliation, there will be virtually no change to BCBSD’s operations. (Tr. at 206-208). Providers, subscribers, group customers, and the insurance-buying public in Delaware will continue to receive services from BCBSD as they do today and will not interact with BCBSD any differently. (*Id.*). Immediately following the closing of the Affiliation, a limited number of BCBSD executives will begin to report organizationally to an executive at Highmark. (*Id.*). For example, Tim Constantine will report to Highmark’s Executive Vice President of Health Services on day one after the Affiliation is effective. (*Id.*). Likewise, James Hynek, the CFO of BCBSD, will report organizationally to Ms. Hanlon at Highmark. (*Id.*). All of the remaining finance employees at BCBSD will continue to report to Mr. Hynek on day one as they do today. (*Id.*). Over time the leader of each BCBSD market-facing function will report to Mr. Constantine, while the BCBSD leaders of

other functions will report to supervisors at Highmark. (*Id.*). Thus, even over time, the market-facing functions which involve the most interaction with Delaware consumers and policyholders will still report to the President of BCBSD. (*Id.*). Ms. Hanlon testified that Highmark has no current plans to replace the officers of BCBSD. (Tr. at 214-215). The present officers of BCBSD will remain in place, including Mr. Constantine as President and CEO, who will also be a member of BCBSD's board. (*Id.*).

Scott Fad of BCBSD testified that “[f]ull and final business integration between BCBSD and Highmark is expected to be completed eighteen to twenty-four months after an approval of the Affiliation.” (Tr. at 141). At that point, there will be three levels of organizational structure for BCBSD: a locally-managed level, a shared-services level with Highmark, and a centralized support services level at Highmark. (Tr. at 135). Mr. Fad explained in detail the types of services at each level. (Tr. at 135-138). Important market-facing functions, such as sales and account management, provider contracting, government affairs, and community affairs, will still be locally managed in Delaware, “thus preserving BCBSD’s ability to be responsive to the Delaware marketplace and [BCBSD] local stakeholders.” (Tr. at 135-136).

Martin Alderson Smith of Blackstone testified that BCBSD “will retain autonomy as a Delaware-based entity with regard to market-facing functions” but that “[k]ey market-facing decisions such as how to price products and how to decide which products to offer in the Delaware market . . . will be subject to both input from the [BCBSD] board and approval by Highmark through the annual budgeting progression.” (Tr. at 373). Mr. Alderson Smith also testified that “[t]he [BCBSD] President will . . . retain relative autonomy when making decisions relating to interactions with [BCBSD] customers and the Delaware public.” (Tr. at 373-374). He stated that “[c]orporate budgets will be determined at Highmark, but the [BCBSD] President

and certain [BCBSD] personnel will have input into Highmark's budget-planning process, so that they can help to address any extraordinary cost issues impacting [BCBSD], or to introduce strategic changes in such areas as pricing and product development." (Tr. at 374).

**Changes to BCBSD Corporate Governance.** As described above, as a result of the Affiliation, Highmark will become the sole member of BCBSD, and will become the sole licensee to the BCBSA marks in Delaware, with BCBSD becoming a controlled affiliate of Highmark.

Other major changes to BCBSD's corporate structure involve its Board of Directors. The post-Affiliation BCBSD board will consist of four Class A directors, four Class B directors, and one President director. (*See* Appendix B, Docket Index, Tab 1, Ex. 3, BCBSD Amended Bylaws Art. V). The Class A directors are the "independent" directors—they cannot be officers or employees of Highmark or BCBSD, will be chosen by BCBSD prior to the closing of the Affiliation, will serve staggered terms, and will nominate new Class A directors for formal election by Highmark to three-year terms. (*Id.*). The Class B directors will be chosen by Highmark and will serve one-year terms. (*Id.*). For the first three years after closing of the Affiliation, Class B directors will include the Chief Executive Officer of Highmark and two Highmark officers who report directly to the Highmark CEO. (*Id.*). The President director is the President of BCBSD and will serve as a director for as long as he or she is President of BCBSD, with the election being subject to the approval of Highmark. (*Id.*).

Pursuant to 18 *Del. C.* § 6311, a majority of the post-Affiliation BCBSD board of directors shall consist of persons who are residents of Delaware and have been so for least 5 years prior to appointment. (18 *Del. C.* § 6311(b)(3); Appendix A, JX 113A, Condition No. 3). Also pursuant to 18 *Del. C.* § 6311, the DOI must give prior approval of any change in the



certificate of incorporation of BCBSD post-Affiliation. (18 *Del. C.* § 6311(b)(1); Appendix A, JX 113A, Condition No. 4). The DOI proposed, and the Applicants accepted, a condition that a quorum of the BCBSD board of directors includes not only a majority of the directors then in office and qualified to act but also at least one Class A director and at least one Class B director, unless two consecutive properly-called meetings have lacked a Class A director or Class B director. (Appendix A, JX 113A, Condition No. 20). The Applicants also agreed to a DOI-proposed condition that extended the terms of the initial Class A directors beyond the terms proposed in the Affiliation Agreement, such that the initial Class A directors will have staggered terms, serving until the third, fourth, fifth, and sixth annual meeting, respectively. (Appendix A, JX 113A, Condition No. 21). Finally, the DOI proposed, and the Applicants agreed to, a condition that prohibits Highmark from unreasonably withholding its election of a nominated Class A director and that requires Highmark to give BCBSD in writing Highmark's reason for withholding any such election. (Appendix A, JX 113A, Condition No. 22).

If certain "triggering events" occur, the Class A directors can require Highmark to disaffiliate, withdrawing from its position as sole member of BCBSD and consenting to BCBSD re-acquiring the license to the Blue marks. (Appendix B, Docket Index, Tab 1, Ex. 1, Affiliation Agreement § 7.8(a)). As outlined in Section 13.1 of the proposed BCBSD Bylaws, these triggering events include, for example, Highmark: (i) converting to a for-profit 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. The DOI has proposed, and the Applicants have accepted, a condition that expands this list of triggering events to include: (i) Highmark not curing any material failure to perform its obligations under any of the Affiliation-related agreements; (ii) Highmark becoming the subject of a delinquency proceeding pursuant to Pennsylvania law; (iii) Highmark's RBC ratio falling below 425 percent; or (iv) any regulator approving a 'Form A' or similar regulatory filing by Highmark that involves a conversion or a change-of-control. (Appendix A, JX 113A, Condition No. 23).

Highmark and BCBSD have also agreed to a condition proposed by the DOI that requires Highmark to use all reasonable best efforts, after any disaffiliation, to assist BCBSD in regaining the Blue mark. (Appendix A, JX 113A, Condition No. 26). The DOI has proposed, and the Applicants have agreed to, other conditions relating to a disaffiliation. For example, following a triggering event, the BCBSD Class A directors will have 180 days, rather than 60 days as initially proposed, to determine whether to disaffiliate from Highmark. (Appendix A, JX 113A, Condition No. 25). During that time, BCBSD shall have reasonable access to and cooperation of certain Highmark resources, including access to material information on BCBSD costs and operations as well as to certain Highmark employees for purposes of conducting due diligence meetings and interviews. (*Id.*). If BCBSD's Class A directors give notice to Highmark of their intent to disaffiliate, at the same time they must also give notice to the DOI—and if either Applicant seeks disaffiliation, it must submit for the DOI's approval a plan that discusses the potential impact on Delaware policyholders and how the current levels of coverage for Delaware policyholders will be maintained. (Appendix A, JX 113A, Condition No. 24). Highmark must continue to provide administrative services to BCBSD for three years after a

disaffiliation, but must also use reasonable best efforts to assist with BCBSD’s transition away from Highmark. (Appendix A, JX 113A, Condition No. 18).

[Insert section re: condition about HMK and BCBSD splitting costs of disaffiliation]

Linda Sizemore testified that the DOI “is concerned that the degree to which Highmark will exercise control over [BCBSD] could cause [BCBSD] to, for example, lose its local control and not make decisions effectively considering the interests of Delaware policyholders.” (Tr. at 530). Due to this concern, the DOI proposed the conditions (described above) that it believes “are necessary to ensure that the corporate governance structure appropriately protects the interests of policyholders and of the Delaware public.” (Tr. at 530-531).

