

BEFORE THE COMMISSIONER OF INSURANCE STATE OF KANSAS

IN THE MATTER OF THE CONVERSION AND
ACQUISITION OF BLUE CROSS AND BLUE
SHIELD OF KANSAS, INC.

CASE NO. 3014-DM

TESTIMONIAL TEAM'S POST-HEARING BRIEF,
PROPOSED FINDINGS OF FACT AND CONCLUSIONS OF LAW

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TO THE HONORABLE COMMISSIONER SEBELIUS:

Pursuant to K.S.A. § 77-532 and paragraph 14 of the Commissioner's Procedural and Scheduling Order of August 21, 2001, the Kansas Insurance Department's Testimonial Team (the "Testimonial Team") hereby submits its post-hearing brief and proposed findings of fact and conclusions of law in the captioned matter. For the reasons set out herein, the Testimonial Team submits respectfully that the proposed demutualization and acquisition do not satisfy the applicable legal requirements. The Testimonial Team submits this brief based on the plan as it stood on January 10, when the Evidentiary Hearing had been concluded, the evidence closed, and the record ripe for decision, awaiting only the policyholders' vote and the parties' briefs. The conclusion expressed herein, however, is not altered by the rate stabilization fund first proposed by Anthem at a press conference today, the date upon which briefs are due, and long after the evidence in this matter has closed. As will be seen, even if it were in evidence (which it clearly is not), it would add absolutely nothing to the issues before the Commissioner. See page 25, below.

1. INTRODUCTION

Officially, this proceeding commenced on May 31, 2001, with the filing by Blue Cross and Blue Shield of Kansas, Inc. ("BCBSKS" or "Blue Cross") of its Plan of Conversion seeking authority for the demutualization of Blue Cross. On July 27, 2001, Anthem BCBS Insurance Companies, Inc. ("Anthem") filed its "Form A," seeking authority to acquire control of the demutualized Blue Cross. In actuality, the demutualization and acquisition (the "Proposed Transaction"), sometimes referred to as a "sponsored demutualization," was designed and proposed as one integral transaction by which ownership of BCBSKS would be transferred from its policyholders to Anthem. For this transfer, policyholders would receive a combined Purchase Price of up to \$321 million, of which no more than \$273 million is proposed to be paid soon after closing, the remaining \$48 million being held in a Contingent Litigation Matter Escrow Fund as described in the applications and the parties' papers filed herein.

Though steps by the Kansas Insurance Department to organize the Testimonial Team had commenced a few weeks before, analysis of the Proposed Transaction did not begin in earnest until

late July or early August.¹ During the ensuing months, experts and consultants for the Testimonial Team, Blue Cross, and Anthem devoted themselves to an extensive exchange and analysis of information regarding the sponsored demutualization. By the last week of December, in accordance with an accelerated schedule requested and pursued vigorously by BCBSKS and Anthem (referred to herein collectively as “the Applicants”), the analysis had been brought to a close. The Testimonial Team filed its PRE-FILED BRIEF (the “KID Brief”) and pre-filed testimony, responsive to the pre-filed brief filed by BCBSKS (the “BCBSKS Brief”) and Anthem (the “Anthem Brief”)² and the pre-filed testimony of BCBSKS and Anthem.

As explained more fully in the KID Brief, the Testimonial Team had:

... concluded that the Proposed Transaction is likely to result in increases in BCBSKS’ premium rates, above those that would occur in the absence of the Proposed Transaction (“additional rate increases”). These additional rate increases are likely to be of sufficient magnitude to justify a finding that they outweigh any benefits expected from the Plan. In the absence of adequate evidence to the contrary presented at the Evidentiary Hearing, the Commissioner would therefore be justified in concluding that, on that basis, the Plan will not be fair and equitable to policyholders and instead may be hazardous or prejudicial to the insurance-buying public. Aside from the issue of additional rate increases, it appears that the proposed conversion and acquisition satisfy the applicable statutory requirements.

KB at 12. Emphasis supplied. Were the Commissioner to approve the Proposed Transaction, the Testimonial Team had also recommended several conditions to which the approval should be made subject. See KB at 36-38. Thus, as the Evidentiary Hearing commenced on January 7, it was the view of the Testimonial Team that the Applicants must demonstrate during the hearing that the

¹Pursuant to K.S.A. §§ 40-3307(c) and 40-4013, the Kansas Insurance Department (“KID”) has authority to retain experts to assist in analyzing demutualizations and acquisitions. However, the department must follow specific procurement procedures including the Professional Services Sunshine Act (“PSSA”), K.S.A. §§ 75-37,130 *et seq.* Under the provisions of that statute, and utilizing an expedited procurement process, it was necessary that a request for proposal be prepared by the Division of Purchases and the KID for each area in which an expert or consultant was deemed necessary by the KID. It was then necessary that the requests for proposal be distributed to potential contractors. Thereafter, potential contractors’ questions were answered. Eventually, offers were received, analyzed, and reduced to a “short list” for each category. Offerors on the short list were interviewed and requested to submit best and final offers. The resulting offers were then analyzed and contractors were selected in all categories. Appropriate engagement letters were then negotiated with the successful contractors. This entire process consumed slightly more than 60 days.

²Citations herein to the KID pre-filed Brief will be stated as “KB at ___.” Citations to BCBSKS’ pre-filed brief will be referenced as “BPFB at ___” and to its Rebuttal Brief as “BRB at ___.” Those to Anthem’s pre-filed brief will be stated as “APFB at ___” and to its Rebuttal Brief as “ARB at ___.”

