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INSURANCE COMMSSIONER RELEASES DECISION OF HEARING OFFICER ON PROPOSED AFFILIATION OF BLUE CROSS/BLUE SHIELD OF DELAWARE WITH CAREFIRST, INC.,

Dover, DE – Insurance Commissioner Donna Lee H. Williams today released the Proposed Findings of Fact, Recommendations and Order of an independent Hearing Officer, former Judge Battle R. Robinson, in the proceeding before the Delaware Insurance Department considering the proposed affiliation of BlueCross BlueShield of Delaware with CareFirst, Inc. The complete text may be viewed on the Department's Web Site found at: www.state.de.us/inscom/.

Judge Robinson's proposed decision is based on extensive testimony presented before her by the parties and interested members of the public at a hearing on October 25, 26, 1999, and the documents and written commentary submitted in conjunction with that hearing.

The Hearing Officer's proposed resolution recommends that the Insurance Commissioner approve the affiliation, subject to an extensive list of conditions to be included in any Final Order. Many of these conditions are aimed at maintaining the independence of Blue Cross of Delaware and preserving its current surplus, as well as assuring the on-going supervision of the affiliated entities by the Delaware Insurance Department.

This proposed decision by Hearing Officer Robinson will be reviewed by Commissioner Williams and may be accepted, modified, or rejected in whole or in part in the Final Order in this case.

The parties now have twenty (20) days to submit comments to the Insurance Commissioner concerning the Hearing Officer's recommendations.

It is anticipated that the Insurance Commissioner will render her decision and a Final Order within approximately thirty (30) days of the close of the comment period.

BEFORE THE INSURANCE COMMISSIONER
OF THE STATE OF DELAWARE

Proposed Affiliation of	:	
BCBSD, Inc. Doing Business As	:	Docket No. 99-09
Blue Cross and Blue Shield Of	:	
Delaware, With CareFirst, Inc.	:	

PROPOSED FINDINGS, RECOMMENDATIONS AND ORDER

These are the findings and recommendations concerning the proposed affiliation between BCBSD, Inc. (Blue Cross and Blue Shield of Delaware) and CareFirst, Inc. of Maryland which I, as the Hearing Officer, am making to the Delaware Insurance Commissioner. Throughout this document Blue Cross and Blue Shield of Delaware and BCBSD, Inc. will be referred to as ABCBSD@; CareFirst, Inc. is ACareFirst;" and the Delaware Insurance Commissioner is ACommissioner@. BCBSD and CareFirst are also sometimes collectively referred to as Aapplicants@ or Acompanies.@ Other abbreviations are as shown. As discussed fully herein, I have found that, with the inclusion of certain additional provisions, or conditions, designed to protect the financial condition of BCBSD and to perpetuate continued local involvement, the proposed affiliation does not violate Delaware law, does not threaten the capital adequacy of BCBSD, Inc. and does not adversely affect the interest of its policy holders. I therefore recommend that the Commissioner approve the affiliation and include in her Order the conditions which are specifically set out in Attachment A.

A. Procedural History

On December 23, 1998, CareFirst, a not-for-profit Maryland corporation, and BCBSD, a non-profit health services corporation regulated by the Delaware Insurance Department under the provisions of 18 Del. C. Ch. 23, executed a Business Affiliation Agreement. The essence of the

Affiliation is that CareFirst will become the sole voting member of BCBSD, and three of the current directors of BCBSD will become a class of members and directors of CareFirst. After the Affiliation is complete, CareFirst will be the sole member of three, non-profit Blue Cross entities: one in Maryland, one in the District of Columbia and one in Delaware.

The Department of Insurance initiated an inquiry into the Affiliation pursuant to Chapter 3, Title 18 of the Delaware Code. On June 18, 1999, I was appointed Hearing Officer for this matter pursuant to 29 *Del. C.* Sec.10125 and the Insurance Commissioner's Pre-Hearing Order dated March 31, 1999. On July 7, 1999, I granted the Attorney General's unopposed application for party status in this matter. On August 23, 1999 I denied the applications of Physicians Health Services of Delaware (APHS@) and two individual physician members of PHS to intervene as parties. The reasons for that denial are discussed in a subsequent order memorializing the decision. Under the terms of the Commissioner=s Pre-Hearing Order of March 31, 1999 these applicants participated as Ainterested persons@ at the public inquiry into the matter.

Both the Delaware Insurance Department (ADOI@) and the Department of Justice (ADOJ@) retained independent financial advisors to assist them in their analysis of this proposed affiliation. The Department of Insurance retained the services of KPMG LLP, (AKPMG@) while the Department of Justice engaged Deloitte & Touche LLP (ADeloitte@).

In accordance with the provisions of the Pre-Hearing Order, Ch. 101 of Title 29 Del. C. and Chapter 3 of Title 18, Del. C., a hearing was held before me on October 25 and 26, 1999. During the hearing, the parties and members of the public were permitted to present testimony. Testifying on behalf of BCBSD were Max S. Bell, Jr., Chairman of the BCBSD Board of Directors; Paul C. King, Jr., President and Chief Executive Officer (ACEO@) of BCBSD; Louis Pavia, Jr., Executive Vice President of McManis Associates; and Marvin A. Mazer, Vice President of Aon Consulting. David S.

Swayze and Christine P. Schiltz of Duane, Morris & Heckscher LLP appeared as Counsel for BCBSD. William L. Jews, CEO of CareFirst testified on behalf of CareFirst and W. Harding Drane, Jr. and W. Laird Stabler, III of Potter Anderson & Corroon appeared as Counsel for CareFirst.

The Honorable M. Jane Brady, Attorney General of Delaware, made a public statement which was entered into the record. Donna C. Novak and Lee H. Resnick of Deloitte, Financial Advisors to the Department of Justice, testified for that Department. Michael J. Rich, State Solicitor, and Malcolm S. Cobin, Assistant State Solicitor, appeared as counsel for the State.

Offering testimony on behalf of the Delaware Department of Insurance were Dana W. Rudmose, Irwin A. Cohen, and Harold Sandstrom, all of KPMG, who served as Financial Advisors to Department of Insurance; David M. Lonchar, Insurance Financial Examiner, Department of Insurance; and Darryl Reese, Director of Company Regulation, Department of Insurance. F.L. Peter Stone, Deputy Attorney General and Counsel for Department of Insurance, represented the Department.

Presenting testimony as interested persons, under the terms of the Commission=s Pre-Hearing Order, were Rita Marocco, Delaware Association of Rehabilitations Facilities; Frank McLoughlin, Esq., Community Catalyst; and John M. Murray, Esq., CPA, for Physician Health Services and for Drs. John DeCarli and Charles Wagner.

In addition to the testimony presented during the hearing, I accepted into the record thousands of pages of documentary evidence offered by the parties and numerous letters from members of the public.

Notice of this hearing was published in two Delaware newspapers of general circulation on September 17th, 18th, 19th, 20th and 21st of 1999.

The record in the case, which was kept open to receive proposed finding of fact and conclusions of law from the parties, memorandums from interested members of the public and additional discovery, was closed on December 17, 1999. Under Delaware law proposed findings and recommendations must be filed within twenty (20) days after the record is closed. 29 Del. C. '10129

B. Background

BCBSD is a not-for-profit Delaware corporation regulated as a health service corporation under Title 18, Chapter 63 of the Delaware Code. While BCBSD has had a number of corporate names, it has continuously operated as a non-profit health service corporation in the State of Delaware since 1935. BCBSD is headquartered in Wilmington, Delaware and provides indemnity, managed care and administrative services to individuals, groups and governmental entities in the State of Delaware. BCBSD is licensed by the National Blue Cross Blue Shield Association to market health insurance using the Blue Cross and Blue Shield names and trademark throughout Delaware. As of June 30, 1999, BCBSD had approximately 210,000 members and $86.5 million and $89.9 million, respectively, of equity required under generally accepted Accounting Principles (AGAAP equity@) and the reserve required by Delaware law.

CareFirst is a non-profit Maryland corporation regulated as a non-profit health service plan under the Maryland Insurance Code Ann. Sec. 14-101, *et seq*. and as a non-profit hospital and medical services corporation under D.C. Code Ann. Sec. 35-4701, *et seq.* CareFirst is a holding company which was formed as the result of an affiliation between two non-profit subsidiaries: Group Hospitalization and Medical Services, Inc. ("GHMSI"), a non-profit corporation organized under federal law, doing business as Blue Cross/Blue Shield of the National Capital Area, and Blue Cross Blue Shield of Maryland, Inc. (now CareFirst of Maryland, Inc.) ("BCBSMD") a non-profit corporation organized under Maryland law, doing business as Blue Cross Blue Shield of Maryland. CareFirst was created in December 1997 after the Maryland Insurance Commissioner (AMIA@) and

D.C. Department of Insurance and Securities Regulation (ADISR@) approved the business affiliation of GHMSI and BCBSMD.

CareFirst and its subsidiaries are headquartered in Owings Mills, Maryland and provide comprehensive health insurance and managed care products through indemnity health insurance, administration, and health maintenance organizations covering individuals, groups and governmental entities in the State of Maryland, the metropolitan area of Washington, D.C., and Northern Virginia. CareFirst holds the license for the use of the Blue Cross and Blue Shield brand name in geographic territories established by its agreement with the National Blue Cross Blue Shield Association. As of June 30, 1999, CareFirst and its subsidiaries had approximately 2.5 million members and $489.3 million of GAAP equity. BCBSMD and GHMSI have statutory surplus of $279.6 million and $162.6 million, respectively.

The proposal under review has been denominated by the applicants as a "Business Affiliation." As set forth in the Applicants' Business Affiliation Agreement (Joint Ex. 5), the essence of the Affiliation is that CareFirst will become the sole voting member of BCBSD, and three of the current directors of BCBSD will become a class of members and directors of CareFirst (Class III members and directors) with special powers relating to the business and governance of CareFirst and BCBSD. CareFirst will be the sole member of three, non-profit entities: BCBSMD, GHMSI and BCBSD. CareFirst will continue to have only a handful of employees and be supported by management and personnel service contracts executed with BCBSMD, GHMSI, and BCBSD. The CareFirst board of directors and members will consist of 21 persons divided into three classes: twelve (12) from Maryland (Class II), six (6) from D.C. (Class I), and three (3) from Delaware (Class III). The Class III directors will have veto powers over significant corporate actions involving CareFirst and BCBSD, and supermajority voting rights would apply to certain significant corporate actions involving BCBSMD and GHMSI.

