

BEFORE THE INSURANCE COMMISSIONER

THE STATE OF DELAWARE

In the matter of :
Proposed Affiliation of : **Docket No. 99-09**
BCBSD, Inc. Doing Business As :
Blue Cross and Blue Shield of :
Delaware, with CareFirst, Inc. :

DECISION AND AMENDED ORDER

BACKGROUND

On December 23, 1998, BCBSD, Inc., a Delaware non-profit health services corporation (“BCBSD”), and CareFirst, Inc., a not-for-profit Maryland corporation (“CareFirst” and together with BCBSD, the “Companies”), executed an affiliation agreement whereby BCBSD would continue to provide health insurance and related services in Delaware as part of the CareFirst organization. CareFirst would become the sole member of BCBSD. BCBSD would give up its primary Blue Cross® and Blue Shield® primary license and would operate under an affiliate license through CareFirst.

On March 20, 2000 in the above-captioned docket, I issued a Final Order and Decision (“Original Order”) approving the affiliation (the “Affiliation”) of BCBSD, Inc., a Delaware non-profit health services corporation (“BCBSD”), and CareFirst, Inc., a not-for-profit Maryland corporation (“CareFirst” and together with BCBSD, the “Companies”), in accordance with the terms of that certain Business Affiliation Agreement dated as of December 23, 1998, the Affiliation Plan appended thereto, and an Amended and Restated Intercompany Agreement dated as of March 22, 2000 (the “Intercompany Agreement”), subject to adherence by BCBSD and CareFirst to the Conditions made part of the Original Order. In accordance with the terms of the Affiliation, as approved and subject to the Conditions ordered by me, CareFirst became the sole member of BCBSD and BCBSD became entitled to representation on the CareFirst Board through three Delaware Class III directors. The evidence upon which that order was based included a representation that CareFirst would have only a minimal staff and would rely on the personnel and service contracts with its affiliated members. As noted in the record in this docket:

. . . 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.* (Report of the Hearing Officer dated January 5, 2000, p. 6)(emphasis added)

In the context of the Rule to Show Cause, it is noteworthy that, although there was a change in membership of BCBSD, there was no change of control as defined by the Delaware holding company act, 18 *Del. C.* Chapter 50. Nor was there any acquisition of assets or the business of BCBSD by CareFirst. In effect, the Original Order was premised on the benefits to be gained by the affiliated companies through a consolidation of services and expense reduction mechanisms as opposed to the integration of BCBSD into CareFirst through a purchase and sale agreement. The subsequent reports and filings submitted by BCBSD as required by the Original Order confirm the companies' adherence to the representations upon which the Original Order was based.

SUMMARY OF THE PROCEEDINGS

In April 2003, the Maryland General Assembly passed legislation directly affecting CareFirst that, in my view, had the potential to adversely impact BCBSD and its Delaware subscribers and as a result of my concerns regarding such legislation as detailed in the record of the Hearing (as defined below), I issued a standstill order in April 2003 (the "Standstill Order") as the first of a series of efforts to protect Delaware consumers and subsequently, on May 22, 2003, I issued a Rule to Show Cause why (1) the effect of the Maryland legislation would not contravene the Original Order, (2) the Original Order should not be terminated, (3) BCBSD's participation in the Affiliation should not be withdrawn, (4) any assets, licenses, authorities, or the like yielded by BCBSD to CareFirst should not be returned and (5) any other and necessary order should not be entered protecting the rights of Delaware citizens to the full benefits offered prior to the Original Order (the "Rule to Show Cause").

Counsel for the parties noted that, for the past several months, representatives of BCBSD and CareFirst frequently met and held extensive discussions with a working group comprised of representatives of and advisors to the Delaware Department of Insurance (the "DOI") in order to resolve the issues raised by the Rule to Show Cause in a manner satisfactory to me and the DOI as well as the Companies.