## 2. Impact on BCBSD’s Financial Condition

### **The Impact of the Affiliation on BCBSD’s Financial Projections Is Positive.**

James Hynek of BCBSD testified to the differences in the financial projections for BCBSD as a standalone entity versus as an affiliate of Highmark. (Tr. at 157-161). He testified that “[o]verall projections indicate that it is more favorable for BCBSD to affiliate with Highmark than to remain a standalone company” and that the “primary financial impact . . . , at least in the period projected by the pro formas, will be the difference between the costs incurred by [BCBSD] to upgrade its IT systems as an affiliate of Highmark versus those same costs if [BCBSD] were to remain a standalone entity.” (Tr. at 157). Mr. Hynek testified that the Affiliation will cost BCBSD \$35 million in one-time IT upgrades, whereas the cost for BCBSD to upgrade as a standalone entity would range between \$88 million and \$140 million. (Tr. at 157). Ken Jackson testified that KPMG agreed with the estimated one-time costs for the

Affiliation, but that KPMG reached a standalone estimate of \$93 million to \$150 million based on KPMG's analysis of additional upgrades necessary for BCBSD to remain competitive. (Tr. at 487, 496). Scott Fad of BCBSD testified that the migration cost of \$37.4 million for BCBSD to migrate onto Highmark's IT platform is "a considerable savings from the estimated \$100 million to \$140 million that BCBSD would otherwise need to spend to obtain such capabilities as an independent company." (Tr. at 142).

Karen Hanlon of Highmark testified that "[c]ontrary to causing the removal of assets out of BCBSD, the Affiliation . . . will enable BCBSD to preserve tens of millions of dollars that it would otherwise expend making IT capital improvements and other capability enhancements." (Tr. at 224). Mr. Hynek also testified that BCBSD enrollment is expected to increase during the Affiliation but would decrease if BCBSD remains a standalone entity. (Tr. at 155). Ms. Hanlon testified that the Affiliation will result in BCBSD having a surplus of \$226 million by the end of 2015, rather than \$89 million if BCBSD remains a standalone company. (Tr. at 224). Martin Alderson Smith of Blackstone testified that "[i]t is unlikely that the financial condition of [BCBSD] will be materially worse in the foreseeable future as a result of an affiliation with Highmark than it would otherwise be if [BCBSD] were to . . . remain a standalone entity, and [the financial condition] may well improve as a consequence of the Affiliation." (Tr. at 388). He also stated that "the Affiliation scenario implies a significantly greater amount of claims-paying resources than the Stand-Alone scenario." (Tr. at 386-387).

**The Affiliation Protects BCBSD's Reserves by Permitting Only Three Types of Economic Transfers Between BCBSD and Highmark.** Mr. Alderson Smith testified that the Affiliation allows for three types of economic transfers from BCBSD to Highmark: (1) payments for upgrades to BCBSD's IT systems; (2) payments for Highmark's ongoing

administrative and technology services; and (3) interest payments to Highmark on any funds BCBSD opts to borrow under a Line of Credit Agreement (“LOC Agreement”) designed to provided funding to BCBSD for integration costs if needed. (Tr. at 378). He testified that “[t]he Affiliation does not otherwise provide for any mechanism for [BCBSD] to transfer funds to Highmark.” (Tr. at 378). The DOI has proposed, and the Applicants have agreed, that the three types of economic transfers identified by Mr. Alderson Smith are the only economic transfers that can be made by BCBSD to Highmark without DOI approval. (Appendix A, JX 113A, Condition No. 9). In addition, the Applicants have agreed that “Highmark shall not improperly use the assets of BCBSD for the benefit of Highmark, rather than the benefit of BCBSD and its subscribers.” (Appendix A, JX 113A, Condition No. 9).

**(1) Payments for upgrades to BCBSD’s IT systems.** The Applicants have estimated that BCBSD will spend approximately \$35 million to \$37 million to upgrade BCBSD’s IT systems and migrate to Highmark’s IT platform. (Tr. at 68, 157, 246). Ken Jackson of KPMG testified that “[b]ased on [KPMG’s] review of affiliation-planning documentation, and based on [KPMG’s] experience in working on integration projects of similar scope and complexity, [KPMG] believe[s] that the estimated range of costs is reasonable.” (Tr. at 496). Mr. Alderson Smith of Blackstone testified that the costs to BCBSD of IT upgrades from Highmark are not unreasonable, “especially ... given the level of functionality and service to be obtained and the fact that the cost to [BCBSD] of upgrading via Highmark’s IT platform does not appear to be higher than the cost to [BCBSD] of achieving the same level of functionality on a standalone basis.” (Tr. at 380). The Applicants have agreed to a DOI-proposed condition that caps the integration costs of BCBSD at \$42 million. (Appendix A, JX 113A, Condition No. 17).

**(2) Payments for Highmark’s ongoing administrative and technology services.** Several witnesses testified about the cost-allocation methodology (“CAM”) of Highmark, which determines how costs will be apportioned to BCBSD under the Administrative Services Agreement. Karen Hanlon of Highmark testified that the Administrative Services Agreement “does not include any profit margin to be paid to Highmark” and that “BCBSD will receive the services and access to Highmark business . . . and simply must pay Highmark for the allocated cost of those services.” (Tr. at 204; *see* Appendix B, Docket Index, Tab 1, Ex. 4, Administrative Services Agreement Art. II, § A).

Ms. Hanlon also testified that costs to BCBSD for services Highmark provides under the Administrative Services Agreement will include those for “executive oversight, strategic planning, procurement, and other corporate services which are sometimes referred to as corporate overhead” and which include some portion of the salaries of Highmark executives, and that “BCBSD’s allocable share of the costs will be based on Highmark’s established cost accounting practices which will be used consistently across all the business lines for which Highmark is providing services.” (Tr. at 203). These business lines include all of Highmark’s subsidiaries and Highmark West Virginia. (Tr. at 204).

Ms. Hanlon also testified about the cost-allocation conditions that were proposed by the DOI and agreed to by the Applicants. Specifically, prior to closing, BCBSD and Highmark will file with the DOI Highmark’s CAM and CAM formula, and thereafter BCBSD will file with the DOI a copy of the proposed budget for the following year, including the planned CAM charges. (Tr. at 246-247; Appendix A, JX 113A, Condition No. 10). The DOI will annually review and approve the proposed CAM charges, which are required to be fair and reasonable. (Tr. at 247; Appendix A, JX 113A, Condition No. 11). BCBSD must obtain the

DOI's approval before making any payment for CAM charges that exceed the DOI-approved budget by more than \$500,000. (Tr. at 247-248; Appendix A, JX 113A, Condition No. 12). These conditions do not apply to reimbursement BCBSD makes to Highmark for third-party costs Highmark incurs for the sole benefit of BCBSD, so long as Highmark submits to the DOI evidence supporting the amount and purpose of any such charges that exceed \$100,000. (Tr. at 248; Appendix A, JX 113A, Condition No. 13).

Two other conditions also relate to CAM charges. The Applicants must maintain their books and records such that the precise nature and details of transactions are clear and that there is support for the reasonableness of charges and fees. (Appendix A, JX 113A, Condition No. 14). Also, pursuant to statute, the Applicants must receive the prior review and approval of the DOI, on the basis of commercial reasonableness, of any expenditure, transfer of funds, or coordinated series of expenditures from BCBSD to Highmark that exceed \$500,000. (18 *Del. C.* § 6311(b)(2); Appendix A, JX 113A, Condition No. 1).

Ken Gebhard is the person responsible at Highmark for administering its budgeting, cost accounting and cost forecasting business (Tr. at 254). Mr. Gebhard testified at length and in detail about the mechanics of Highmark's established cost-allocation methodology, including the ways in which Highmark determines which costs to apportion to which of its affiliates and subsidiaries, (Tr. at 258-262, 273-275). Mr. Gebhard testified that the CAM itself is reflected in a detailed Highmark internal document approximately three-hundred pages in length. (Tr. at 267). He explained that the intent of the CAM is to reflect Highmark's "single set of cost accounting practices" across all of its affiliates and subsidiaries, and that "the important thing about the cost accounting is the consistency, and that's what [Highmark is] basically

maintaining through the discipline of the cost accounting methodologies that [Highmark has] in place.” (Tr. at 264-265).

Mr. Gebhard noted that “the most significant allocations from Highmark to BCBSD will be related to technology costs associated with the core applications [and that] [a]lllocations of these costs tend to be the most objective by their very nature due to the availability of common statistics that are used to logically allocate these cost pools.” (Tr. at 278-279). He also testified that approximately ten to twenty percent of Highmark’s CAM charges to BCBSD will involve administrative costs from the central Highmark office itself, including a portion of the salary of Highmark’s CEO. (Tr. at 283). He confirmed that several government entities audit the cost-accounting practices for several segments of Highmark’s businesses, and that he cannot think of an example in which Highmark was found to be noncompliant or that there was an audit issue requiring Highmark to institute a change. (Tr. at 267-269, 283-285).