The basic purpose of the Affiliation is two-fold. First, the Affiliation is intended to allow BCBSD to remain competitive and economically viable over the long term by providing BCBSD with access to the larger financial resources of CareFirst. Additionally, the proposed Affiliation is intended to provide BCBSD with economies of scale and access to innovative products which can be offered only by a larger entity, as well as access to a larger market for the coordinated services of three Blue Cross and Blue Shield Companies. Second, CareFirst hopes the Affiliation will benefit it as well though increased economies of scale, additional marketing advantages, and enhanced performance as a result of synergies created by the Affiliation. Applicants also aver that the Affiliation will provide the residents of the Mid-Atlantic region with locally managed, high quality, comprehensive health services at competitive premiums. In essence, the Affiliation is intended to offer the benefits of a combination or affiliation with a large, regional, non-profit insurer while preserving the significant local control which has long been a hallmark of BCBSD. This continued local involvement would come about through preserving BCBSD as a continuing, separate corporate entity with a local board of directors, and through continued regulation by the Delaware Department of Insurance.

C. Standards of Review

This proceeding is broadly governed by Title 18, Chapter 3 of the Delaware Code. Pursuant to Chapter 3 and the Commissioner's Pre-Hearing Order, the Hearing Officer must determine whether the affiliation of BCBSD with CareFirst: (i) violates any provision of Title 18, Delaware Code, or regulations duly promulgated thereunder; or (ii) poses a risk to the capital adequacy of BCBSD; or (iii) adversely affects the interest of its policyholders. As part of such review, the Hearing Officer is charged with applying the specific criteria for approving or disapproving a change of control of a Delaware insurer found at 18 Del. C. ' 5003(d)(1). Under Section 5003(d)(1) the Commissioner shall approve any merger or other acquisition unless the Commissioner finds that:

a. After the change of control, the domestic insurer 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 merger or other acquisition would be substantially to lessen competition in insurance in the State or tend to create a monopoly therein;

c. The financial condition of any acquiring party is such as might jeopardize the financial stability of the insurer, or prejudice the interests of its policyholders;

d. The plans or proposals which the acquiring party has to liquidate the insurer, sell its assets or consolidate or merge it with any person, or to make a material change in its business or corporate structure or management, are unfair and unreasonable to policyholders of the insurer and not in the public interest;

e. The competence, experience and integrity of those persons who would control the operation of the insurer are such that it would not be in the interest of policyholders of the insurer and of the public to permit the merger or other acquisition of control; or

f. The acquisition is likely to be hazardous or prejudicial to the insurance buying public.

As hearing officer, I have carefully reviewed the extensive evidence presented in light of these specific criteria. And, as directed by the Commissioner, I have more broadly considered the effect the Affiliation may have on the capital adequacy of BCBSD and its impact on BCBSD policyholders.

D. Summary of the Evidence

The evidence in this matter consists of the sworn testimony of numerous witnesses, as well as thirteen (13) Joint Exhibits offered into evidence by CareFirst, BCBSD, the DOI and Department of Justice ("DOJ"), ten (10) exhibits offered into evidence by the Applicants, two (2) exhibits offered into evidence by the DOJ, two (2) exhibits offered into evidence by the DOI, oral testimony from the public, and written submissions from members of the public which were entered into the hearing record. Joint Exhibit 1 includes the entire pre-hearing documentary record in this matter.

a) Chapter 50 Criteria:

The facts as adduced at the 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:

1. After 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 it is presently licensed?

BCBSD is currently licensed as a health service corporation pursuant to Title 18, Chapter 63 of the Delaware Code. David Lonchar, Insurance Financial Examiner for the DOI, testified that after the proposed affiliation, BCBSD will be able to satisfy all licensing requirements for Delaware. (Tr. at 424).[1] BCBSD officials also indicated that the affiliation would not affect its current Delaware license. (Tr. at 135).

[1]References to the hearing transcript will be cited as (Tr. at ____).

While not technically related to the statutory licensing requirements of Title 18, Chapter 63, BCBSD is also dependent on a license from the National Blue Cross Blue Shield Association to market health insurance using the Blue Cross/Blue Shield (ABlues@) name and trademark throughout Delaware. Paul King stated that BCBSD will continue to hold Blues licenses post-affiliation and the National Blue Cross Blue Shield Association had approved the use of the Blues marks after the Affiliation. (Tr. at 135). A letter from the Association was introduced into evidence confirming Mr. King's testimony relating to the use of the licenses by BCBSD post-affiliation. (App. Ex. 5).[2]

Finally, under the Business Affiliation Plan executed on December 23, 1998, BCBSD warrants that the consummation of the contemplated transaction will not "conflict with violate or result in any breach of, or constitute a default ... or give rise to any right of termination, cancellation... or render unenforceable, any ... license including any license granted by the Blue Cross and Blue Shield Association..." (Joint Ex. 5 at Bates 29).

2. Will the affiliation substantially lessen competition in insurance in the State or tend to create a monopoly therein?

Several witnesses testified about the impact of the proposed Affiliation on competition from both the standpoint of healthcare economics and as part of a market share analysis required under the Delaware statutes.

As a long-standing health care executive, Paul King described the current Delaware health insurance marketplace as Aextraordinarily competitive.@ According to Mr. King ACompetition is strong, and there are constantly moving, into the Delaware market, companies from other areas, such as Aetna U.S. Healthcare, Principal, Amerihealth, and Horizon Blue Cross Blue Shield of New Jersey." (Tr. at 109-110). Because of this competitive environment, Mr. King testified that

[2] References to Joint Exhibits will be cited as (Joint. Ex. ____). References to Applicants' Exhibits will be cited as (App. Ex. ___). References to Department of Justice Exhibits will be cited as (DOJ Ex. ___). References to Department of Insurance Exhibits will be cited at (DOI Ex. _).

insurers must work on very small margins, strive to keep administrative costs down, find access to capital, and offer a wide variety of products at a competitive price. (Tr. at 109-110).

Louis Pavia, Executive Vice President of McManis Associates and an expert in the field of healthcare economics, testified about trends in the health insurance industry generally and in Delaware specifically, and about his work with BCBSD. Mr. Pavia testified that there is ease of entry and exit into the Delaware health insurance marketplace and that the proposed Affiliation Ashould have no negative effect on the competition.@ (Tr. at 222). Delaware has witnessed a Acompression@ of health insurance rates over the past few years, an indication of a competitive marketplace. (Tr. at 221).

Even though BCBSD is current the market leader among Delaware insurers, none of the witnesses indicated that the Affiliation would cause it to dominate the Delaware market. According to Mr. Pavia, the Affiliation with CareFirst Awill not create such a market power that they could dictate prices in this marketplace.@ (Tr. at 223). Mr. Bell, Chairman of the BCBSD Board stated that the Amarketplace is too competitive@ for the competition to be Aswallowed up.@ (Tr. at 105).

Indeed the gist of much testimony was that the Affiliation is essential if BCBSD is to remain competitive in the Delaware marketplace. In Mr. Pavia=s opinion, BCBSD is engaged in a Alife and death search for a strategic partner@ in order to remain competitive. (Tr. at 228). He and Mr. King noted that the larger, national insurers which have moved into the State have access to capital and economies of scale which are simply not available to an insurer of BCBSD=s smaller size. Without access to capital to provide for managed care, innovative products, technological infrastructure and other resources which the current marketplace requires, BCBSD would Acontinue to fall behind@ in its ability to be competitive. (Tr. at 215-216).

William Jews, CEO of CareFirst, testified that he did not believe the Affiliation would lessen competition in Delaware. Rather, the transaction should increase competition by making the current Delaware Plan a stronger, more competitive Plan better positioned to meet the challenges of larger competitors. (Tr. at 292).

Witnesses also presented testimony regarding 1998 market share data for Delaware health and accident insurers. According to the market share data introduced into evidence (Tr. at 131 and 425, App. Ex. 2), BCBSD maintains 21% of the accident and health market share while CareFirst, through an indirect subsidiary, Delmarva Health Plans, has 0.15 % of the market share. (App. Ex. 2). Mr. Pavia testified that, in his opinion, these market shares will not substantially lessen the competition in the health insurance market nor tend to create a health insurance monopoly in Delaware, as CareFirst virtually has no presence in the Delaware market. (Tr. at 222-223). Rather, the transaction "should have a positive effect on the relative competitiveness of this marketplace." (Tr. at 222).

David Lonchar reviewed the 1998 market share data in relationship to the standards set forth in 18 *Del.C.* '5003A(d)(2) and found that the 1998 Delaware accident and health market was not classified as a highly concentrated market. According to Mr. Lonchar, "[s]ince Delmarva Health Plan had a market share of less than one percent, the competitive standard was not violated." (Tr. at 425).

Finally, the Applicants presented a letter from the Federal Trade Commission ("FTC") stating that the FTC would not object to the Hart-Scott-Rodino filing under the provisions of the federal Sherman Antitrust Act, 15 U.S. C. '1 and 2, or the Clayton Antitrust Act, 15 U.S.C. '18. (App. Ex. 3).

Some witnesses addressed the fact CareFirst owns a subsidiary, Delmarva Health Plan, which operates on the Eastern Shore and has Aa very modest number@ of Delaware subscribers.

(Tr. at 321). According to Mr. Jews, CareFirst has not aggressively pursued expansion of the Delmarva Plan in the State and will not do so if the Affiliation is approved. (Tr. at 329-330).

3. Will the financial condition of the acquiring party jeopardize the financial stability of the insurer, or prejudice the interests of its policyholders?

The witnesses presented a plethora of evidence concerning the financial condition of the Applicants, the financial impact of the transaction on BCBSD, as well as recommendations for safeguards, or "conditions," to protect the assets of BCBSD. In addition to this oral testimony, the DOI introduced a report from its independent financial advisor, KPMG LLP, which conducted an analysis of the proposed affiliation and performed an assessment of the financial aspects of the transaction. (DOI Ex. 1). The evidence pertaining to various aspects of the Affiliation=s impact on BCBSD=s financial condition is discussed in separate segments below.