In accordance with 29 *Del. C.* § 101 *et seq.* and 18 *Del. C.* § 301 *et seq.*, a hearing on the Rule to Show Cause was held before me, as hearing officer, on November 4, 2003 (the "Hearing") where all parties were heard with respect the issues set forth in the Rule to Show Cause. BCBSD and CareFirst jointly proposed a modified affiliation arrangement between the Companies on the terms and conditions set forth in the forms of an Administrative Services and Business Affiliation Agreement (the "Administrative Services and Business Affiliation Agreement") (Stipulated Exhibit 1) and amended and/or restated charters and bylaws for BCBSD and CareFirst (the "Revised Corporate Documents") (Stipulated Exhibits 2, 3, 7 and 8) presented and introduced into evidence by the Companies which, among other things, provide for: (i) restoration of majority membership of BCBSD to the BCBSD Board, (ii) the continued maintenance and fostering of shared business and support services between the Companies, (iii) various reporting requirements and corrective measures, and (iv) the issuance of primary licenses to BCBSD for the use of the Blue Cross® and Blue Shield® service marks (the "Marks") in the State of Delaware by the Blue Cross and Blue Shield Association (the "Association"), effective

immediately upon the closing under the Administrative Services and Business Affiliation Agreement.

The Department and the Delaware Department of Justice (the “DOJ”) expressed conditional support for and recommended approval of the above-described restructuring of the BCBSD/CareFirst relationship in the form of an order that modifies the Original Order (as amended by the Standstill Order) and retires the Rule to Show Cause.

SUMMARY OF THE EVIDENCE

Evidence was presented in the form of stipulated exhibits and through the sworn testimony of witnesses for the parties. Max S. Bell, Jr. has served as the chairman of the Board of Directors of BCBSD since 1982 and as one of the Delaware Class III directors of CareFirst since the Affiliation. He stated that the Affiliation between the Companies was “based on trust and a shared vision” and “that there was no purchase price to be paid by CareFirst, because we were not selling BCBSD.” The Affiliation also required BCBSD to give up its licenses to use the Marks as a primary licensee of the Association in favor of controlled affiliate licenses through CareFirst’s primary licenses.

Both he and Timothy Constantine, the President of BCBSD, presented testimony identifying significant benefits to BCBSD as a result of the Affiliation, including growth in subscribers, introduction of new products, increased jobs in Delaware and better performance ratios.

After the legislative changes in Maryland became law, BCBSD’s Board of Directors identified four primary provisions of the law that the Board felt were unacceptable. Mr. Bell identified those concerns as follows:

First, the Legislation made CareFirst, and not-for-profit companies owned or controlled by CareFirst, subject to a new state-mandated “non-profit” mission. *Second*, the Legislation would require certain routine management decisions made by any affiliate or subsidiary of CareFirst to be pushed up to the CareFirst Board for approval. *Third*, CareFirst was prohibited from merging with or being acquired by another company for a period of five years, irrespective of whether the Board felt that such a merger was in the best interests of the company and its subscribers. *Fourth*, and perhaps most grievous, the Legislation would cause the removal and replacement within a year of every one of the twelve Maryland Directors of the CareFirst Board, a Board that we had come to know and to trust.

Mr. Bell also reviewed the additional concerns raised by the lawsuit brought by the Association to revoke CareFirst’s primary and affiliate licenses. Although that crisis passed as a result of a judicial settlement in Maryland, BCBSD believed that protective measures were necessary to assure continuation of Blue coverage in Delaware regardless of events occurring in other jurisdictions. BCBSD felt that the return of majority control to BCBSD and the other measures contained in the proposed Administrative Services and Business Affiliation Agreement

provided the best measure of protection for BCBSD while retaining the benefits of the Affiliation in a continuing contractual affiliated arrangement.

Mr. Constantine reviewed the benefits that have accrued to BCBSD as a result of the Affiliation. They include:

- The retention of a local headquarters and local management;
- Increased membership growth;
- Increased revenue growth;
- Reduction in the ratio of administrative costs to premium revenue from 13.7% in 1999 to 8.1% by the end of 2003;
- Reduction in the percentage of administrative costs on a per member per month basis from \$21.44 during calendar year 1999 to \$16.86 in calendar year 2002; and
- Growth in the number of employees from 490 at the time of the affiliation to 630 at present.