Mr. Gebhard noted that Highmark had recently hired a consulting firm regarding cost allocation, and the consultant concluded that Highmark’s cost accounting practices conformed with industry best practices. (Tr. at 285). He testified that Highmark has since made changes to its CAM but that no changes have been structural in nature, that Highmark takes steps to ensure its CAM is as fair and equitable as possible, and that integrity and consistency are critical to Highmark. (Tr. at 285-287). He also stated that he does not see Highmark as having full discretion regarding its CAM, in light of contractual obligations in administrative services agreements that the CAM must be fair and reasonable. (Tr. at 290-291).

Mr. Gebhard also testified concerning the flexibility of Highmark’s CAM. Specifically, he indicated that “[t]o lay [the CAM] out specifically as though they were going to be in place for the entire duration of the agreement that hopefully has a long life, it would be



impossible because they would be constantly changing to keep up with the changes in the business.” (Tr. at 264). He testified about the origins of the CAM system, and about the various kinds of business developments that could lead to revisions of the CAM, such as the introduction of new technologies or products. (Tr. at 270-273). Mr. Gebhard testified that there is a mix of objectivity and subjectivity to the development of Highmark’s CAM. (Tr. at 277-278). He also stated that Highmark seeks to mitigate inherent subjectivity, such as by establishing consistency in the CAM across Highmark’s businesses, engaging in discussions at least annually with cost center managers, and providing a review process for challenges to CAM charges. (Tr. at 278).

James Hynek testified that, from BCBSD’s perspective, it is expected that the cost-allocation process will change over time “to meet new business requirements [and] new types of costs” and that it is not as if the CAM is “frozen in time and written down for posterity.” (Tr. at 169). Mr. Hynek also testified that BCBSD has not yet engaged in a comprehensive review of Highmark’s cost-allocation methodology, given that the Affiliation has not yet been approved, the evaluation will involve a substantial expenditure of time and energy, and the review may involve access to at least some information that is proprietary and confidential to Highmark. (Tr. at 163). Mr. Hynek testified that BCBSD will conduct such a review in the first quarter following the closing of the Affiliation and that BCBSD “believe[s] that the post-closing period is adequate to develop [BCBSD] testing and monitoring protocols.” (*Id.*). He described one product of that review as an internal BCBSD document that would be used to confirm BCBSD’s analytical testing (for example, change over time) and substantive testing (for example, verifying the accuracy of apportioned costs) of the proposed CAM accounting from Highmark. (Tr. at 178-179).

Martin Alderson Smith of Blackstone testified that the CAM charges to BCBSD from Highmark will in almost all instances “represent less than ten percent and in many instances less than five percent of the overall Highmark enterprise.” (Tr. at 417). He described the process by which BCBSD can review and challenge costs charged by Highmark, and concluded that conditions proposed by the DOI have struck the right balance between allowing BCBSD to continue to run effectively while also ensuring that BCBSD’s reserves and interests are protected in Delaware. (Tr. at 417-421). Mr. Alderson Smith also testified that rather than impose a hard cap on annual CAM charge increases—such as no higher than two percentage points more than the percentage growth in the Consumer Price Index (“CPI+2”), which is the cap in effect for Highmark West Virginia—the DOI preferred to use a more flexible combination of several conditions and regulatory powers to monitor and approve ongoing CAM charges to BCBSD. (Tr. at 421-423, 442-444). Mr. Alderson Smith stated that “Highmark’s methodology for allocating ongoing operational and administrative charges to [BCBSD] is not unreasonable, subject to appropriate monitoring, authorization, and dispute controls being implemented as planned.” (Tr. at 383).

Ken Jackson testified that KPMG believes that the ongoing CAM charges are reasonable. (Tr. at 496-497). He also explained the specific types of IT services that would generate ongoing CAM charges, and that Highmark’s proposed provision of services to BCBSD “at-cost” is a system common in the industry. (Tr. at 497-498). Mr. Jackson expressed his belief that “the cost allocation methodology is set up in a way that allows for transparency in terms of how costs are captured and how they are allocated based on various allocations bases” and that given this transparency “there will be plenty of opportunity for there to be an audit of these specific allocation costs on an annual basis or on an as-needed basis, and that can ensure that the

allocation of costs is fair and equitable” and “will be implemented appropriately and fairly.” (Tr. at 511-513).

Linda Sizemore of the DOI testified that she was “impressed by how rigorous and complex [Highmark’s] cost allocation methodology is,” including the numerous allocation factors. (Tr. at 556). She explained her views on the adequacy of the information contained in the CAM provided by Highmark, as well as the mechanics by which the DOI would engage in a review of the CAM charges using that information. (Tr. at 555-562). Ms. Sizemore also testified that the DOI had discussed with its advisors the possibility of a hard cap on annual CAM charges, such as the CPI+2 cap in West Virginia, but that the DOI felt more comfortable with a flexible set of constraints that could result in lower cost increases than with the hard cap in West Virginia. (Tr. at 594-595).

**(3) Payments Under the Line of Credit.** Tim Constantine testified that BCBSD has no current plans to draw on the line of credit. (Tr. at 76). Martin Alderson Smith expressed Blackstone’s belief that “[t]he terms and interest rate of [BCBSD’s] line of credit Agreement with Highmark considered as a whole are not unreasonable.” (Tr. at 384). The Applicants have accepted a condition proposed by the DOI that would provide BCBSD three years after any termination of the Line of Credit Agreement to repay funds it has borrowed under the line of credit, unless BCBSD affiliates with a for-profit company (in which case an immediate repayment is required). (Appendix A, JX 113A, Condition No. 27).

The Applicants have also accepted two other DOI-proposed conditions relating to the Line of Credit: a condition that any default by BCBSD will entitle Highmark to terminate the Line of Credit Agreement only if the default is material and goes uncured for sixty days; and a condition that allows BCBSD to take on certain debts, to issue certain security interests, or to

encumber its assets so long as Highmark has given prior written consent or any such activity or encumbrance by BCBSD is subordinate to any security interest held by Highmark. (Appendix A, JX 113A, Condition Nos. 28 and 29).

3. Impact on BCBSD's Capabilities and Provision of Services to its Customers and Policyholders

Martin Alderson Smith of Blackstone testified that BCBSD faces several capability challenges, including limited technology resources, a limited ability to adapt to regulatory change, and difficulty innovating in the areas of product development and pricing structures. (Tr. at 389). Mr. Alderson Smith testified that “[t]he Affiliation is anticipated to address many of these capability gaps, particularly given the breadth of experience [ ] Highmark has with various affiliations and administrative services agreements.” (Tr. at 390). Karen Hanlon of Highmark testified that BCBSD subscribers, group customers, and the insurance-buying public will have their business administered on a more automated advanced technology platform. (Tr. at 208). She also noted that these stakeholders “will have access to member and group customer portals that were not previously available to them, and in some cases will be able to complete transactions electronically that would have previously been manually processed.” (Tr. at 208). Ms. Hanlon stated that there “most likely [will be] new products in the market BCBSD will be able to offer because of its affiliation with Highmark.” (*Id.*). She testified that “[e]mployees will also have access to better online tools to assist in completing their functions” and that “[t]he technology and business process changes will ultimately enable BCBSD to operate more efficiently.” (Tr. at 208-209).

Ken Jackson of KPMG testified that information technology “goes to the heart of what [BCBSD] does. Almost all of the services provided by [BCBSD] run off of [BCBSD's] IT platform.” (Tr. at 476). Mr. Jackson further noted that information technology capabilities “can

[ ] affect the company's ability to perform current processes more efficiently and to address new services required to compete with other providers in the market." (*Id.*). He stated that "IT upgrades may substantively improve the quality of service [BCBSD] is able to provide . . . [and] may help [BCBSD] create higher-value products that are more attractive to various types of customers, thereby supporting an increase in or retention of its policyholders." (*Id.*).