(a) Current Financial Condition

Both the report and testimony provided by KPMG indicate that BCBSD and CareFirst enjoy strong financial conditions. As of June 30, 1999, CareFirst had approximately 2.5 million members and $489.3 million of GAAP equity. BCBSMD and GHMSI had statutory surplus of $279.6 million and $162.6 million, respectively. CareFirst had 120.3% of the Blue Cross Blue Shield Association Capital Benchmark. (DOI Ex. 1 at p. 4). As of June 30, 1999, BCBSD had approximately 210,000 members and $86.5 million and $89.9 million, respectively of GAAP equity and statutory surplus. BCBSD has 223% of the Blue Cross Blue Shield Association Capital Benchmark. (DOI Ex. 1 at p. 4).

Dana Rudmose, Director of Regulatory Services for KPMG, stated that "KPMG found no evidence that the proposed transaction would jeopardize the current financial stability of Blue Cross Blue Shield Delaware or CareFirst." (Tr. at 402 - 403). David Lonchar also testified that the

DOI's review of the financial records of both companies indicate that there is no reason to believe the financial condition of BCBSD would be jeopardized by the financial condition of CareFirst or its subsidiaries. (Tr. at 426).

(b) Transfer of Funds

Although there was general agreement that the applicants currently enjoy strong financial situations and the Affiliation would not immediately affect the financial stability of BCBSD, concern was expressed about potential for the transfer of BCBSD capital and assets among CareFirst=s affiliates. (Tr. at 387). The transfer of assets and funds between the parties is contemplated by the Intercompany Agreement between BCBSD, CareFirst, BCBSMD and GHMSI.

This Agreement was introduced into evidence as Appendix G of the Business Affiliation Agreement. (Joint Ex. 5 at Bates 95 - 106). The stated purpose of the Agreement is to facilitate the integration of the business operations of the respective parties by allowing the transfer of assets and services between the parties with maximum administrative ease while maintaining adequate controls over the nature and size of such transfers. (Joint Ex. 5 at Bates 95 and DOI Ex. 1 at p. 5). The Agreement allows for transfers between the parties for capital reserves, claims payment and other legally enforceable obligations. Transfers are also permitted for cost allocations and discretional funding. (Joint Ex. 5 at Bates 97 - 102 and DOI Ex. 1 at p. 5). A similar intercompany agreement has been in existence since CareFirst was formed in December of 1997, and according to KPMG, transfers between BCBSMD and GHMSI have been minimal. (DOI Ex. 1 at p. 6).

The Intercompany Agreement provides certain checks and balances on the ability of the companies to transfer funds. However, witnesses called by KPMG, Deloitte & Touche LLP and the DOI testified as to the need for regulatory oversight of intercompany transfers in order to protect the assets and solvency of BCBSD. KPMG recommended that CareFirst, BCBSMD, GHMSI and BCBSD should comply with the provisions of 18 Delaware Code, Chapter 50, the Delaware Insurance Holding Company statute for registration, financial reporting and examination purposes with regard to transactions among affiliates. (DOI Ex. 1 at p. 7, and Tr. at 399 - 400). Donna C. Novak of Deloitte & Touche LLP also expressed the need for oversight in the area of movement of assets between the companies. (Tr. at 387). David Lonchar recommended that, to lessen such concerns, transfers from BCBSD to any entity in the CareFirst holding company system should require prior notice and approval if such transfers exceed $500,000 in the aggregate annually. Mr. Lonchar also recommended that CareFirst and BCBSD comply with the Delaware Holding Company statutes and with all Delaware financial examination statutes. (Tr. at 427). Darryl Reese, Director of Company Regulation for the DOI, reiterated Mr. Lonchar's recommendation and indicated that similar conditions had been adopted in the BCBSMD and GHMSI affiliation. (Tr. at 452 - 453).

(c) Cost Allocations of Future Operating Expenses

The Intercompany Agreement also contemplates the allocation of costs and operating expenses among the affiliates. The manner in which these costs are allocated also potentially impacts the financial condition of BCBSD and the interests of its policyholders.

Pursuant to the Agreement, the Companies are required to determine the appropriate methodology for the allocation of costs for one or more of the following: costs of capital, shared expenses, payroll costs, joint development of products, contributed services, capital contributions or purchase of surplus notes or other securities. The Intercompany Agreement requires certain standards for the allocations as follows:

If any transfers of assets are made pursuant to this Agreement through an allocation of costs methodology, such applications will be made in compliance with generally accepted accounting principles, Cost Accounting Standards, Federal Acquisition Regulation of Cost Principles, insurance regulators' requirements, Blue Cross and Blue Shield Association Cost Accounting practices and techniques and contractual requirements including, but not limited to, the regulations governing the Federal Employee Health Benefits Program as well as any allocation methodologies that may be required by the Parties' respective insurance regulators.

(Joint Ex. 5 at Bates 101).

According to the testimony presented, the Companies have not yet fully developed this cost allocation methodology. (Tr. at 182). Mr. Jews testified that a cost sharing agreement is currently in effect between Maryland and D.C., and the agreement must be amended to include Delaware if this transaction is approved. (Tr. at 346 - 347). The Business Affiliation Agreement requires that the amended cost sharing agreement must be approved by the Primary Regulator of CareFirst, BCBSMD, GHMSI and BCBSD prior to the effective date of the affiliation. (Joint Ex. 5 at Bates 49).

Lee Resnick of Deloitte & Touche LLP testified that, based on his experience, these cost sharing agreements are not simple undertakings. In developing a cost sharing formula, the parties must address many issues, and it is difficult to estimate the amount of work and time necessary to develop such a formula. (Tr. at 390-391). Dana Rudmose of KPMG on behalf of DOI testified that he would recommend as a condition of approval that the Companies report to the Commissioner a method of allocating costs and revenue after their strategy is implemented. (Tr. at 401).

(d) Potential Savings from Combination Synergies:

There was also much testimony discussing positive financial impact which the Affiliation is expected to have on BCBSD as the result of synergies the companies hope to achieve. Paul King testified that the proposed transaction should allow BCBSD to achieve significant economies of scale and lower its administrative costs. (Tr. at 112). Mr. King also testified that the transaction will allow BCBSD access to capital for investments in technology, particularly information systems, over the next decade. Additionally, through affiliation with CareFirst, BCBSD will have expanded opportunities to offer additional services to its current customers and to compete for new customers. (Tr. at 113). Louis Pavia echoed the anticipated benefits of these coordinated efforts. (Tr. at 218 - 221).

William Jews reflected on the results of the BCBSMD/GHMSI combination and its potential financial benefits to both companies. In the 18 months of affiliation, CareFirst identified operational savings of more than $5 million in the first year, added 168,000 members, streamlined operations, increased overall employment, and enhanced its customer service by investing nearly $100 million in technology and expanding network of physicians. (Tr. at 285-286). Mr. Jews anticipated that similar benefits will result from the affiliation with BCBSD. (Tr. at 289).

KPMG engaged in discussions with both of Applicants' management groups about these projected synergies. (DOI Ex. 1 at p. 9). While the integration plan is not yet complete, the preliminary cumulative savings through 2003 are estimated to be $22.7 million. Such benefits are projected to result largely from a combination of net revenue opportunities, including provider contracts and accounts estimated to be $4.8 million over the five-year period; and cost savings of $17.9 million over the same period. According to Paul King cost savings would occur from consolidating corporate functions and "back room" operations, (DOI Ex. 1 at p. 9) including possibly MIS, accounting, finance, auditing, pharmacology, investment portfolios, and common fees. (Tr. at 144-145). According to KPMG, although some reduction of Aexecutive costs@ is anticipated, these synergies do not appear to result from major layoffs or staff reductions of line personnel nor anticipated reductions in payment to providers. (DOI Ex. 1 at p. 10, Tr. at 412). In

KPMG's opinion it is reasonable to project cost savings of 5% over five years without specifically identifying the specific source or sources thereof (Tr. at 417-418)

Mr. Rudmose of KPMG cautioned that future financial results depend Aon management=s ability to execute its business in a competitive environment. . . The future operating performance of the combined plans will require execution of a sound strategy and coordinated business plan.@ (Tr. at 402-403). John Murray, Esquire appearing on behalf of interested persons, claimed that the economic advantage of the affiliation Aare more than likely illusory@, basing his view on a recent survey of 300 hospital mergers and affiliations which indicated the combinations failed to save money, increase market share, or gain higher reimbursement.

(e) Financial Protection Offered by Local Board Control:

Testimony was presented that the financial assets of BCBSD will be protected by the structure of the CareFirst Board of Directors and the maintenance of local control. Max Bell testified that the Delaware corporate entity, its Board, its assets, and its regulatory status will continue in existence after the Affiliation. (Tr. at 39 - 40). The Affiliation Agreement creates a class of Delaware directors on the CareFirst Board who will be known as the Class III directors. (Joint Ex. 5 at Bates 84 - 85). These Class III directors will be able to veto certain decisions affecting the governance and operations of BCBSD if two or more of them do not believe such decisions are in the Plan's best interest. The Class III directors will be able to veto any significant or substantial corporate transaction involving CareFirst or BCBSD, including any future proposed conversion, change of control, merger or other comparable transaction. (Joint Ex. 5 at Bates 90 - 92 and Tr. at 40 - 41).

Mr. Bell further testified that the Class III directors will have the exclusive power to elect the directors of the Delaware Plan and the future Class III directors of CareFirst from those nominated by the BCBSD board. (Tr. at 41 and Joint Ex. 5 at Bates 86 and 87). The powers of the Class III directors are further defined in the Business Affiliation Agreement. (Joint Ex. 5).

Finally, Mr. Bell testified that it was the intention of the Class III Directors to exercise their authority on the CareFirst Board Ato assure that the capital strength of Delaware Blue Cross is preserved, the significant presence of the Delaware Plan in Delaware is continued, the licenses to use the Blue Cross and Blue Shield service marks are maintained, and the commitment to the Delaware Blue Cross customers and policyholders is un-diminished.@ (Tr. at 43).