Leon Kaplan, Vice-President of Operations for CareFirst, testified in support of the proposed modifications to the current affiliation arrangement between the Companies. He stated that:

The Department and BCBSD have expressed concerns about the effects and potential effects of the Maryland legislation upon CareFirst and BCBSD. As others have indicated in their statements earlier today, CareFirst has worked hard with the Department and BCBSD to come up with a solution that is acceptable to the Department and to BCBSD, and that will continue, albeit in somewhat different form, the affiliation between CareFirst and BCBSD. CareFirst is committed to working with BCBSD, its other affiliates, the Department, and other regulatory authorities to make this revised affiliation a continued success for all concerned.

On behalf of the DOI, Darryl Reese, Director of the Bureau of Examination Rehabilitation and Guaranty, discussed the intensive process over the last five months between and among the Department and the two Companies to find a satisfactory proposal that would avoid the troublesome aspects of the Maryland legislation insofar as it could affect BCBSD, Delaware consumers and the DOI's regulatory oversight of BCBSD and allow the Companies to continue doing business through a contractual affiliation. He noted the significant levels of review and oversight conducted by the DOI since the date of the Affiliation. He also testified about the significant concerns that were raised when the Association took action to revoke the licenses to use the Marks held by CareFirst and its affiliates, including BCBSD, in May of this year. Mr. Reese further stated that the resolution of the litigation resulting from the license dispute did not increase the DOI's level of confidence that BCBSD was sufficiently protected from any future adverse action that might affect CareFirst and its controlled affiliates.

Mr. Reese stated that the DOI had two primary goals: "First, to protect Delaware subscribers by insuring that they have continued access to the full range of health services within

the Blue Cross and Blue Shield Association's benefit structure. Second, to assure that decisions impacting BCBSD and its subscribers are maintained under local control." In that context, the Companies proposed and the DOI supported the concept that lead to the proposed changes in majority control and the Association's agreement to allow BCBSD to have its own primary licenses. Among the important aspects of the proposed Administrative Services and Business Affiliation Agreement, according to Mr. Reese, are quarterly financial reporting requirements, as well as certain items that must be reported immediately to BCBSD by CareFirst, including:

- any communication from the Maryland Insurance Administration questioning or jeopardizing the renewal of CareFirst's certificate of authority or respecting the financial impairment or insolvency of CareFirst,
- any non-routine communication from the Blue Cross Blue Shield Association addressing the continued availability of the Blue Cross Blue Shield mark to CareFirst,
- any future Maryland law or regulation or any amendment of, or change to, any existing Maryland law or regulation directly affecting insurance companies that could adversely impact the financial condition, management, structure or operations of CareFirst or any affiliate thereof, and
- subpoenas and formal requests for information from CareFirst or any of its officers or directors from any state or federal investigatory authority.

Mr. Reese also noted that the affiliation could be entirely terminated upon the occurrence of a number of triggering events, including:

- the adoption by non-Delaware authorities of any law, regulation or statement of policy purporting to impose requirements or restrictions of any sort on BCBSD as an insurer licensed outside of that other jurisdiction,
- a final and enforceable determination by relevant authorities that BCBSD is required to adhere to provisions of the recently enacted Maryland legislation, such as the Maryland nonprofit mission requirements and mandatory imposition of direct oversight and approval of Delaware specific matters by the CareFirst Board of Directors,
- the unanimous vote of the BCBSD Board of Directors (excluding the vote of the one director on the Board elected by CareFirst) to accept a merger or acquisition offer or an alternative business affiliation, or to convert to a for profit basis,
- any notice issued by the Blue Cross Blue Shield Association to CareFirst terminating, suspending, materially impairing or limiting CareFirst's right to use the Blue Cross Blue Shield mark unless such circumstance is cured within 30 days,
- the suspension of or failure to renew CareFirst's certificate of authority, and

- a determination by the Maryland Insurance Commissioner that CareFirst is in a financially impaired condition.