Mr. Jackson reviewed government mandates that present challenges for BCBSD given its current capabilities, including the new coding system required under the International Classification of Diseases standard ("ICD-10") and the new electronic exchange standards under standard 5010 of the Health Insurance Portability and Accountability Act ("HIPAA"). (Tr. at 477-479). Mr. Jackson expressed KPMG's general agreement with the BCBSD capability gaps identified in earlier reports commissioned by BCBSD. (Tr. at 483; *see also* JX 47, Deloitte 2008 Report; JX 48, Deloitte 2010 Report). He described how KPMG recommended additional capabilities for BCBSD beyond those identified in the reports, such as the development of private exchanges and of retail initiatives, as well as a different methodology for BCBSD meeting the new ICD-10 coding structure given the limited time remaining for BCBSD to prepare to meet the new standards. (Tr. at 484-486). Tim Constantine of BCBSD testified that the federal compliance deadline for ICD-10 is October 2013 and that "BCBSD would need to have systems, products, and services ready to go to market in early 2013 in order to meet the January 1, 2014 effective date" for HIPAA standard 5010. (Tr. at 69). Karen Hanlon of Highmark testified that "Highmark and BCBSD believe that the closing of the Affiliation needs to occur by year end 2011 so that BCBSD is able to fully comply with [the ICD-10 requirements] . . . by the October 2013 deadline." (Tr. at 211). Ms. Hanlon testified that if the Affiliation does not close by year end 2011, BCBSD will be forced to incur \$2 million to \$2.5

million in compliance costs for work that ultimately will be discarded once BCBSD does migrate onto Highmark's IT systems. (Tr. at 212). Mr. Jackson testified that KPMG estimated these "throw-away costs" to be \$3 million to \$5 million, which BCBSD would have to incur if the Affiliation is not approved by December 31, 2011. (Tr. at 504-505).

Mr. Jackson described the pros and cons of BCBSD seeking to improve its capabilities as a standalone entity or via an outsourcing arrangement. (Tr. at 488-495). He concluded that the neither the stand-alone option nor the outsourcing option meets the strategic goals of the BCBSD board of directors, and that those options would not allow BCBSD to benefit from the full range of other capabilities which are offered by a partner such as Highmark. (Tr. at 495). Mr. Jackson also provided an evaluation of the mechanics and costs of the Affiliation, from the perspective of IT and capabilities enhancements. (Tr. at 495-504). Mr. Jackson concluded that "the Affiliation appears to be a feasible solution for [BCBSD's] needs, including allowing [BCBSD] to meet the ICD-10 and HIPAA 5010 guidelines. The Affiliation plan also appears well suited to address . . . each capability concern raised in the 2008 Deloitte report, and will also provide an additional forty-two capabilities to [BCBSD]." (Tr. at 499-500). He testified that, additionally, the Affiliation will enable BCBSD to benefit from the economies of scale, including lower ongoing costs and a low-cost structure for BCBSD to migrate onto Highmark's IT systems. (Tr. at 500). He noted risks relating to cost allocations under the Affiliation, and that a risk of underfunding or inadequate support for BCBSD's service requests to Highmark could be addressed by a DOI-proposed condition mandating ongoing reporting of service-level performance. (Tr. at 503-504). Specifically, Condition No. 16 requires BCBSD and Highmark to agree on a service level agreement (including appropriate service level metrics) that shall take effect upon completion of integration, which is expected to take approximately 18

months. For the first 18 months after the service level agreement takes effect, BCBSD will provide quarterly reporting to the DOI concerning whether the metrics and other standards in the agreement are met. (Appendix A, JX 113A, Condition No. 16).

Mr. Jackson's testimony is consistent with the testimony of Martin Alderson Smith of Blackstone and Linda Sizemore of the DOI. Mr. Alderson Smith testified that "[n]either an outsourcing relationship with a business process provider, nor investing in additional capabilities as a standalone entity would be expected to provide [BCBSD] with capabilities that exceed those anticipated in the Affiliation [and that] [f]urthermore, such arrangements would likely entail greater costs to [BCBSD] and would not address [BCBSD's] lack of scale and resources in areas such as strategic development, product innovation, and regulatory planning." (Tr. at 389). Ms. Sizemore testified that "of these choices [of affiliating with Highmark, upgrading as a standalone entity, or upgrading via outsourcing], the [DOI] determined that the proposed Affiliation is fair and reasonable and, quite frankly, the best option." (Tr. at 539).

#### 4. Executive Compensation

The parties also applied Section 5003 to analyze whether Highmark has or had any plans relating to the compensation of any of the BCBSD executives, to incent them to favor the affiliation with Highmark. Tim Constantine testified that "[n]o BCBSD executive will be paid any bonus or incentive compensation as a result of negotiating or closing [the Affiliation]." (Tr. at 78). He testified that the current compensation and incentive packages for BCBSD executives are "far below the average for non-publicly traded Blue Cross Blue Shield plan officers, as well as the health insurance and managed care industry sector averages." (Tr. at 79). Mr. Constantine described the process by which the BCBSD board reviews executive

compensation packages, as well as the process involved in amending the agreements to address the agreements' tax impacts on BCBSD. (Tr. at 79-80). He explained the limited reasons for which a BCBSD executive may be entitled to severance payments after the closing of the Affiliation, which includes a substantial reduction of the executive's duties or a substantial reduction in compensation. (Tr. at 80-81). He testified, however, that "BCBSD and Highmark have no plans to terminate any of the BCBSD executives following the Affiliation." (Tr. at 82). Mr. Constantine testified about a "worst-case scenario," which is that in the "highly unlikely event that all seven [BCBSD] executives were terminated immediately after closing [of the Affiliation]," there would be a total lump-sum severance payment of approximately \$5,960,000 to the seven BCBSD executives. (Tr. at 82-83).

The testimony of Martin Alderson Smith of Blackstone confirmed this description of executive compensation packages. (Tr. at 367-369). Mr. Alderson Smith also testified that "Blackstone has not discovered and is not aware of any [side] agreement" between Highmark and BCBSD executives which would give those executives a personal financial incentive to enter into the Affiliation, and that "[i]t is unlikely that [BCBSD] management will gain direct financial benefit from the Affiliation at the expense of the company's policyholders." (Tr. at 369). Linda Sizemore testified that the DOI "determined that the [BCBSD] executives will not receive any financial compensation as a result of the consummation of the Affiliation" and that "[a]lthough certain [BCBSD] executives have employment agreements that include severance payments under certain conditions, those rights were in place before the Affiliation was negotiated and will not be automatically triggered by the Affiliation." (Tr. at 544). The DOI also proposed a condition, which has been agreed to by the Applicants, that precludes "any separate arrangements or understandings with BCBSD executives that would give BCBSD executives any



personal, financial incentives to favor the Affiliation.” (Appendix A, JX 113A, Condition No. 36; *see also* Tr. at 544-545).

Mr. Constantine also addressed certain non-executive “stay” bonuses. He testified that “[i]n 2009, BCBSD utilized [an independent advisor] to assist it in evaluating a retention bonus program to help ensure that BCBSD retains employees who have special skills or knowledge that is vital to maintaining certain business-critical functions during the Affiliation’s transition period.” (Tr. at 83). Under this program, eight BCBSD nonexecutive employees will receive a total of approximately \$300,000 in stay bonuses. (*Id.*). Mr. Alderson Smith testified that “[t]hese bonuses were approved by the [BCBSD] board of directors after consultation with an industry advisor in June of 2010, and range between twenty-five percent and thirty percent of the recipients’ annual salaries.” (Tr. at 370).

#### 5. Employment in Delaware

The parties also presented testimony on the impact of the proposed Affiliation on employment in Delaware. Scott Fad of BCBSD noted that “in order to achieve the administrative efficiencies, economies of scale and synergies that are so important to the Affiliation, the BCBSD end-state employment levels appear to place BCBSD at approximately 435 full-time equivalents [FTEs],” which is “a significant reduction from the current employment level of 617 FTEs.” (Tr. at 142-143). Mr. Fad went on to testify that “in negotiating the Affiliation . . . [BCBSD] stressed the importance of preserving robust employment in Delaware” and discussed a number of employment-related commitments that appear in the Affiliation documents. (Tr. at 143). Mr. Fad also testified to three voluntary commitments that BCBSD and Highmark have made with respect to employment: (i) “the total number of employees in Delaware will remain the same after implementation of the Affiliation is

complete, approximately 18 months, as it was a the start of the Affiliation integration activities”;

(ii) “any BCBSD employee whose positions are eliminated due to the implementation will be given first opportunity to fill any new BCBSD or Highmark positions that are created in Delaware”; and (iii) for four years, BCBSD and Highmark have agreed to “maintain account management, customer service and provider service to Delaware customers by Delaware-based staff under the immediate supervision of Delaware based staff.” (Tr. at 144-145). Karen Hanlon of Highmark reaffirmed Mr. Fad’s testimony. Specifically, Ms. Hanlon testified that “Highmark and BCBSD have committed to maintaining a significant Delaware presence and to maintain the BCBSD corporate headquarters in Delaware.” (Tr. at 216). This commitment is also in Section 7.4 of the Affiliation Agreement. (*See* Appendix B, Docket Index, Tab 1, Ex. 1, Affiliation Agreement §§ 7.4). Ms. Hanlon also testified that BCBSD and Highmark have “agreed to use commercially reasonable efforts to maintain employment levels that are proportionate to those in other Highmark service areas for health business.” (Tr. at 216-217; *see also* Appendix B, Docket Index, Tab 1, Ex. 1, Affiliation Agreement § 7.4). Further, Highmark has committed to having the same number of full-time employee [FTE] positions in Delaware at the end of the integration process as there are at the beginning of that process, which is expected to last eighteen months, although Highmark has not committed to replacing any lost positions resulting from a significant decrease in BCBSD’s enrollment or market share during the integration period. (Tr. at 217). Ms. Hanlon also stated that “[a]ny BCBSD employees whose positions are eliminated due to the implementation will be given the first opportunity to fill any new positions that are created in Delaware [and that] Highmark will make good-faith efforts to locate additional FTE positions in Delaware as Highmark’s business opportunities arise.” (Tr. at 217-218; *see also* Appendix B, Docket Index, Tab 1, Ex. 1, Affiliation Agreement § 7.4).