Donna Novak of Deloitte & Touche LLP on behalf of the Attorney General commented on the issue of local control, stating that based on her experience, particularly with the National Blue Cross Blue Shield Association, the proposed Affiliation permits this Blue Cross entity to retain a greater amount of local control as compared to other transactions she has witnessed. (Tr. at 386).

(f) Officer Employment Agreements:

A great deal of testimony concerned the officer employment agreements executed between BCBSD and all ten of its officers.

Max Bell testified that in 1994 the BCBSD Board began directing and overseeing the development of officer employment agreements. The original contracts were implemented in 1995. (Tr. at 46). In 1996, after an unsuccessful attempt to affiliate with New Jersey Blue Cross and Blue Shield, the Board's management began working on comprehensive amendments to the contracts. (Tr. at 56). According to Mr. Bell, at this point it "became clear to us that it was unlikely we would be able to have a marriage of equals and that our officers would be aware that their careers would be at greater risk in such circumstances, that being the likely consolidation with a company or companies much larger in size than Delaware." (Tr. at 44-45).

The Personnel Committee of the Board was primarily charged with developing the contracts. However, according to Mr. Bell, the Board was briefed on the process and the Board ultimately approved the contracts in fall 1998, shortly before the Affiliation Agreement was executed. (Tr. at 56 and 67). In the process, BCBSD received the advice of two Delaware attorneys and of Aon Consulting, a prominent compensation and benefits consulting firm. (Tr. at 46-47 and App. Ex. 9).

Mr. Bell and Martin Mazer, Vice President of Aon Consulting, who testified on behalf of BCBSD, testified about the Board's objectives in developing the contracts. (Tr. at 45-46, 237). They were: retention of its management team to assure continuity of business strategy during a period of high uncertainly; to make it possible to attract new executives during this period; and to enable the executive management team to negotiate with prospective acquirers without being unduly concerned for their personal job security. The Board also wanted to maintain a competitive overall compensation and benefits package commensurate with benefits offered by similar organizations. (Tr. at 45-46, 237 and App. Ex. 9 at p. 1-2). According to Mr. Mazer, these objectives were fair and reasonable and consistent with the objectives he had experienced with other companies during time of organizational turbulence. (Tr. at 239).

Mr. Mazer described how the contracts were developed. The analyses performed by Aon focused on paying the BCBSD executives at the median levels for the "All Employer Labor Market". (Tr. at 239). This Market was heavily weighted toward the insurance industry and included other BCBS organizations and other not-for-profit organizations (Tr. at 239). Aon reviewed published compensation and benefits surveys, looked at 26 different insurance and financial services organizations and compared the nature of their employment agreements to those of BCBSD. (Tr. at 239-240). Specifically, Aon reviewed the contracts' term, treatment of early retirement, termination for death, termination for cause, change of control, and mitigation and other matters. (Tr. at 240 and App. Ex. 9 at p.3).

Mr. Mazer also testified that Aon had compared the original 1994 agreements and the amended 1998 agreements. This review showed that the amended benefits included some terms that increased benefits and other which reduced benefits. He stated that overall the amended contracts provided fewer benefits, primarily because of reduced benefits under the change of control provisions. (Tr. at 243 and App. Ex. 9 at p.6)

With respect to the officer compensation agreements, Mr. Mazer opined:

> The Blue Cross Blue Shield of Delaware agreements were reasonable and competitive relative to the terms and conditions that are typically found in the insurance and financial services industry. And, in particular, these agreements were reasonable relative to Delaware Blue Cross' need to retain, attract, and motivate these critical executives under these highly uncertain conditions.

(Tr. at 240).

KPMG, financial advisor to the DOI, also reviewed the contracts. According to the KPMG report, "(w)e did not note any unreasonable changes to salary and benefit packages for senior management and officers in contemplation of the proposed affiliation agreement." In KPMG's opinion, the target SERP benefit was a bit more liberal when compared to other executive employment contracts; however, the other provisions of the contracts were customary and typical. (DOI Ex. 1 at pp. 11-12).

Lee Resnick of Deloitte, financial advisor to the DOJ, also addressed the contracts. Mr. Resnick stated that while Deloitte had not done the type of analysis performed by Aon, "(w)e can generally say that we agree with the Aon presentation that the terms and features of those contracts were not inappropriate in terms of what kind of features were provided." Mr. Resnick did observe that in some respects the provisions were at "the higher end" of the range of what is acceptable. (Tr. at 385-386).

It was the Board of Directors of BCBSD which determined that all ten BCBSD officers should receive an employment contract. (Tr. at 87-88 and 96). Mr. Mazer testified this decision was reasonable on a competitive industry basis, particularly in relationship to the circumstances of the company. (Tr. at 241-245). He agreed, however, that ten such contracts with the same terms constituted a "more liberal" plan than most. (Tr. at 263).

Testimony was also offered concerning the potential costs associated with the contracts. This testimony indicated that the financial impact depends on how many executives leave and whether their departure is based on voluntary retirement or involuntary termination. (Tr. at 407). It also indicated that for accounting purposes any severance pay would be directly charged against operations, but would ultimately affect the surplus. (Tr. at 415).

Mr. Bell and Mr. King testified that they do not expect a wholesale elimination of BCBSD officers after the affiliation. (Tr. at 58 and 123). BCBSD anticipates that 3 - 4 officers will leave the company post-affiliation. (Tr. at 124). However, Mr. Jews indicated that all three GHMSI executives who were covered by agreements departed their employment within three or four months of the affiliation between GHMSI and BCBSMD. (Tr. at 327).

According to KPMG, "the maximum future compensation and benefits cost under the agreement could amount to approximately $9.9 million if all of these officers of BCBSD were to exercise change of control provisions in the agreements." (DOI Ex. 1 at p. 12). In the event of the involuntary termination of all the officers, there would be an additional severance cost of $5.1 million, making the total cost in this event $15 million. (DOI Ex. 1, at p. 12, Tr. At 406). If all the executives remain in their positions through the current agreement expiration dates, BCBSD would be obligated to incur approximately $4.0 million in both 2000 and 2001, whether or not there is an affiliation. (DOI Ex. 1 at p. 12, Tr. At 406).

David Lonchar of the DOI agreed with these calculations. (Tr. at 430). Mr. Lonchar stated that under the "worst case scenario" the possible diminution to the BCBSD surplus would amount to $15 million. This figure represents 16% of BCBSD's June 30th 1999 surplus level. (Tr. at 430). Mr. Lonchar stated that if this $15 million was not shared with CareFirst of Maryland and GHMSI, this would be considered material by the DOI, and such a reduction in surplus could pose a concern as to the capital adequacy of BCBSD. (Tr. at 431). According to Mr. Lonchar, the DOI considers any reduction in surplus in excess of 10% a material transaction. (Tr. at 434). Mr. Lonchar agreed that the BCBSD surplus exceeds the National Blue Cross Blue Shield Association Benchmark by 223%. He also agreed that under a "worst case scenario" the reduction in the surplus would still leave BCBSD with a surplus in excess of 200% of that particular Benchmark. (Tr. at 434).

Testimony also addressed the understanding of the parties as to who would bear the cost of the agreements. Mr. Bell testified that the Board always intended BCBSD to bear the full cost. (Tr. at 58). He believes BCBSD received the benefits of the agreements and testified that the BCBSD Board sought the affiliation and undertook the agreements independently in part to make that affiliation more attractive. (Tr. at 58-59). He believes that Sec. 11.1 of the Business Affiliation Agreement, which provides for each party to bear its "costs and expenses" in connection with the affiliation but does not specifically mention the employment agreements, can reasonably be interpreted to cover the costs of the contracts. (Tr. at 61). Mr. King testified he and Mr. Jews discussed this issue at least six times and always understood BCBSD would bear these costs. (Tr.

at 161-162). Mr. Jews concurred. (Tr. at 336). He stated that BCBSMD had willingly borne a portion of the costs associated with the GHMSI contracts in the earlier affiliation because of the significant value an association with a company with 1 million subscribers brought to the transaction. (Tr. at 342-343). Testimony indicated only three officers were involved. (Tr. at 326).

4. Does the acquiring party have any plans or proposals to liquidate the insurer, sell its assets or consolidate or merge it with any person, or to make a material change in its business or corporate structure or management, which are unfair and unreasonable to policyholders of the insurer and not in the public interest?

A number of witnesses addressed whether or not CareFirst had any plans to make any material changes to the corporate structure or management of BCBSD. According to Paul King, there are absolutely no plans to liquidate or substantially change the business of BCBSD. (Tr. at 127). Mr. King stated that BCBSD would continue to have local Delaware operations, and further stated that CareFirst is committed to ensuring that BCBSD maintains a local presence in Delaware. (Tr. at 127 and Joint Ex. 5 at Bates 51). Mr. King testified that he did not foresee any diminishment in products or offerings in Delaware. (Tr. at 128). Mr. King did set forth a number of corporate changes that will occur post-affiliation such as a reduction in the number of members of the BCBSD Board of Directors from fourteen (14) to seven (7) over a period of time. (Joint Ex. 5 at Bates 88). Mr. King also presented testimony regarding the establishment of the Delaware Class III directors on the CareFirst Board. (Tr. at 127). The Class III directors are more fully described in the previous section entitled "(e) Local Board Control." Finally, Mr. King further stated that he intends to remain employed with BCBSD after the Affiliation as the President and Chief Operating Officer of the Delaware Plan. (Tr. at 125). The role of the COO and other

BCBSD officers is set forth in the Business Affiliation Agreement. (Joint Ex. 5 at Bates 90).

Mr. Jews confirmed that BCBSD would maintain significant local operations and Paul King would remain as President and COO of BCBSD with responsibility for managing the day-to-day operations of the Delaware Plan. (Tr. at 291). David Lonchar testified that based on the DOI's review of the transaction, "CareFirst has no intention to liquidate Blue Cross of Delaware, sell its assets, or consolidate or merge with any other person or make any other material change in its business or corporate structure or management which are unfair and unreasonable to the policyholders or the public." (Tr. at 428 - 429).

The parties agree that critical to this Affiliation is the continuation of the independent, non-profit status for all entities. (Joint Ex. 5 at Bates 51). According to both Mr. King and Mr. Jews, there are no plans to convert the Companies to for-profit status. (Tr. at 117 and 287). The KPMG report reinforces the Companies' present intent to maintain their existing non-profit status. (DOI Ex. 1 at p. 7). However, Mr. Jews does not "permanently foreclose" the possibility of converting to for profit status at some point in the future. (Tr. 287-88).