In assessing the proposed modified affiliation arrangement, the DOI also relied on the opinion of its outside financial consultant, Sandler O'Neill & Partners, L.P. Harold Sandstrom, a principal of Sandler O'Neill & Partners, L.P., provided a report and testimony evaluating BCBSD from a financial point of view, on a historical basis and in relation to the proposed contractual affiliation arrangement. Mr. Sandstrom noted that the Affiliation has been good for BCBSD and its subscribers and that BCBSD has strong financial position, strong management and a strong market position in Delaware. He further stated that it was beneficial for BCBSD to continue to have a cooperative or partnership relationship with an entity like CareFirst because of the market trend in favor of consolidated larger health service organizations. In particular, it was noted that the recent announcements of business combinations by UnitedHealth Group and Mid-Atlantic Medical Services, Inc. and by WellPoint Health Networks, Inc. and Anthem Inc. underscored the need to have some regional relationship because of the small size of the Delaware market. It was Sandler O'Neill & Partners, L.P.'s opinion that the proposed Administrative Services and Business Affiliation Agreement would "not have a material adverse effect on the financial condition of BCBSD."

On behalf of the Delaware Attorney General and the DOJ, Deputy Attorney General Marsha Kramarck expressed support for the proposal submitted by the Companies, subject to certain conditions. She noted that the return of majority control and the primary Blue Cross® and Blue Shield® licenses to BCBSD did not "present the problems of wasting of assets which the Attorney General had previously resisted." She also requested, in connection with the entry of any modified order approving the proposal presented by the Companies, that (i) the Delaware Attorney General and the DOJ continue to receive the notices required in the Original Order, (ii) the Commissioner and the DOI retain strict oversight and approval authority with respect to all significant asset and job transfers proposed by the Companies, and (iii) either the entry of an order be delayed until the Board of Directors of the Association approves the issuance of primary Blue Cross® and Blue Shield® licenses to BCBSD or a provision be included in the order that makes approval of the proposed modified affiliation arrangement between the Companies contingent upon the Association's grant of primary Blue Cross® and Blue Shield® licenses to BCBSD.

FINDINGS OF FACT AND DECISION

1. The companies' proposed Administrative Services and Business Affiliation Agreement does not constitute a change of control or ownership of BCBSD or CareFirst that requires any action on the part of the Department or the Commissioner beyond a determination of whether the Rule to Show Cause should be retired and, if so, on what basis the Rule will be retired and the companies permitted to continue in a business relationship or affiliation.

2. The proposed forms of Amended and Restated Certificate of Incorporation and Bylaws of BCBSD effectively restore majority membership of BCBSD to the Board of Directors of BCBSD.

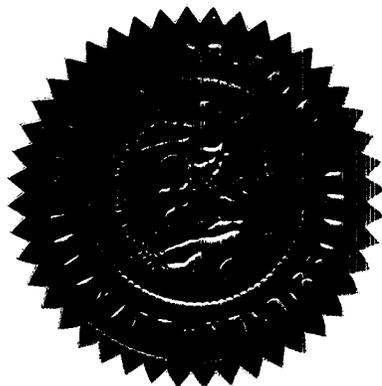
3. Restoration of majority membership of BCBSD to the BCBSD Board as aforesaid will best assure the avoidance by BCBSD of certain principal areas of concern arising from the enactment of the Maryland legislation, including the possible application of Section 14-102(f) and Section 14-115(d)(11)(I) of the Maryland Insurance Code (as enacted pursuant to the Maryland legislation) to BCBSD.

4. The Administrative Services and Business Affiliation Agreement: (a) preserves the ability of the parties to maintain on a contractual basis the various benefits realized by BCBSD during the more than three years of Affiliation, including cost savings, competitiveness in the marketplace, enhanced financial viability and improved health services for Delaware subscribers, including access to regional health facilities; (b) through the mechanism of the various reporting requirements and corrective measures, adequately protects BCBSD from any direct or indirect adverse consequences to the operations and governance of CareFirst or BCBSD posed by the application of the Maryland legislation and any future impaired financial condition of CareFirst; (c) terminates any obligation of BCBSD under the Intercompany Agreement to make available financial resources to other CareFirst affiliates; (d) is a primary step to effectuating the return of primary licenses for use of the Marks in Delaware to BCBSD; and (e) is otherwise in the best interests of BCBSD and the subscribers and the insurance buying public of Delaware.