Martin Alderson Smith of Blackstone testified that BCBSD employment levels “could decline as a result of the Affiliation” and that “ultimately [there is] a tension between Highmark’s goal of enhancing [BCBSD’s] competitiveness by promoting greater efficiency with [BCBSD] and efforts to preserve employment levels.” (Tr. at 387).

Linda Sizemore testified that the DOI has proposed that Highmark and BCBSD’s employment commitments be made conditions to the Affiliation. (Tr. at 545-546). The Applicants have agreed, and their employment commitments are shown in Condition No. 7 in JX 113A. Highmark also agreed to a DOI-proposed condition that seeks to preserve the quality and focus of BCBSD’s service to its customers and stakeholders in Delaware, in part and in effect through employment of Delaware-based staff. (Tr. at 218). That condition requires that

[f]or 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.

(Appendix A, JX 113A, Condition No. 8).

#### 6. The Experiences of Highmark West Virginia

Scott Fad of BCBSD testified that the proposed Affiliation is generally based on the affiliation that has led to the creation of Highmark West Virginia, and that BCBSD’s diligence efforts support its conclusion that the Highmark West Virginia affiliation involved an integration with Highmark’s technology platforms but also a preservation of a local presence and customer focus in West Virginia. (Tr. at 130-132). Mr. Fad testified that although the West Virginia plan “experienced the same significant integration between Highmark and West

Virginia that Highmark and BCBSD anticipate, employment has actually grown meaningfully in West Virginia since the affiliation as the plan has grown stronger both financially and in enrollment as the beneficiary of Highmark's business capabilities." (Tr. at 145-146).

Fred Earley of Highmark West Virginia testified about the history of the Blue Cross Blue Shield West Virginia entity and the process by which it came to be Highmark West Virginia. (Tr. at 294-304). He testified that integration into Highmark's technology systems exceeded West Virginia's expectations relating to: increasing functionality and automation; improving operations service, efficiency, new product development, and interactions with customers and providers; minimizing the cost of regulatory compliance; and increasing revenue growth by increasing capabilities. (Tr. at 305-306). He also testified about specific products and capabilities now available to clients, and about improvements in contractual terms and the financial strength of the company as well as in job and economic benefits to the local economy. (Tr. at 313-315). Mr. Earley emphasized the significance of the affiliation having "provided Highmark West Virginia the advantages, economies of scale, and access to expertise needed to address the unprecedented challenges and changes associated with healthcare reform, while at the same time maintaining an organizational structure designed to serve the specific needs of the West Virginia markets." (Tr. at 309-310).

Mr. Earley also testified about the process of cost-allocation review between Highmark and Highmark West Virginia. (Tr. at 310-313, 317-318). He testified that there is also an annual review with the West Virginia Insurance Commission. (Tr. at 318-320). He described the CPI+2 cap on the growth of costs under the administrative services agreements. (Tr. at 319-320). He also believes "without any hesitation that the affiliation has been beneficial

to [Highmark West Virginia] customers and providers and has provided an overall benefit to the state of West Virginia, as well as its citizens.” (Tr. at 315).

Martin Alderson Smith provided a summary of Blackstone’s review of the Highmark West Virginia affiliation, including the results of the affiliation and Blackstone’s conclusion that “Highmark’s affiliation with Highmark West Virginia has resulted in that company having significant capabilities and corporate support and has not been detrimental to Highmark West Virginia’s policyholders.” (Tr. at 390-392).

- E. Are the competence, experience, and integrity of those persons who would control the operation of BCBSD such that it would not be in the interest of BCBSD policyholders and of the public to permit the Affiliation? (18 *Del. C.* § 5003(d)(1)(e)).

Karen Hanlon of Highmark testified that “the Highmark board of directors and management team is highly qualified to competently govern and manage Highmark and all of its affiliates.” (Tr. at 224). Ms. Hanlon noted that the qualifications of the members of this team are found in the biographical affidavits filed with the Affiliation Statement, which include the affidavits of three of the four proposed BCBSD Class B directors: Dr. Kenneth Melani, Nanette DeTurk, and Deborah Rice. (Tr. at 224-225; *see also* JX 40-42). Ms. Hanlon testified that Tim Constantine, the current President of BCBSD, will continue in that position post-closing. (Tr. at 224-225).

Linda Sizemore testified that the DOI’s review “found that [Dr. Melani, Ms. DeTurk, and Ms. Rice] are executives in a highly regulated industry whose qualifications have also been reviewed and accepted by other state departments of insurance [and that] they collectively have forty-three years of executive experience at healthcare entities.” (Tr. at 547-548). The DOI also reviewed the biographies, credentials, and records of the twenty-one board

members and eleven executive officers of Highmark. (Tr. at 547). Ms. Sizemore testified that the DOI “is familiar with [Tim] Constantine and the current [BCBSD] board of directors and has no concerns about their competence, experience, or integrity.” (Tr. at 548). On the basis of its review, the DOI concluded that it has “no reason to question the competence, experience, or integrity of these individuals such that their control of [BCBSD] post-Affiliation would be contrary to the interests of [BCBSD’s] policyholders or to the public interest.” (Tr. at 548-549).

Mr. Constantine testified that Highmark is in the process of selecting the fourth and final Class B director, and has asked BCBSD to recommend suitable candidates. (Tr. at 74-75). Ms. Sizemore confirmed that, prior to the final approval of the affiliation by the Commissioner, the DOI will conduct the same thorough review of the last Class B director in order to make a final determination as to whether the affiliation satisfies the criteria of 18 *Del. C.* § 5003(d)(1)(e). (Tr. at 547-548).

F. Is the Affiliation likely to be hazardous or prejudicial to the insurance-buying public? (18 *Del. C.* § 5003(d)(1)(f)).

Karen Hanlon of Highmark testified that the Affiliation will be beneficial to the insurance-buying public for several reasons, including: (1) the significant upgrades to BCBSD’s infrastructure and the benefit of BCBSD gaining access to the efficiencies and scale associated with a larger company; (2) BCBSD gaining access to the significant resources Highmark devotes to ensuring compliance with federal and state healthcare reform initiatives; and (3) because of the prospect for improvements in BCBSD’s financial outcomes, enrollment, efficiencies, and product development, as evidenced by the outcomes of the affiliation with Highmark West Virginia. (Tr. at 225-227). She also testified that employers, providers, and producers will gain access to, and enjoy the benefits of, Highmark’s state-of-the-art technology systems, and that premium increases for BCBSD are projected to be lower than they would be for BCBSD as a

standalone entity. (Tr. at 219-221). Ms. Hanlon also testified about the IT cost savings for BCBSD and its stakeholders as a result of the Affiliation. (Tr. at 218-219).

Tim Constantine testified that the Affiliation will allow BCBSD to maintain its not-for-profit status, to continue to provide a high level of local service, and to expand its product offerings and enhanced capabilities and resources for BCBSD customers, providers, and brokers. (Tr. at 85-86). Mr. Constantine also testified that the Affiliation will enable BCBSD to “continue as a significant local employer, a good corporate citizen, and a strong contributor to Delaware’s economy.” (Tr. at 86).

Martin Alderson Smith of Blackstone testified that given BCBSD’s unique market position as Delaware’s largest locally based not-for-profit insurer, the proposed Affiliation could have a significant impact on the insurance-buying public. (Tr. at 393). Blackstone’s analysis focused on BCBSD’s current market position, BCBSD’s search for a strategic partner, and the feedback Blackstone received in public information sessions and in private interviews with interested parties.<sup>9</sup> (Tr. at 393). Mr. Alderson Smith testified that “[BCBSD] provides services to a significant portion of the Delaware population and, as a result, has many stakeholders . . . in the Delaware market, including customers, providers, employers, brokers, and community members, [who] are generally satisfied with [BCBSD’s] performance.” (Tr. at 394).