Whether or not the present proposed affiliation constitutes a conversion or similar restructuring was not raised as an issue by any of the parties. (DOI Ex. 1 at p. 8). The Insurance Commissioners of Maryland and the District of Columbia determined that the very similar affiliations which affected BCBSMD and GHMSI did not constitute a "conversion" to for-profit status and that a corporate merger did not occur as a result of that affiliation.

In light of this precedent, plus the apparent agreement of the DOI and DOJ that the transaction is not a conversion, I have not found it necessary to address this issue.

Although the evidence presented indicates that this transaction will not affect the Companies' non-profit status, many witnesses suggested that certain conditions should be imposed to protect the assets of BCBSD in the event of a for-profit conversion in the future. KPMG recommended that the Insurance Commissioner require a "snapshot" valuation of BCBSD on a stand-alone basis to ensure that a historic and current valuation of BCBSD could be performed in the future. (DOI Ex. 1 at p. 8). KPMG also recommended that CareFirst should be required to notify the Commissioner if at any time a plan to restructure, or materially change CareFirst's operations, assets or corporate existence is filed with its other regulatory authorities. (DOI Ex. 1 at p. 8).

Darryl Reese testified that both Maryland and D.C. required a "snapshot" valuation for the BCBSMD/GHMSI transaction, and the DOI would recommend a similar valuation for BCBSD. (Tr. at 449). Additionally, interested party Frank McLoughlin of Community Catalyst agreed that a snapshot valuation would be important to ensure that Delaware residents receive the full value of Blue Cross Blue Shield assets should CareFirst decide to convert to for-profit status in the future. (Tr. at 484).

The Applicants presented testimony regarding oversight in the event of a future effort to convert to for-profit status. William Jews testified that a "snapshot" valuation of BCBSD was appropriate to place a pre-affiliation value on Delaware's assets, revenues, market share, reserves, surplus level and other financial information. (Tr. at 228).

The Applicants also presented documentary evidence relating to the distribution of the Applicants' assets upon dissolution. The Draft Amended and Restated Certificate of Incorporation of BCBSD provides, "Eight: Upon dissolution of the Corporation, the Board of Directors shall, after paying or making reasonable provisions for the payment of the liabilities of the corporation, distribute the assets of the Corporation to or for the use of one or more corporations, trusts, community chests, funds or foundations which at the time of distribution are qualified as a corporation described in Section 501(c)(3) or Section 501(c)(4) of the United States Internal Revenue Code of 1954..." (Joint Ex. 9). The Draft CareFirst Amended and Restated Certificate of Incorporation contains a similar provision regarding the distribution of assets upon dissolution of the Corporation. (Joint Ex. 11).

5. Is the competence, experience and integrity of those persons who would control the operation of the insurer 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?

Max Bell presented testimony regarding the members of the BCBSD Board who will serve as Class III directors on the CareFirst Board. Robert Rider, who is CEO of O.A. Newton Company will serve on the CareFirst Board and on its finance committee. Bernard Daney, a CPA, will serve on the CareFirst Board and will become chairman of its audit committee. Mr. Bell will be the third Class III director and serve on the strategic planning committee. (Tr. at 40). Mr. King testified that all three are unanimous in their intention to use their Class III status to protect the interests of BCBSD (Tr. at 98-99). Paul King testified that these three directors are very talented and, in his opinion, they will strongly represent the interests of the citizens of Delaware. (Tr. at 156).

Both Mr. King and William Jews testified that Mr. King will remain with BCBSD as President and COO responsible for managing the day-to-day operations of the Delaware Plan. (Tr. at 125 and 291). Mr. King testified that he has worked in health care for most of his adult life. He spent 22 years in hospital administration and served CEO of St. Francis Hospital. He has served as President of BCBSD since the summer of 1998, and CEO since January 1, 1999. (Tr. at 107 - 108). Mr. King cannot be terminated without the agreement of the Class III directors and a majority vote of directors of the BCBSD board. (Tr. at 73 and Joint Ex. 5 at Bates 90).

Mr. King also presented testimony concerning the level of experience of the existing BCBSD officers. Seven of the ten BCBSD officers have between 17 and 31 years of service. (Tr. at 123). While three or four officers may retire after the Affiliation, the majority of the BCBSD officers are expected to remain with the Company. (Tr. at 98).

There was also testimony presented regarding the qualifications of CareFirst management. Mr. Jews, the CEO of CareFirst, will serve as CEO of BCBSD after the Affiliation. (Joint Ex. 5 at Bates 86 and Tr. at 291). He has spent seven years in the Blue Cross and Blue Shield system. Prior to joining BCBSMD, he was president and chief executive officer of three health care corporations. (Tr. at 277). Mr. King testified that through his dealings with Mr. Jews, he believes they have similar views on quality of care and access to care, and further believes that they will work well together. In Mr. King's opinion, Delaware will benefit from their working relationship. (Tr. at 118 - 119).

David Lonchar of the DOI testified commented that the DOI had reviewed the officer and director biographical affidavits and third party investigative reports and found no items of concern with respect to any proposed officer or executive. (Tr. at 429). A number of witnesses commented on the quality of the CareFirst management. Donna Novak of Deloitte & Touche LLP stated that based on her review of the BCBSMD/GHMSI affiliation, she has no concerns about mismanagement. (Tr. at 387). Dana Rudmose testified that both management teams are expected to stay in place. In KPMG's discussions with management, they found no evidence that the officers and directors would not act in the interests of the subscribers or the public. (Tr. at 403).

6. Is the acquisition likely to be hazardous or prejudicial to the insurance buying public?

The evidence presented with respect to the other five factors enumerated in 18 Del. C. '5003(e)(1) - including the ability of BCBSD to meet Delaware licensing requirements, the financial condition of BCBSD and CareFirst, the competence and experience of the officers and executives involved, and the plans and proposals for the future status and structure of BCBSD - are all pertinent to this factor and will not be repeated here. There was no direct testimony to suggest that the Affiliation is likely to be hazardous or prejudicial to the insurance buying public.

b) Effect on Capital Adequacy:

In addition to considering the factors set out in 18 Del. C. '5003(d)(1) I was also directed by the Commissioner to consider whether the Affiliation "poses a threat to the capital adequacy of BCBSD, Inc." or "adversely affects the interest of its policyholders." Evidence pertaining to the effect of the Affiliation on capital adequacy had been discussed at some length in the preceding section and will not be here repeated.

c) Effect on Policyholders:

As for the effect on policyholders, during the course of the hearing many witnesses testified as to the impact of the transaction on policyholders and the insurance buying public. Additionally, many members of the public submitted oral and written testimony on this issue. The six criteria of '5003(d)(1) relate to this issue and the evidence already summarized will not be repeated. Rather, this section will focus on those issues not yet outlined in the evidentiary summary, including much of the public comment received during the hearing.

(a) Services to the Policyholders

Paul King testified to the numerous benefits he believes the Affiliation will offer to policyholders and the insurance buying public. In his view, the Affiliation will allow BCBSD to lower its administrative costs by consolidating "back room" operations, allowing more money to go into healthcare. (Tr. at 112). The Affiliation will enable BCBSD to make substantial investments in technology and it will create synergies that will ultimately benefit the insurance buying public by making BCBSD more competitive in the health insurance market. (Tr. at 113, 148 - 149 and Joint Ex. 5 at Bates 51). Paul King also testified that, in his opinion, the levels of service to the policyholders will be equal or better than what they are today. (Tr. At 138). He anticipated that BCBSD will continue to have a substantial employment force and corporate presence in Delaware, and it is likely that customer service and claim handling will continue to be handled locally. (Tr. at 117 B 118, 143 and Joint Ex. 5 at Bates 51).

BCBSD is expected to maintain most of its current facilities in Delaware; however, there may be a modest contraction of physical facilities because of current excess capacity. (Tr. at 150 B 151). Mr. King does not foresee any differences in the delivery of Medicare products. (Tr. at 142), and BCBSD's small group presence should remain strong and hopefully benefit from the synergies created from the transaction. (Tr. at 144-145). William Jews confirms that service to policyholders should be equal to or better than presently provided (Tr 300-305). The DOI presented no evidence to the contrary.

(b) Provider Networks

BCBSD envisions that after the Affiliation policyholders will have seamless health insurance coverage throughout the region. (Tr. at 114). The Affiliation will allow policyholders to have access to doctors and hospitals throughout the region. For example, a policyholder who needed specialty care could go to Johns Hopkins or the University of Maryland for that specialty care. (Tr. at 114 - 115). However, the decision to travel out-of-state for services would be optional at the subscriber's choice. (Tr. at 139).

BCBSD currently has contracts with 90% of physicians in this State and maintains contracts with every hospital in Delaware as well as several Maryland hospitals. Mr. King hopes this percentage will expand after the Affiliation, and anticipates no material disruption to the provider networks. (Tr. at 141 and 152).

Mr. Jews indicated that contracts with providers and hospitals will continue to be negotiated by local management, and CareFirst does not intend to negatively impact the relationships in Delaware between BCBSD and hospitals and providers. (Tr. at 314, 338 - 339). Mr. Jews also recounted the experiences in Maryland and D.C. post-affiliation as to service, provider networks and related matters. The Maryland and D.C. Plans have experienced operational savings of more than $5 million in the first year, membership has increased by 168,000 members, business has extended and CareFirst expanded its overall employment by nearly 300 new associates. The physician network has also expanded, including the addition of over 1,200 primary care physicians. The MD/DC affiliation broadened product offerings, such as offering a Medicare HMO product in Washington, D.C., and providing more health coverage options for individuals in the D.C. metropolitan area. Additionally, customer service was enhanced due to significant upgrades in technology and e-commerce. (Tr. at 285 - 286).   According to Mr. Jews, CareFirst believes that an affiliation of BCBSD and CareFirst will achieve the same benefits that have occurred in provider networks and other areas as a result of the BCBSMD/GHMSI affiliation. (Tr. at 288 - 289).