5. Accordingly, the restoration of majority membership of BCBSD to the BCBSD Board of Directors pursuant to the Revised Corporate Documents, together with and subject to the terms and conditions of the Administrative Services and Business Affiliation Agreement which is made a part hereof, and subject to the satisfaction of all of the conditions set forth in Exhibit A attached to and incorporated in this Amended Order no later than December 31, 2003 and further subject to all of the conditions found in the Original Order as amended and restated as set forth in Exhibit B attached to and incorporated in this Amended Order, is hereby APPROVED; and

6. The Rule to Show Cause, shall be retired upon the satisfactory completion of the final conditions set forth in Exhibit A to be accomplished on or before December 31, 2003 at which time this Amended Order shall supercede the Original Order. If such conditions are not satisfied or waived by me, then this Amended Order shall be rescinded and the Original Order, as modified and supplemented by the Standstill Order shall remain in full force and effect.

SO ORDERED this 1st day of December, 2003.



Donna Lee H. Williams
DONNA LEE H. WILLIAMS
Insurance Commissioner

EXHIBIT A

REQUIRED CONDITIONS

The following conditions must be satisfied no later than December 31, 2003:

1. BCBSD, CareFirst, CareFirst of Maryland Inc. and Group Hospitalization and Medical Services, Inc. must execute the Administrative Services and Business Affiliation Agreement, in substantially the form presented and introduced into evidence at the Hearing (Stipulated Exhibit 1), with only such changes thereto, if any, as are of a nonmaterial nature and approved by the DOI prior to execution thereof, including without limitation the final forms of Appendix "G" thereof regarding employee benefits arrangements and Appendix "H" thereof regarding cost allocations (the "Administrative Services and Business Affiliation Agreement"), and deliver a copy of the executed Administrative Services and Business Affiliation Agreement to the Commissioner, the DOI and the DOJ.

2. The closing under the Administrative Services and Business Affiliation Agreement shall have been consummated.

3. BCBSD must execute an Amended and Restated Certificate of Incorporation, in substantially the form presented and introduced into evidence at the Hearing (Stipulated Exhibit 2), with only such changes thereto, if any, as are of a nonmaterial nature and approved by the DOI prior to the execution and filing thereof (the "BCBSD Charter"), and the BCBSD Charter shall have been filed with the Office of the Secretary of State of the State of Delaware.

4. No material changes shall be made to the form of Amended Bylaws of BCBSD, as presented and introduced into evidence at the Hearing (Stipulated Exhibit 3) (the "BCBSD Bylaws"), without the prior approval of the DOI, and such BCBSD Bylaws, with any material changes approved by the DOI, shall have become effective.

5. The Board of Directors of the Blue Cross and Blue Shield Association (the "Association") shall have approved the issuance of primary licenses to BCBSD for the use of the Blue Cross[®] and Blue Shield[®] service marks (the "Marks") in Delaware, CareFirst's rights to use the Marks in Delaware shall have been relinquished and terminated, and the Association shall have executed a license agreement with respect to use of the Marks in Delaware by BCBSD.

6. CareFirst must execute Articles of Amendment and Restatement, in substantially the form presented and introduced into evidence at the Hearing (Stipulated Exhibit 7), with only such changes thereto, if any, as are of a nonmaterial nature (including without limitation such revisions as may be appropriate to address concerns of GHMSI and which do not affect BCBSD in any material respect) and approved by the DOI prior to the execution and filing thereof (the "CareFirst Charter"), and the CareFirst Charter shall have been filed with the Office of the Secretary of State of the State of Maryland.

7. No material changes shall be made to the form of Amended and Restated By-laws of CareFirst, as presented and introduced into evidence at the Hearing (Stipulated Exhibit 8) (the

“CareFirst By-laws”), without the prior approval of the DOI and such CareFirst By-laws, with any material changes approved by the DOI, shall have become effective.