Mr. Alderson Smith testified that the results of Blackstone’s interviews with Delaware stakeholders indicate that “[t]he greatest concern conveyed was generally related to [BCBSD’s] ability to retain a strong local presence and local decision-making authority [and that] [e]ven with these concerns, however, nearly all . . . voiced their support on balance for the

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<sup>9</sup> Blackstone interviewed 14 total stakeholders in Delaware, including 6 hospital providers, 2 physician providers, 1 homecare provider, 2 businesses in the Delaware community, 1 insurance broker and 2 consumers. (BX 124).

proposed Affiliation due to [BCBSD's] perceived lack of cutting-edge products and capabilities when compared to larger competitors.” (Tr. at 398). He testified that “Blackstone believes that conditions designed to preserve [BCBSD's] local presence and autonomy, and to ensure local decision-making and local customer service and account management, would be appropriate to bring the Affiliation into compliance with the statutory criteria” and that “[w]ith such conditions in place, the Affiliation is not likely to be hazardous or prejudicial to the insurance-buying public of Delaware.” (Tr. at 399-400).

Linda Sizemore testified that the DOJ agrees with this conclusion, particularly given “the prospects and challenges for [BCBSD] and the risks to its local identity that it faces as a standalone entity in the coming years.” (Tr. at 550).

## II. THE DEPARTMENT OF JUSTICE'S PROPOSED CONDITION

The DOJ's proposed condition is that BCBSD and Highmark must establish a mechanism to guarantee that the public's investment in BCBSD remains in Delaware to be held and protected for the benefit of Delawareans, specifically to serve the State's unmet health needs. (*See* Appendix B, Docket Index, Tab 93, October 3, 2011 letter from I. McConnel to Judge Robinson). The parties dispute whether the DOJ's proposed condition falls within either of Section 5003 or 6311, which, as I mentioned earlier, are the statutory sections at issue in this proceeding. The parties have made no argument that the DOJ's proposed condition implicates Section 6310.

Just prior to the hearing, I denied as premature the admission into the record of a report prepared by the DOJ's financial advisor, which discussed the methodology of establishing an amount that might be put into a charitable foundation established in connection with the Affiliation. (Tr. at 25). I excluded this report after determining that the purpose of the public



hearing was not to discuss or evaluate such a methodology, but to examine the rationales for what conditions would be appropriate. (Tr. at 26). I now summarize the testimony concerning the rationale of whether the DOJ's proposed condition is appropriate under Sections 5003 or 6311.

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, is essentially 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 as *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 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).

### III. PUBLIC COMMENTS

Several members of the public spoke at the public hearing or submitted letters to the Hearing Officer, the DOI, or to counsel for the parties. Some of the testimony and letters raised concerns or questions regarding the proposed Affiliation, while others urged the Commissioner to approve the Affiliation.

At the public hearing, James Lafferty, Executive Director, Mental Health Association in Delaware, spoke about his gratitude for BCBSD's involvement in the community through its charitable support of the Mental Health Association's fundraising efforts and treatment programs for individuals with mental health disorders. (Tr. at 618-621). Joanne Hasse, Former Board Member, Delaware Health Information Network, expressed several thoughts, including: (1) her hope that the public understands BCBSD needs to, not simply wants to, upgrade its IT systems; (2) her view that the Conversion Act has no bearing on the Affiliation because both of the Applicants are not-for-profit; (3) her belief that the DOI's concerns have to include the Delaware community; and (4) that although Highmark should not be required to contribute to a fund as suggested by the Delaware Attorney General, the Affiliation should address BCBSD continuing its commitment to the Delaware Community Foundation. (Tr. at 622-628). Jo Ann Fields, M.D. expressed gratitude for BCBSD's charitable contributions but stressed the need for the Affiliation to require a continued charitable commitment, and supported the Attorney General's proposal to have a foundation set aside and funded with at least \$45 million. (Tr. at 650-652). Mitch Crane questioned the logic of BCBSD entering into the Affiliation, given a variety of factors such as BCBSD's large reserves and its lack of any real competition, and expressed his view that the Affiliation jeopardizes the financial stability of BCBSD and is unfair and unreasonable to policyholders and not in the public interest. (Tr. at

628-639). Vincent White also spoke against the Affiliation for a variety of reasons, including his skepticism of any cost-reduction commitment by Highmark and of the qualifications and motives of the current BCBSD management. (Tr. at 639-650).

The Hearing Officer and DOI also received several letters before and after the public hearing. The large majority of letters expressed support for the Affiliation. These letters came from the Medical Society of Delaware (JX 51); John Still (JX 114); the Delaware State Chamber of Commerce (JX 116); Jim Trost (JX 117); Vicenta G. Marquez, M.D. (JX 118); the Dover Interfaith Mission for Housing (JX 122); the New Castle County Chamber of Commerce (JX 123); Nicholas A. Moriello, R.H.U. (JX 126); the Nemours Fund for Children's Health (JX 128); Catholic Charities, Inc. of the Diocese of Wilmington (JX 129); W.L. Gore & Associates, Inc. (JX 130); La Red Health Center (JX 131); and George J. Weiner Associates L.L.P. (JX 132). Letters expressing disapproval of the Affiliation or raising questions about the Affiliation came from Coventry Health Care of Delaware (JX 112); Lee Mullett (JX 124); V. Raman Sukumar, M.D. (JX 125); and the Delaware Health Information Network (JX 134). Another member of the public contacted the DOI outside the context of the public hearings. (JX 115).

Support for the Affiliation was based on several considerations. The Medical Society of Delaware submitted a comprehensive letter expressing its support for the Affiliation because BCBSD's viability depends upon alignment with a larger insurer, because the Affiliation is not a merger or acquisition, and because Highmark provides the right set of characteristics for BCBSD and the Delaware community. (JX 51). Vicenta G. Marquez, M.D., described BCBSD's commitment to good health for all Delawareans via its charitable grants to The Hope Medical Clinic, Inc. (JX 118). The Dover Interfaith Mission for Housing expressed similar sentiments, writing that "[w]ith [BCBSD's] help, we were able to shelter, feed, and help over

150 homeless men with their health care and employment needs.” (JX 122). Jim Trost objected to Attorney General Biden’s proposal to set aside \$45 million of BCBSD’s reserves for uninsured Delawareans, stating that “[a]ny excess reserves should be returned to BCBSD’s customers in the form of lower future premiums” and “need to be returned to BCBSD’s customers and not diverted for other social purposes.” (JX 117).

The Delaware State Chamber of Commerce, the New Castle County Chamber of Commerce, and George J. Weiner Associates L.L.P. wrote to express their support of the Affiliation for, among other reasons, the Affiliation enabling BCBSD to maintain its local presence and to remain competitive in the marketplace. (JX 116; JX 123; JX 132). The Nemours Fund for Children’s Health expressed its gratitude for BCBSD’s charitable contributions to the Nemours/Alfred I. duPont Hospital for Children, including a \$250,000 grant in 2008 supporting dental care for children with mental and physical disabilities, as well as a \$500,000 grant to support the expansion of the hospital. (JX 128). Catholic Charities Inc. of the Diocese of Wilmington, which has received more than \$200,000 to support its counseling services for those under- or uninsured who need treatment of mental health disorders, wrote that it “depends on a vibrant Blue Cross Blue Shield organization in Delaware to support our mission of providing caring service to those in need.” (JX 129).

Other letters spoke against the Affiliation or raised questions or concerns about it. Coventry Health Care of Delaware characterized the Affiliation as a “defacto takeover,” questioned how the Affiliation will benefit Delaware stakeholders, and suggested that a series of twelve conditions be included in any order approving the proposed Affiliation. (JX 112). An email from Lee Mullett expressed disapproval of the Affiliation and agreement with the Attorney General that a fund should be set aside, otherwise BCBSD should have to upgrade its IT systems

using funds directly from its reserves. (JX 124). An email from V. Raman Sukumar, M.D. expressed concern on behalf of Doctors Pathology Services that bundling of ancillary services may crowd out “honest ancillary service who improve quality with lower cost.” (JX 125). A letter from the Delaware Health Information Network (“DHIN”) asked the Hearing Officer and the Commissioner to condition the Affiliation on “BCBSD reach[ing] agreement with the DHIN regarding BCBSD’s ongoing financial support of the DHIN via per member per month fees that will enable the continued financial sustainability of the DHIN.” (JX 134 at 3). An email from a member of the public, sent outside the context of the public hearings, expressed concern about negative impacts on the ability to practice primary care in Delaware, and on the burden of claims processing having to go through Pennsylvania rather than Delaware. (JX 115).