(c) <u>Premiums</u>

BCBSD anticipates its premiums becoming more competitive after the proposed affiliation due to reduction in administrative costs. Mr. King testified that realistically this means not that premiums would decrease but that they Awould be increasing at a decreasing rate.@ (Tr. 146-47). CareFirst also believes the anticipated synergies may well slow the increase in premiums. This phenomenon has occurred in DC in the two years since affiliation with CareFirst. (Tr. 311-14).

(d) Medicare/Medicaid

Mr. King indicated that post affiliation BCBSD would provide equal or greater Medicare services in Delaware. A Medicare HMO has been applied for. CareFirst currently offers Medicare supplements in Maryland and DC. (Tr. 142 B 43).

CareFirst indicated that since the Maryland-DC affiliation they have been able to expand the services offered in the Medicare-Medicaid area and could likely replicate this in certain areas in this under served field in Delaware. (Tr. 301 B 302).

(e) Small Group Market

Mr. King testified that BCBSD presently has a Avery strong presence@ in the small group market. He sees that continuing and possibly improving as the business combination synergies take place in the future. (Tr 144-45).

Mr. Jews testified that CareFirst already has a significant presence in this market in Maryland and DC. (Tr. 309).

(f) Underinsured/Uninsured

On behalf of BCBSD, Mr. King pledged no diminishment of corporate concern for the underinsured and uninsured population in Delaware. (Tr. 145).

(g) Public Concerns Expressed

Concerned members of the public submitted numerous letters to the Hearing Officer and the DOI regarding the Affiliation. Some of the letter raised concerns regarding the proposed transaction, while others urged the Commissioner to approve the Affiliation.

The Hearing Officer and DOI received letters expressing concern or posing questions regarding the Affiliation from Laura McKeown, the Delaware Association of Rehabilitation

Facilities (which also presented oral testimony at the hearing), National Association of Retired Federal Employees, Mental Health Association in Delaware, Delaware State Education Association, and Community Catalyst (which also presented oral testimony at the hearing) and submitted a letter following the hearing. John Murray, Esquire, on behalf of PHS and two of its physician members also sent a letter and offered testimony at the hearing. Mr. Murray's letter is marked "Personal and Confidential" so its contents will not be discussed herein. Letters were received in support of the Affiliation from M. Davis & Sons, Inc., W.L. Gore & Associates, Inc., Poland & Sullivan Insurance, Inc., Jarrell, Benson, Giles & Sweeney, M.D.'s, CitiSteel USA, Inc., and The Delaware River and Bay Authority. (Joint Ex. 7).

A number of letters, including those from Laura McKeown and the Delaware State Education Association, requested the DOI to ensure that the Affiliation would not diminish the quality of the service or products currently provided by BCBSD. As the Delaware State Education Association stated,

> The DSEA would like to request that the Dept. of Insurance assure itself that it has sufficient information from BCBSD, Inc. and CAREFIRST, Inc. so that it can be absolutely certain that the proposed affiliation will be in the best interest of the thousands of policyholders in this state - including many of the active and retired state employees.
>
> For example, we understand that the affiliation will result in an increase in provider networks for Delaware and Maryland/D.C. policyholders. Will this mean an increase or decrease in BCBSD's resources? ... could [the Delaware Board] be dominated by CAREFIRST staff people? Could this Board then restrict access in order to conserve resources? ... could [the Affiliation] mandate that certain procedures must be done at particular out-of-state facilities?

(Joint Ex. 7).

Some of the letters expressed concern with CareFirst's history of claims payment, and asked the Department to ensure that BCBSD would maintain its good record of claims payment and customer service after the Affiliation. (Joint Ex. 7).

Community Catalyst wrote to express its concern about the impact of the transaction on the assets of BCBSD, the structure of CareFirst and Delaware's representation within the CareFirst system, as well as the impact of the transaction on Delaware residents and BCBSD subscribers. While Community Catalyst raised a number of issues in its written submission to the Hearing Officer, Frank McLoughlin testified that after two days of hearings, many of his initial comments had been greatly truncated. (Tr. at 480). However, Mr. McLoughlin urged the Hearing Officer to ensure that sufficient safeguards be implemented to protect the assets of BCBSD in the event of a future conversion to for-profit status. (Tr. at 484).

In his post-hearing submittal, Mr. McLouglin asks that steps be taken to ensure that CareFirst and BCBSD share in the responsibility for meeting the needs of the medically underserved, including the roughly 13% of Delaware residents who are currently uninsured. Noting that BCBSD has a "64 year history of serving the community, not just its subscribers," he asks that CareFirst and BCBSD clearly indicate how it would continue this legacy. He suggests that a percentage of its direct written premiums "be dedicated to social or charitable health care endeavors" and informed the hearing officer that the Pennsylvania Insurance Commissioner had so directed in a Pennsylvania case involving the change of control of subsidiaries of two consolidating nonprofit BCBS plans. The details of that transaction are not part of the record and at the hearing there was limited testimony on the needs of the medically underserved in Delaware. This appears to be more appropriately an area for the Commissioner to consider as part of the licensing process.

Many of the letters of support focused on BCBSD's ability to retain local control post-affiliation and viewed this as a positive aspect of the Affiliation. For example, the letter from Jarrell, Benson, Giles & Sweeney, M.D.'s stated,

> We have had a good relationship for many years with Blue Cross, Blue Shield of Delaware, and we hope to see that relationship continue in the future. In any proposed meager [sic] we are in favor of Blue Cross Blue Shield of Delaware continuing as a separate entity, with its own local Board of Directors. CareFirst has made it clear that they want Paul King to continue as President of the Delaware Company. Mr. King has an excellent reputation in Delaware's medical community, and CareFirst's confidence in him can only be regarded as a good sign.

(Joint Ex. 7).

Many of the letters supporting the transaction were received from businesses with operations in both Maryland and Delaware. For example, W.L. Gore, Inc., a company with operations in Delaware and Maryland, stated, "[w]e need to be able to provide our employees and their families with coverage that smoothly crosses state lines, because they live, work and receive care in a number of nearby states, including Maryland. We believe this affiliation makes it more likely that they will enjoy even easier access to care at hospitals such as Johns Hopkins." (Joint Ex. 7).

Finally, other letters of support focused on BCBSD's need to remain competitive in the health insurance market place. For example, CitiSteel USA, Inc. stated,

> In today's market, our Company needs to be able to attract and retain excellent employees, and one of the ways we do this is by providing them with outstanding health benefits. ... there is a difficult balance to be struck among several goals, including comprehensive coverage, accurate, timely and personalized service, and of course affordability.
>
> Blue Cross Blue Shield of Delaware had been quite successful in meeting these needs, despite stiff competition in their business. However, that competition continues to intensify, and recently there has been a noticeable trend toward consolidation among the competitors.... It is clear that in the future, successful competitors (including BCBSD) will need to achieve ever-greater efficiency in their operations... We believe it is in our Company's best interest that a strong and healthy BCBSD continue to be one of the competitors from which we can choose in the future, and therefore we are supportive of their affiliation in general.
>
> ... BCBSD has been quite successful in meeting our needs and our employees are generally pleased to have Blue coverage available. One of the important benefits to

> them is the nationwide recognition and acceptance of a Blue Cross card. So we see it as a positive that the Delaware Blues have chosen to affiliate with another Blue Cross and Blue Shield organization such as CareFirst, as opposed to a commercial insurer, a hospital or hospital-centered organization, or some other alternative.

(Joint Ex. 7).

E. Findings of Fact; Conclusions of Law and Recommendation

Having considered the testimony and documents submitted for the record, as summarized above, in light of the standards of review set forth in the Pre-Hearing Order and the statutory requirements of 18 Del. C. Chapter 50 and of the Administrative Procedure Act, 29 Del. C. Sections 10100 et. seq. I make the following findings and recommendations:

1. A review of the testimony and evidence submitted into the record indicates that BCBSD is currently licensed as a Delaware health service corporation pursuant to Title 18, Chapter 63 of the Delaware Code. (Joint Ex. 13 at p. 1). After the Affiliation, BCBSD will continue as a separate corporate and operating entity with a local board of directors. (Joint Ex. 5 at Bates 88). BCBSD will continue to be subject to regulatory control by the Delaware Insurance Department. (Joint Ex. 5 at Bates 50). As a result of the proposed affiliation, BCBSD will remain able to satisfy the requirements for issuance of a license to write the lines of insurance for which it is currently licensed in the state of Delaware. (Tr. at 424). Additionally, BCBSD will continue to hold Blues licenses post-affiliation and the National Blue Cross Blue Shield Association has approved the use of the Blues marks after the Affiliation. (App. Ex. 5).

In order to assure that BCBSD continues as a separate corporate and operating entity and to maximize continue responsiveness to local concerns, several conditions for approval of the Affiliation are recommended to the Commissioner set out as Conditions 1-4 of Attachment A. These include requirements that BCBSD retain its separate corporate status, that it continue to be subject to regulation by the DOI, and that a majority of the members of its Board of Directors be Delaware residents. In addition, it is recommended that, as a condition of approval of the affiliation, BCBSD and CareFirst must agree to be governed by the provisions of Ch. 50 of the Delaware Insurance Code and subject to the general regulatory authority of the DOI.

2. A review of the testimony and evidence submitted into the record indicates that the proposed transaction has no anti-competitive effect from either a healthcare economic standpoint or a statutory market share analysis. The record is replete with evidence that the Delaware health insurance market place is competitive, and large players continue to move into the market place. (Tr. at 109 - 110).

The DOI conducted a market share analysis and reviewed the 1998 Delaware accident and health market share data in relationship to the standards set forth in 18 *Del. C*. Sec. 5003A(d)(2) and found that the market was not classified as highly concentrated. (Tr. at 425). The evidence presented indicates that BCBSD maintains 21% of the accident and health market share while CareFirst, through an indirect subsidiary, Delmarva Health Plans, has 0.15% of the market share. (App. Ex. 2). According to Mr. Lonchar, since Delmarva Health Plans has a market share of less than one percent, the competitive standard is not violated. (Tr. at 425).

Therefore, the proposed affiliation will not substantially lessen competition in insurance in the State nor tend to create a monopoly therein.