EXHIBIT B

AMENDED AND RESTATED REQUIRED CONDITIONS

1. BCBSD 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. BCBSD and CareFirst shall comply with the provisions of 18 Del. C. Ch. 50 with respect to any future change of control or change in ownership of BCBSD. CareFirst shall be subject to the general supervisory authority of the Commissioner pursuant to 18 Del. C. Ch. 3 for the purpose of assuring the authority of the Commissioner to oversee and enforce the terms and conditions of Administrative Services and Business Affiliation Agreement and all terms and conditions of the Amended Order.
4. The Boards of Directors of BCBSD and CareFirst shall be restructured, to the extent necessary, to (i) comply with the terms of the amended and/or restated charters and bylaws of BCBSD and CareFirst as approved in accordance with and pursuant to this Amended Order and its conditions; and (ii) return majority membership in BCBSD to the Board of Directors of BSBSD. Any change in this structure must receive prior approval of the DOI.
5. Cost Allocations and Transfers: Payment by BCBSD pursuant to cost allocation agreements, service contracts, management, rental and any similar intercompany agreements with CareFirst shall be subject to the prior approval of the Commissioner.

BCBSD must notify the Commissioner in writing of its intention to engage in any transfer that requires the approval of the Commissioner under this paragraph 6 at least thirty (30) days prior to the actual transfer and may engage in the transfer only if the Commissioner approves the transfer. All transfers shall be deemed to be approved unless, within such thirty day period, the Commissioner disapproves the transfer in a writing setting forth her reasons for the disapproval.

A transfer shall not be made, and the Commissioner shall not approve a transfer, which (a) does not meet all requirements of applicable law, (b) does not comply with the terms of the Administrative Services and Business Affiliation Agreement, and specifically with Appendix "H" thereof, (c) would cause the policyholder surplus of BCBSD to fall below statutory reserve requirements of the Association, or (d) would cause BCBSD's RBC ratio to fall below 800% of the authorized control level.

All transfers of money, notes, investments, equipment or other assets between BCBSD and CareFirst or any of their subsidiaries or other affiliates must be properly recorded in the financial records of BCBSD 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.

Prior to the payment of any amounts referenced in Section 2.3(b) of the Administrative Services and Business Affiliation Agreement, BCBSD and CareFirst shall obtain the approval of the DOI- (if such approval has not already been obtained), and the DOI shall use its best efforts to review and, as appropriate, approve such payments no later than January 15, 2004.

6. Each calendar year, upon the BCBSD's board of director's annual deliberation with respect to the merits of transferring sole membership of BCBSD back to CareFirst in accordance with Section 2.4 of the Administrative Services and Business Affiliation Agreement, BCBSD shall provide the DOI and DOJ with notice of the outcome of such deliberation. Sole membership of BCBSD shall not be returned to CareFirst without the prior approval of the Commissioner.

7. Copies of all notices provided by BCBSD and CareFirst to the other Company under the Administrative Services and Business Affiliation Agreement, including, without limitation, all reports required under Article IV, any notice with respect to the initiation of Dispute Resolution under Section 8.9, and any notice related to termination of the Agreement under Article VII shall be provided to the DOI and the DOJ.

8. Any information provided to CareFirst by BCBSD, or by CareFirst to BCBSD, pursuant to Article IV of the Administrative Services and Business Affiliation Agreement shall be treated as confidential in accordance with the provisions of Section 8.11 that Agreement.

9. BCBSD shall not participate in any joint venture(s) with CareFirst, or any of its subsidiaries or other affiliates, to purchase any asset or assets without the prior written approval of the DOI.

10. BCBSD shall not convert to a for-profit status without the approval of the Commissioner.

11. 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 receive the 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.

12. The charter of BCBSD shall continue to provide that upon any dissolution its assets shall be distributed to another non-profit entity. Article Tenth of the BCBSD Charter as approved by this Amended Order and its conditions shall not be amended or altered without prior approval of the DOI and the DOJ.

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

14. These conditions and the Findings and Amended Order are subject to further orders, sanctions and proceedings as circumstances may require and are subject to further modification, amendment or supplementation and further review either *sua sponte* by the Commissioner or by motion of a party.

15. BCBSD and CareFirst shall continue to be subject to the jurisdiction of the DOI for the purpose of implementing and enforcing the terms of these conditions and this Amended Order.