#### FINDINGS OF FACT; CONCLUSIONS OF LAW; RECOMMENDATIONS

Having considered the testimony and documents submitted into the record as summarized above, and in light of the standard of review as set forth in the Pre-Hearing Order and the statutory requirements of 18 *Del. C.* c. 50 and of the Delaware Administrative Procedures Act at 29 *Del. C.* § 10101 *et seq.*, I make the following findings and recommendations. With the exception of the condition proposed by the Attorney General, which I discuss below, I note that all other conditions have been agreed to by the Applicants and the DOI (attached as Appendix A). I will note below the impact of the conditions on the Affiliation’s satisfaction of the relevant statutory criteria.

1. BCBSD is currently authorized to write business as a Delaware health service corporation pursuant to Title 18, Chapter 63 of the Delaware Code. After the closing of the Affiliation, BCBSD will maintain its not-for-profit status and its exemption from having to obtain a certificate of authority from the DOI. Although not formally related to BCBSD’s

licensing status or requirements, it is confirmed that Highmark's subsidiaries in Delaware will continue to be sufficiently capitalized to fulfill their own licensing requirements. I therefore conclude that the Affiliation meets the criteria under 18 *Del. C.* § 5003(d)(1)(a).

2. BCBSD and Highmark currently compete in Delaware in two lines of insurance: Stop-Loss and Dental. The Affiliation has no anti-competitive effect in the Stop-Loss segment of the Delaware insurance market, as indicated by the application of statutory criteria using the conservative calculation Blackstone employed to compensate for imperfections in the data available from the National Association of Insurance Commissioners. There is evidence of a prima facie violation of the statutory standard in the Dental segment. I find, however, that, based on Blackstone's analysis regarding other factors to consider (chiefly those relating to the current market dominance of Delta Dental and the ways in which the Affiliation may increase competition within the Delaware dental insurance market by providing a counterweight to Delta Dental), the Affiliation will have no anti-competitive impact on the Dental segment. I also am persuaded by the concerns Blackstone and the DOI raise regarding the issue of ancillary bundling, particularly given the submission of similar concerns by a member of the Delaware public. I find the DOI's proposed anti-bundling condition (Condition 30) to be an appropriate approach towards ensuring the Affiliation does not have an anti-competitive effect beyond those contemplated by the quantitative statutory standards. I find that the effect of the proposed Affiliation, with adoption of Condition 30, will not be substantially to lessen competition in insurance in Delaware or tend to create a monopoly therein, and, therefore, that the Affiliation will satisfy the criteria of 18 *Del. C.* § 5003(d)(1)(b).

3. Highmark is a financially strong company and projects growth in its reserves and investment portfolio in the coming years. Its current and projected financial

strength does not jeopardize the financial stability of BCBSD or prejudice the interests of BCBSD policyholders. Further, BCBSD's own strength of reserves helps to provide a buffer from BCBSD becoming financially dependent on Highmark or being in a position to be jeopardized permanently by any financial downturn of Highmark. This relative stability applies even if Highmark were to experience a complete loss of the funds it intends to commit to the West Penn Allegheny transaction, given that its RBC ratio is projected to remain above market averages even in the event of such a loss. Nonetheless, the DOI seeks, and the Applicants have agreed to, a condition that Highmark will not directly or indirectly pass any costs of the West Penn Allegheny transaction on to BCBSD (Condition 35). Therefore, I find that, with adoption of Condition 35, the financial condition of Highmark does not jeopardize the financial stability of BCBSD or prejudice the interests of BCBSD policyholders, and, thus, that the Affiliation will satisfy the criteria of 18 *Del. C.* § 5003(d)(1)(c).

4. Highmark has testified that it has no plans or proposals to liquidate BCBSD, sell BCBSD's assets, or consolidate or merge BCBSD with any person. The Applicants and the DOI have proposed a condition that memorializes this commitment (Condition 37). Highmark also has testified that it has no plans to convert to a for-profit entity. The proposed Affiliation will involve several changes to BCBSD's governance, management, and business structures. A significant change is the composition of the BCBSD board of directors, which will be controlled by Highmark. Highmark does not intend to replace the current officers of BCBSD, but nonetheless there will be important changes at the board level. Given the importance of BCBSD continuing to have a local focus and a voice on the board that is familiar with local concerns, the DOI has proposed, and the Applicants have agreed to, several conditions that provide protection beyond the contractual terms of the Affiliation Agreement and

the revised BCBSD governance documents. These include Conditions 20 through 23, which, respectively, mandate that a board quorum include at least one Class A director; extend the initial Class A directors' terms of service; mandate that Highmark not unreasonably withhold the election of any nominated Class A director; and expand the events giving rise to the Class A directors' ability to withdraw BCBSD from the Affiliation.

Although the Affiliation is projected to provide significant cost savings for BCBSD, it also provides for mechanisms by which BCBSD will transfer funds to Highmark. I find nothing in the record to indicate that any of the payments that are anticipated to be made by BCBSD to Highmark, including allocations under the CAM, will result in inappropriate transfers of assets from BCBSD to Highmark. The DOI has proposed, however, and the Applicants have accepted, a series of conditions designed to place appropriate limits on the transfer of funds from BCBSD to Highmark. Condition 9 prohibits Highmark from improperly using BCBSD's assets for the benefit of Highmark and confirms that there are only three ways that BCBSD can transfer funds to Highmark without DOI approval: (i) payments for BCBSD's integration to Highmark's IT systems; (ii) ongoing payments for the administrative services Highmark will provide to BCBSD under the Administrative Services Agreement; and (iii) payments pursuant to the Line of Credit Agreement.

As to (i), Condition 17 caps integration costs to be paid to Highmark by BCBSD, currently estimated to be \$35 million to \$37 million, at \$42 million. As to (iii), Condition 28 limits the ability of Highmark to terminate the Line of Credit agreement if a default by BCBSD is material and is uncured for sixty days. In addition, Condition 29 introduces flexibility into the Line of Credit Agreement, alleviating an unintended rigidity regarding security interests as initially proposed in the agreement). Condition 27 extends BCBSD's time limit to repay any



obligations under the Line of Credit Agreement to three years following a termination of the agreement, unless BCBSD first affiliates with a for-profit company.

As to (ii), there is also a series of conditions relating to charges against BCBSD for Highmark's provision of services under the Administrative Services Agreement, as determined by Highmark's cost allocation methodology. Prior to closing of the Affiliation, BCBSD and Highmark must file with the DOI a copy of Highmark's CAM, and BCBSD must annually file with the DOI a copy of the following year's approved budget (Condition 10). The DOI will have annual review and approval authority over the planned charges (Condition 11). Any excess charges more than \$500,000 over the approved budget must receive approval of the DOI (Condition 12). There is an exemption from these conditions for third-party expenses incurred by Highmark for the sole benefit of BCBSD so long as invoices are provided for such costs exceeding \$100,000 (Condition 13). Both Applicants must maintain books, accounts, and records sufficiently clearly to enable the DOI to assess the reasonableness of any charges (Condition 14).

Condition 15 limits the circumstances under which the Administrative Services Agreement may be terminated and requires 180 days' prior written notice of termination. Condition 19 provides the DOI with final decision-making authority with respect to disputes between BCBSD and Highmark regarding costs allocated to BCBSD under the Administrative Services Agreement.

I conclude that these conditions fully address any concerns and uncertainties about the cost allocation process, and enable the DOI to play a significant regulatory role in preventing Highmark from inappropriately accessing BCBSD's reserves through improper cost allocation charges. I also conclude that the success of West Virginia Highmark provides an

example of what may unfold in Delaware, particularly with regard to the transparency and collaboration with which CAM charges are allocated and planned.

I conclude that the Affiliation is likely to bring a significant upgrade in the capabilities and services BCBSD is able to offer its customers and policyholders. This is due in large part to the advanced technology platforms Highmark has developed, as well as the broader product offerings BCBSD will be able to offer. The integration period is a complex one, however, and to promote a smooth integration of new capabilities with a continued focus on local concerns and service to local customers, the DOI has proposed, and the Applicants have accepted, three conditions. Condition 8 requires that for four years after the effective date of the Affiliation, BCBSD must take the necessary actions to ensure there is no material decrease in the quality of its local customer and provider services by Delaware staff under the direction of Delaware staff. Highmark and BCBSD also must agree on a service-level agreement and appropriate service-level metrics so as to provide the DOI with quarterly reporting for the first six quarters post-IT migration (Condition 16). Condition 7 memorializes BCBSD and Highmark's several commitments to maintaining a local corporate presence and certain levels of local employment during the integration process and during the Affiliation.