3 A review of the testimony and evidence submitted into the record indicates that there is no reason to believe that the financial stability of BCBSD will be jeopardized by the financial condition of CareFirst or that the interests of the policyholders will be prejudiced. The proposed Affiliation has been examined in detail by financial examiners for the DOI, KPMG LLP, a financial advisor to the DOI, the DOJ, and Deloitte & Touche LLP, a financial advisor to the

DOJ. Each of these financial experts arrived at the same general conclusion: namely, the proposed Affiliation does not pose a financial hazard to either BCBSD or CareFirst. (Tr. at 383 - 384, 402 - 403 and 426).

Nevertheless, the potential for the transfer of capital and assets of BCBSD to another affiliate, and the possible impact on the company of future cost allocations among the affiliates, suggest that additional safeguards are merited to assure the continued financial stability of BCBSD. I therefore recommend to the Commissioner that she impose, as a condition of her approval of the Affiliation, the requirements which are set out in Attachment A as Conditions 5 and 6. These would require BCBSD to receive approval from Delaware regulators prior to certain transfers of funds and allocations of costs. Notice and approval would also be required for participation in a joint venture to purchase certain assets.

4. Evidence concerning the potential financial impact of the BCBSD Officers Employment Agreements has also been carefully scrutinized. These Agreements are pertinent to the inquiry at hand because of their possible effect on the financial condition of BCBSD. The Attorney General, who has a responsibility to protect the charitable interests involved, is also appropriately concerned about whether the Agreements unduly enrich executives of a not-for-profit organization at the cost of the policyholders.

The extensive evidence in the record establishes that these agreements, while generous in some respects, are reasonable and are not excessive. The evaluation of Aon Consulting indicated that the agreements are reasonable on a competitive industry basis, particularly in relationship to the circumstances of the company. The financial advisors who testified on behalf of the DOI and DOJ did not find the contracts to be unreasonable or excessive, although it was generally acknowledged that both the number of executives covered by the Agreements and the SERP provisions contained in the Agreements tend to be on the liberal side. There was no testimony by any witness to the effect that the contracts are unreasonable, and no documentary evidence was presented to contradict BCBSD's claim that the contracts are reasonable. Based on this record, I find that the officer employment contracts and the terms thereof are not excessive and were reasonable in light of the particular circumstances of BCBSD.

5. I have also thoroughly considered the information offered concerning the financial cost of these agreements. This information was largely speculative and based on various "scenarios" and projections since the precise financial impact cannot be known at this time. For instance, it is not known how many, if any, of the BCBSD officers covered by the agreements will leave the company. Mr. King opined it would be three or four officers, less than half of the officers covered by the contracts. However, the exact number is not known, nor is it known whether the officers will be involuntarily terminated or whether they will exercise the change of control option of their contracts. It is also not clear from the record when or how any decision involving severance will be made. Also not known are the dates when the officers will leave the company; their contracts remain in effect through December 2001 and the severance provisions can take effect at any time during this two year period. Finally, it is not clear if these benefits will be paid as lump sums or in installments.

It is therefore impossible to assess at this time the agreements' impact, if any, upon the BCBSD reserve. If few officers leave and BCBSD income exceeds its operating expenses, there may be no direct impact on the reserve, or a very modest impact. However, the departure of a large number of executives could have a substantial impact. Information presented at the hearing tended to focus on the "worst case scenario" - that is, all ten covered officers being terminated involuntarily on the date the affiliation becomes effective. In that event, it is projected the cost of severance pay would be approximately $15 million. This scenario also contemplates that the reserve would need to be tapped to meet these costs. Thus, under the "worst case scenario", the BCBSD reserve would be reduced by $15 million. Under a second scenario if all ten officers were to exercise change of control provisions, it is anticipated that the maximum future compensation and benefits would amount to approximately $9.9 million. It is, however, unlikely that either of these scenarios will occur, as Mr. King anticipated only 3 or 4 officers departing. Also, since the severance provisions can be exercised over a two year period, the financial impact may not be felt at any one time. And it was acknowledged that BCBSD would be obligated to incur approximately $4.0 million in both 2000 and 2001 under the terms of the agreement, regardless of the Affiliation. (DOI Ex. 1 at p. 12).

In short, the financial impact of the officers' contracts simply cannot be assessed with any degree of accuracy at the present time. I am, therefore, reluctant to recommend to the Commissioner that CareFirst or its affiliates be required, as a condition of approval of the affiliation, to contribute a portion of the severance pay paid to BCBSD officers under the contracts as the DOI and DOJ urge. By the same token, I also decline to recommend that BCBSD bear the total financial responsibility under all circumstances.

Rather, the impact of these agreements should be treated in the same manner as other significant future financial transactions undertaken by the parties. I therefore recommend that whenever it is necessary to tap the BCBSD reserve in an amount greater than $500,000 in the aggregate in a fiscal year in order to meet financial obligations under the contracts, the Commissioner and the DOJ should be notified.

This condition is similar to other recommended conditions which require notice and approval of transfers of capital and assets in the amount of $500,000. See Conditions 5 and 6 of

Attachment A. I also recommend a further condition to the effect that the existing contracts not be extended or renewed beyond their current termination date.

6. There is ample evidence in the record that CareFirst does not have any plans to materially change the corporate structure or management of BCBSD.

The evidence indicates that a number of corporate changes will occur post-affiliation. First, as set forth in the Affiliation Plan, BCBSD will become part of the CareFirst holding company structure, and CareFirst will become the sole member of three non-profit Blue Cross entities: BCBSD, BCBSMD and GHMSI. (Joint Ex. 5 at Bates 82 - 94). Second, there will be a reduction in the number of members of the BCBSD Board of Directors from fourteen to seven over a period of time. (Joint Ex. 5 at Bates 88). Third, the CareFirst Board will be amended to include three Delaware Class III directors who will have special powers relating to the business and governance of CareFirst and BCBSD, including veto powers over significant corporate actions involving BCBSD. (Joint Ex. 5 at Bates 85 and 90 - 92).

The testimony and evidence received into the record indicates that BCBSD plans to continue its independent, non-profit status. (Joint Ex. 5 at Bates 51). It also indicates BCBSD will maintain significant operations in Delaware (Joint Ex. 5 at Bates 51) BCBSD and that it expects to maintain a significant employment force and corporate presence in Delaware, (Joint Ex. 5 at Bates 51 and Tr. at 117 - 118).

Therefore, I find that the proposed Affiliation, with adoption of the proposed recommended will not result in a material change to the corporate structure or management of BCBSD which is unfair and unreasonable to the policyholders and not in the public interest.

In order to assure that these plans in fact occur, I am recommending to the Commissioner several additional conditions to her approval. They are set out as Conditions 8 and 9 of

Attachment A and provide as follows: first, that BCBSD continue its non-profit status for at least two years; second, that it notify the DOI of any plans to change its status; and third, that CareFirst also advise the DOI of any restructuring plans which it files with any other regulator.

Further, while all of the financial examiners indicated that the proposed Affiliation would not materially change the corporate structure of BCBSD, neither the Affiliation agreement nor the recommended conditions foreclose a future conversion to for-profit status. The disposition of the assets of BCBSD in the event of such a conversion was a matter of concern to many of the witnesses, particularly to the members of the public who testified.

It is therefore important to place certain restrictions on the distributions of these assets. Condition 10 set out in Attachment A is designed to do so, not only by providing notice of any proposed restructuring but by requiring that, in the event of a conversion to a for-profit status, the assets of BCBSD are used for a charitable purpose. To this end, the Commissioner should also impose a condition requiring the applicant to develop a valuation of BCBSD to be used in the eventuality of a conversion.

7. The record is replete with evidence as to the competence, experience and integrity of both BCBSD directors and officers as well as the management of CareFirst. Both Paul King and William Jews have long experience in the health care industry, and CareFirst intends for Mr. King to remain with BCBSD as President and COO responsible for managing the day-to-day operations of the Delaware Plan. (Tr. at 125, 291). Mr. King cannot be terminated without the agreement of the Class III directors and a majority vote of the directors of the BCBSD Board. (Joint Ex. 5 at Bates 90).

The independent financial analysts retained by the DOI and DOJ both testified as to the quality of BCBSD and CareFirst management. (Tr. at 387 and 403). Additionally, the DOI stated that it had reviewed the officer and director biographical affidavits and third party investigative reports and found no items of concern with respect to any proposed officer or executive. (Tr. at 429).

Based on my review of the evidence presented, I find that the competence, experience and integrity of those persons who would control the operation of BCBSD is such that the Affiliation will be in the best interests of the policyholders and the public.

8. The evidence in the record shows that under the Affiliation BCBSD will continue to meet licensing requirements of Delaware law; that the applicants enjoy strong financial conditions; that investigative reports revealed no concern about the integrity or competence of the executives or Board members involved; that BCBSD plans to maintain its existing corporate structure and its presence in the State; and that it plans to maintain or expand its offering to its customers.

I therefore find that the Affiliation will not be hazardous or prejudicial to the insurance buying public.

9. The record also shows that the financial advisors who reviewed the proposed Affiliation agree that the Affiliation does not pose a financial hazard to either BCBSD or CareFirst and that both applicants enjoy sound financial footing. Further, the Intercompany Agreement contains certain controls over the transfer of assets between the companies and over future allocations of costs among the affiliates; and the proposed affiliation holds the promise of financial benefits to BCBSD due to economies of scale and access to capital and "critical mass". Thus, the Affiliation does not pose a threat to the capital adequacy of BCBSD.

As discussed in paragraph 3 above, I have recommended the adoption of a number of conditions designed to ensure the future financial solvency of BCBSD. Pursuant to these conditions, the DOI would be able to monitor and prevent, if necessary, any outflow of capital that would jeopardize the financial stability of BCBSD. These protections are included in Conditions 5, 6 and 7, Attachment A.

10. With respect to the impact of the Affiliation on the interest of the policyholders, I must make the following findings.

First, there is no doubt that the Affiliation will mark the end of BCBSD, Inc. as a uniquely Delaware entity. There is a sense of loss when such an event occurs.

Nevertheless, the record indicates that the Affiliation promises to open up enhanced opportunities for policyholders. It will permit "seamless" health care across the state lines and on a regional basis, thereby benefitting policyholders. This is important to current customers, as many Delaware employees live in other states and many Delaware employers have operations throughout the region.

Further, the Affiliation presents an opportunity for economies of scale, enhanced services and cooperative undertakings which would not otherwise be available to BCBSD. These in turn, should benefit policyholders by permitting more money to go into healthcare, by slowing the rate of increase in the cost of health insurance and by offering enhanced services. These anticipated benefits are, however, largely dependent on the abilities of the Boards of Directors and management of BCBSD and CareFirst to bring them about.

I also find that BCBSD and CareFirst have made certain claims concerning services. These include a pledge to maintain at least their current levels of services to policyholders (Tr. at 138), that delivery of Medicare products will not change, and that BCBSD will retain its presence in the small group market. (Tr. at 142, 144-145). In addition, BCBSD contemplates maintaining a substantial employment force and corporate presence in Delaware. Customer service and claims handling will be handled locally. (Tr. at 143-144, 177-188). BCBSD also anticipates no material disruption in provider services and contracts with providers and hospitals will continue to be negotiated by local management. (Tr. at 314, 338-339). Again, the ability to deliver on these claims depends largely on the skills of management and the respective Boards and to some extent on market forces beyond any individual's control.

After hearing two days of testimony, reviewing the extensive record and considering the comments of the public, I am satisfied that the Affiliation holds the promise of substantial benefits to policyholders and to the insurance buying public.

Further, I am also convinced that the Affiliation is necessary for the long-term survival of BCBSD in the increasingly competitive arena in which it operates. In the long run, this is important to consumers of health insurance who will benefit from healthy competition among insurers and from the continuation of the high quality service which the Blues have traditionally provided. The Affiliation is also attractive because it contemplates the continued presence of BCBSD within the State and the maintenance of a substantial degree of local control.

I therefore find that the Affiliation does not adversely affect the interest of policyholders. Once again, I have recommended that certain provisions be included in the Commissioner's order as Conditions 12 through 17. These provide for periodic reports to the DOI about the operations, programs and level of service of BCBSD, including any plans to substantially reduce its work force or facilities. In addition, Condition 14 recommends a market conduct examination by the DOI. The remaining concern the use of Blue Cross service marks by the Delmarva Health Plan, and the ongoing authority of the Commissioner to monitor compliance with her Order.

F. Conclusion

Based on a thorough review of all the evidence and consideration of all the information provided, as well as the criteria set forth in 18 *Del. C.* Sec. 5003, I conclude that the Business Affiliation between BCBSD and CareFirst does not: (i) violate any provision of Title 18, Delaware Code, or regulations duly promulgated thereunder; (ii) pose a threat to the capital adequacy of BCBSD; or (iii) adversely affect the interest of BCBSD's policyholders.

I also conclude that, in order to protect the future financial solvency of BCBSD and the long-term interest of the policyholders, the Commissioner's approval should require compliance with certain conditions. I have set out a list of recommended conditions in Exhibit A.

Therefore, upon adoption of the conditions,

I recommend approval of the proposed Affiliation.

SO RECOMMENDED the ________ day of _______________________, 2000.

____

The Honorable Battle R. Robinson

Hearing Officer

Upon review, I hereby accept the findings of fact and conclusions of law and adopt them as my order.

____

Date

The Honorable Donna Lee H. Williams
Insurance Commissioner

ATTACHMENT A

RECOMMENDED CONDITIONS

1. BCBSD, GHMSI and BCBSMD and CareFirst must maintain their separate corporate identities for legal, financial, accounting, tax and insurance regulatory purposes.

2. BCBSD will continue to be bound by, and conduct its affairs pursuant to, the requirements of 18 Del. C. Ch. 63.

3. CareFirst and BCBSD must agree to comply with the provisions of 18 Del. C. Ch. 50 (Insurance Holding Company System Registration). CareFirst must also agree to the general supervisory authority of the Delaware Insurance Commissioner pursuant to 18 Del. C. Ch. 3.

4. The Boards of Directors of BCBSD and CareFirst shall be restructured, to the extent necessary, to (i) comply with the terms of the draft amended Certificates of Incorporation and By-Laws of the two companies (Joint Exhibits 9, 10 11, 12); (2) minimize interlocking directors by assuring that no less than two members of the Board of Directors of each Board are outside directors who shall not at the same time also serve on the Board of BCBSD or any subsidiary or affiliate of BCBSD (in the case of the CareFirst directors) or on the Board of GHMSI, BCBSMD, CareFirst or any of their subsidiaries or affiliates (in the case of BCBSD Directors); iii) ensure that no officer or employee of BCBSD or CareFirst is on either Board; and (iv) provide that a majority of the members of the BCBSD Board shall be residents of the State of Delaware. Any change in this structure must receive prior approval of the DOI.

5. The following transfers of assets by BCBSD to GHMSI, BCBSMD, CareFirst or its subsidiaries, or any subsequent agreement providing for facilitating such transfers, are subject to

the prior approval of the Commissioner, as follows:

(a) Cost allocations: Cost allocation agreements, service contracts, management, rental, and similar agreements which exceed $500,000 in the aggregate in any fiscal year;

(b) Mandatory transfers: Any transfer for capital reserves, claims payments and other legally enforceable obligations, as defined in the Amended and Restated Intercompany Agreement;

(c) Discretionary funding: Any other transfer which exceeds $500,000 in the aggregate in any fiscal year.

BCBSD must notify the Commissioner in writing of its intention to engage in any transfer that requires approval under this paragraph at least 30 days prior to the actual transfer and may engage in the transfer only if the Commissioner approves the transfer in writing or does not disapprove the transfer within the notice period.

A transfer shall not be made, and the Commissioner shall not approve a transfer, which does not meet all requirements of applicable law, does not comply with the terms of the Intercompany Agreement or which would cause the reserve of BCBSD to fall below statutory reserve requirements or reserve requirements of the BCBSA.

All transfers of money, notes, investments, equipment or other assets among BCBSD and GHMSI, BCBSMD and CareFirst or any subsidiaries must be properly recorded in the financial records of the company and documented by a note or other evidence of indebtedness, as an asset of the transferring company and as a liability of the transferee company, unless adequate, reasonable consideration for the transfer has been obtained and documented.

6. BCBSD shall not participate in any joint venture with CareFirst, BCBSMD, GHMSI or any affiliates to purchase any asset greater than $500,000 in any fiscal year without the prior written approval of the DOI.

7. After the date the Affiliation becomes effective, BCBSD shall notify the DOI and the DOJ any time it is necessary to use its surplus reserve funds in an amount greater than $500,000 in the aggregate in any fiscal year in order to make payments under the existing Officer Employment Agreements to officers of BCBSD who have exercised the change of control provisions of their contracts or who have been terminated by the company pursuant to the change of control provisions. Any contracts between BCBSD and its executive officers which contain provisions for compensation to be paid in the event of a change of control shall not be renewed or extended beyond their current expiration dates. For a period of two years following the effective date of the affiliation, any new agreements entered into by BCBSD or CareFirst with any of the ten executives covered by the current contracts and which provide for compensation in the event of a change of control shall be filed with the DOI and the DOJ.

8. BCBSD shall maintain its not-for-profit status for at least two years from the date the Affiliation becomes effective. Thereafter, as provided in paragraph 9, it shall not convert to a for-profit status without the approval of the Commissioner and of such other governmental entities as may be required.

9. Any change in the corporate status of BCBSD, including dissolution, merger or change (or conversion) to a for-profit status must receive the prior written approval of the DOI. Likewise, any change in the financial, accounting, or tax reporting methodologies of BCBSD must

also receive prior written approval of the DOI. No sale or transfer of all, or substantially all, of the assets of BCBSD shall take place without prior written approval of the DOI. Any change in the corporate structure of CareFirst or any of the affiliates which is required to be filed with another regulator must also be filed with the DOI.

10. The By-Laws of BCBSD shall provide that upon any dissolution its assets shall be distributed to another non-profit entity with a similar purpose. Article Eight of the draft Amended and Restated Certificate of Incorporation of BCBSD which was admitted into the record at the October 25, 1999 hearing as Joint Exhibit 9 and which was approved by the DOI and the DOJ shall not be amended or altered without prior approval of the DOI and the DOJ.

11. Within 60 days of the date the Affiliation becomes effective, BCBSD shall provide to the DOI for approval a proposal outlining a method for performing a valuation of BCBSD as of the date the Affiliation is effective. The purpose of such valuation is to facilitate a future distribution of assets, in the event of a future conversion to a for-profit entity. The proposal should be consistent with the approach being taken to develop similar valuations of GHMSI and BCBSMD under the direction of the District of Columbia Division of Insurance and Securities Regulation and the Maryland Insurance Administration and include the same information.

12. BCBSD and CareFirst shall cooperate in any effort by the DISR, the MIA and the DOI to establish identical categories of information on all statutory financial statements and reports.

13. BCBSD will maintain the level of its employees in Delaware as of the date the affiliation is effective. Any plans to reduce the number of employees from this level are subject to

prior notice to the DOI and must be demonstrated to be an exercise of prudent business judgment.

14. BCBSD and CareFirst shall cooperate in a market conduct examination by the DOI, possibly in conjunction with the DISR and the MIA, pursuant to Chapter 3 or Chapter 50 of Title 18 of the Delaware Code.

15. Within 180 days of the effective date of the affiliation and annually thereafter, BCBSD shall file with DOI a report which shall set out in detail any actual or planned integration of products, service and administrative functions; any actual or projected cost savings; and timetables for any proposed integration.

16. Within 180 of the effective date of the affiliation and quarterly thereafter BCBSD shall file with the DOI a report which shall set out in detail, and for each county of the State, changes in products, services and provider contractors, any proposed reduction in staff and any proposed reduction in the size of, or the closing of, any facility.

17. Without prior approval of the DOI, the Delmarva Health Plan shall not use the BCBS marks.

18. Whenever prior approval must be obtained from the DOI under any of these conditions, simultaneous notice shall be given to the DOJ.

19. This matter is subject to further orders as circumstances may require.

20. These Findings and Recommendations and the Commissioner's Order are subject to further modification or amendment or further review either sua sponte by the hearing officer or Commissioner or on motion of a party.

21. BCBSD and CareFirst shall continue to be subject to the jurisdiction of the DOI for

purposes of implementing the terms of the Commissioner's Order.