The employment agreements of the BCBSD executives do not provide for benefits that have been introduced as part of the Affiliation. Blackstone and the DOI did not identify any aspects of the employment agreements that suggest the executives have financial incentives tied directly to the consummation of the Affiliation, and the executives' overall compensation packages are already below market average. The stay bonuses identified for the eight nonexecutive employees were developed in connection with a consultant's advice and did not impact BCBSD's decision to enter into the Affiliation. Together, this evidence does not

suggest individual financial agreements that are unfair or unreasonable to BCBSD policyholders or to the public. To ensure that no such unreasonable financial agreements exist, the DOI has proposed, and the Applicants have agreed to, a condition that Highmark does not and will not have any arrangements or understandings with BCBSD executives that would give them any personal incentives, financial or otherwise, to favor the Affiliation (Condition 36).

The numerous and significant changes to the governance, management, and business structures of BCBSD do raise the question of the potential impact of a disaffiliation on BCBSD, particularly given the extensive testimony on the issue of disaffiliation costs and BCBSD's RBC ratio in the event of a disaffiliation. The DOI has proposed, and the Applicants have agreed to, several conditions relating to disaffiliation. Condition 18 requires Highmark to continue providing BCBSD with administrative services for three years post-disaffiliation, under certain terms, including cost plus certain additional amounts to Highmark. Condition 18 also requires Highmark to use reasonable best efforts, acting with diligence and in good faith, to assist BCBSD in transitioning away from Highmark if a disaffiliation occurs. Condition 24 requires that notice be given to the DOI, and a plan submitted for DOI approval, in the event of an intended disaffiliation, so as to anticipate the ways to maintain current coverage levels of BCBSD policyholders. Condition 25 extends the time period in which the Class A directors have to determine whether to disaffiliate from Highmark under certain circumstances, and requires Highmark to provide certain cooperation and resources to BCBSD so as to make disaffiliation a viable option. Condition 26 requires Highmark to use all reasonable best efforts to help BCBSD regain the Blue marks in the event of disaffiliation.

Considering all of the evidence presented, as well as the conditions proposed by the DOI and accepted by the Applicants, I find no reason to conclude that Highmark's plans for

BCBSD are unfair and unreasonable to BCBSD policyholders and not in the public interest. Accordingly, I conclude that the Affiliation meets the criteria of 18 *Del. C.* § 5003(d)(1)(d).

5. The individuals who have been put forth by Highmark as the Class B directors have extensive experience as executives, officers, and board members in the health care industry. The DOI's review revealed no reason to doubt their competence, experience, and integrity. The DOI expressed its familiarity and confidence in the likely Class A directors and in the President director. I understand that Highmark is in the process of selecting the fourth and final Class B director, and that the DOI intends to review the qualifications of that director. Subject to the DOI's satisfaction with the qualifications of the last Class B director, and my review of the DOI's analysis, I conclude that the Affiliation fulfills the criteria of 18 *Del. C.* § 5003(d)(1)(e).

6. The evidence presented strongly supports a conclusion that the benefits of the Affiliation for BCBSD policyholders, customers, and providers are broad and significant. There is evidence that the benefits will be felt by the insurance-buying public beyond BCBSD's own membership and customers, and into the Delaware general public as well. These benefits are important, particularly given the serious challenges BCBSD is likely to face as a standalone company, and given the positive feedback from many stakeholders in the Delaware community. The proposed conditions discussed above are designed to prevent the Affiliation from being hazardous or prejudicial to the insurance-buying public. Subject to these conditions, I conclude that the Affiliation fulfills the criteria of 18 *Del. C.* § 5003(d)(1)(f).

7. [insert section re: proposed condition relating to community contributions]

8. I have reviewed the conditions proposed by members of the public. I decline to impose the condition proposed by the DHIN on a stand-alone basis. (*See* JX 134).

That condition involves a specific relationship between BCBSD and the DHIN, as well as a complex issue for which I have only the limited information presented in the DHIN letter (and no additional testimony from the DHIN at the public hearings). Further, and importantly, I find that the DHIN's proposed condition does not bear on the proposed Affiliation's satisfaction of the statutory criteria of Sections 5003, 6310, and 6311. However, the DHIN plainly does commendable and important work, and to the extent that BCBSD is willing to include DHIN funding within a larger commitment respecting community support following closing of the Affiliation, I am happy to recommend it. I also find that the conditions proposed by Coventry either are already sufficiently contained within the terms of the proposed Affiliation and my recommended conditions, or are inappropriate conditions in this proceeding. (*See* JX 112). Specifically, the proposed conditions in groups (iii) and (iv) of Coventry's letter, and the first three proposed conditions in group (v), are covered by the recommended condition on community contributions, the terms of the Line of Credit Agreement, and the DOI's continued review and approval authority over BCBSD (both the DOI's statutory authority and its authority pursuant to agreed-upon conditions). I decline to include the proposed conditions in groups (i) and (ii) and in the final item of group (v) in my recommended conditions. As I have concluded above, the test for whether the Affiliation will have an anticompetitive effect is statutory, and I am satisfied that the Affiliation will not have an anti-competitive effect, which is the primary concern of Coventry's letter.

9. I note that the DOI has proposed, and the Applicants have accepted, four additional conditions (Conditions 31 through 34) designed to confirm and preserve the jurisdiction of the DOI over the Affiliation moving forward and the DOI's ability to monitor and

verify the Applicants' compliance with their obligations under the Affiliation, including the conditions.

10. I also note that the conditions mandated by Section 6311 are included as Conditions 1 through 6.

11. There is another statutory provision that affects the approval of this proposed Affiliation: 18 *Del. C.* § 6310. This provision requires that the Commissioner shall not approve this proposed Affiliation, unless it results in BCBSD offering a CHIP plan (Delaware Healthy Children Program) for children without access to health insurance, offering the same benefits and eligibility criteria as provided for under 16 *Del. C.* § 9909(i) with the premiums to be initially charged approved as part of the Affiliation approval process.

More specifically, under 18 *Del. C.* § 6310, the Commissioner's approval of the proposed Affiliation is contingent upon:

(1) the Applicants showing, and the Commissioner being satisfied, that the affiliation will result in BCBSD offering an insurance plan with the same benefits and eligibility criteria as the Delaware program created under 16 *Del. C.* § 9909(j) (the "CHIP Plan"). (*See* 18 *Del. C.* § 6310(a)(1));

(2) the Commissioner having approved the specific premiums to be initially charged under the CHIP Plan, using the analysis required by Chapter 25 of Title 18 of the Delaware Code and also taking into account the premiums charged by Highmark in its pre-existing CHIP buy-in program. (*See* 18 *Del. C.* § 6310(a)(2)).

The parties have submitted and agreed upon a condition that requires BCBSD, as part of the approval of the proposed Affiliation, to obtain Commissioner approval of the premiums to be initially charged under 18 *Del. C.* § 6310(a)(2) for the CHIP Plan addressed by

Section 6310, and that BCBSD shall have the referenced CHIP Plan in place and effective within 180 days after consummation of the Affiliation and the CHIP Plan shall meet all applicable statutory criteria, including, without limitation, those of 18 *Del. C.* § 6310(a)(1), (a)(2) and (a)(3). I agree that this condition is appropriate to memorialize the requirement of 18 *Del. C.* § 6310 and the intention of the Applicants to ensure that they comply with that statute. (Appendix A, JX 113A, Condition 38).

12. Finally, I find the Applicants' and KPMG's testimony concerning the timing of the proposed Affiliation—that it must close by December 31, 2011—credible, and I recommend final approval of the proposed Affiliation by the Commissioner no later than that date.

#### CONCLUSION

Based on a thorough review of all the evidence and on consideration of all the information provided, including the 38 proposed conditions listed in Appendix A, I conclude that the proposed Affiliation between BCBSD and Highmark satisfies all the requirements of 18 *Del. C.* §§ 5003, 6310, and 6311.

Therefore, subject to adoption of the conditions in Appendix A, I recommend approval of the proposed Affiliation before December 31, 2011.

SO RECOMMENDED this \_\_\_\_\_ day of \_\_\_\_\_, 2011.

\_\_\_\_\_  
The Honorable Battle R. Robinson  
Hearing Officer