Testimonial Team's concerns regarding premium rate increases would not compel rejection of the Proposed Transaction. More specifically, it was the belief of the Testimonial Team that the Applicants should, and would, demonstrate that either: (1) they would not seek to realize the operating margins assumed by the Testimonial Team, or (2) they would achieve such operating margins without the premium rate increases feared by the Testimonial Team. In addition, the Testimonial Team expected the Applicants to demonstrate at the Evidentiary Hearing that the Proposed Transaction would produce benefits and advantages for policyholders and the insurance-buying public outweighing the concerns about premium rate increases. Leaving no doubt as to these matters, the Testimonial Team advised the Commissioner and the Applicants as follows:

The Testimonial Team believes that the anticipated transaction-related premium rate increases, when compared to the speculative conversion benefits articulated by the parties, are of sufficient magnitude to support a conclusion that the Proposed Transaction will not be fair and equitable to policyholders and instead may be hazardous or prejudicial to the insurance-buying public. However, the Testimonial Team recognizes that sufficient evidence may be presented to the Commissioner at the Evidentiary Hearing to justify the contrary conclusion.

KB at 36. There could have been little doubt, therefore, as to the principal issue to be addressed at the hearing. As will be seen, however, the Applicants did not in fact provide satisfactory responses to the key issues posed by the Testimonial Team. Accordingly, it remains the view of the Testimonial Team that the record before the Commissioner justifies, indeed compels, the conclusion that the Proposed Transaction is likely to result in significant premium rate increases that would not occur in the absence of the demutualization and acquisition. Moreover, the Testimonial Team does not believe that the Applicants produced evidence of benefits from the Proposed Transaction that justify such premium rate increases. Consequently, it is the considered conclusion of the Testimonial Team that the Proposed Transaction is not likely to be fair or equitable to policyholders. Indeed, it is likely to be hazardous or prejudicial to the insurance-buying public.

2. BACKGROUND

The Testimonial Team sets out herein a brief summary of salient elements of the background and history of this proceeding, serving as the context within which the conclusions expressed herein must be evaluated.

1. PROCEDURAL HISTORY AND BACKGROUND

On May 30, 2001, BCBSKS and Anthem entered into an Alliance Agreement (the “Agreement”) for a sponsored demutualization whereby Anthem BCBS or a designated affiliate would, in a single transaction, purchase the stock of BCBSKS (the “Acquisition of Control”) immediately following conversion of BCBSKS from a mutual life insurance company to a stock life insurance company (the “Conversion”).

On May 31, 2001, Blue Cross submitted a draft plan of conversion (the “Draft Plan of Conversion”) to the Kansas Commissioner of Insurance (the “Commissioner”) for review and comment prior to adoption of such a plan of conversion by the Board, pursuant to K.S.A. § 40-4002(b).

On July 27, 2001, Anthem filed a “Statement Regarding the Acquisition of Control of or Merger with a Domestic Insurer” (the “Form A”), pursuant to K.S.A. § 40-3304 (the “Kansas Insurance Holding Companies Act”), seeking the Commissioner’s approval of the transfer of the shares of BCBSKS, upon conversion, to Anthem or a designated affiliate (the “Designated Purchaser”).

The regulatory review and proceedings associated with the Transaction were conducted pursuant to the Kansas Administrative Procedures Act, K.S.A. §§ 77-501 *et seq.*, and the Procedural Order issued by the Commissioner, under authority of K.S.A. § 77-517(c), on August 21, 2001.

The Alliance Agreement was amended on September 28, 2001, to extend, from September 30, 2001, to November 30, 2001, the date by which a plan of conversion was required to be adopted by the Board.

On October 23, 2001, the Commissioner entered her Order on Intervention, denying the petition to intervene of William E. Dakan and granting the petitions to intervene with full rights of participation of the Kansas Medical Society (the “KMS”), the Kansas Hospital Association (the “KHA”), the Kansas State Nurse’s Association (the “KSNA”), and the Kansas Association of the Medically Underserved (the “KAMU”).

On October 25, 2001, the Board adopted a plan of conversion (the “Plan of Conversion”), which BCBSKS formally submitted to the KID on October 26, 2001.

Pursuant to the Plan of Conversion, if approved by the Commissioner and BCBSKS policyholders eligible to vote (“Eligible Policyholders”), and if other conditions are satisfied, BCBSKS would convert to a stock company and all policyholders’ membership interests would be extinguished. Eligible Policyholders, as determined under the Plan of Conversion, would receive (i) a special distribution (the “Special Distribution”), to the extent declared by the Board of Directors of BCBSKS, that would be no greater than the amount, if any, by which the book value of BCBSKS at the date the

Conversion becomes effective (the “Closing Book Value”) exceeds \$155 million and (ii) subject to the Plan of Conversion, the sum of \$190 million (the “Purchase Price”). The Special Distribution would be paid in cash to the Eligible Policyholders as provided in the Plan of Conversion. Of the Purchase Price, \$142 million would be distributed to Eligible Policyholders. The remaining \$48 million of the Purchase Price would be deposited into an Escrow Fund pending the resolution of the Contingent Litigation Matter (the “CLM”). Amounts left in the Escrow Fund after that resolution and satisfaction of certain related liabilities, would also be distributed to Eligible Policyholders.

On November 9, 2001, BCBSKS and Anthem amended the Agreement, which is an exhibit to the Plan of Conversion and the Form A. The Agreement was amended to reflect changes or modifications in at least three areas: (a) the amount of the Purchase Price to be deposited into escrow; (b) the appointment procedures for the Policyholder Committee; and (c) tax matters related to the escrow account and the CLM.

Between November 19, 2001, and November 27, 2001, BCBSKS mailed to 171,403 Eligible Policyholders the Policyholder Information Statement, the Policyholder Instruction Guide, and the Plan 65 Information document.

Commissioner Sebelius conducted public comment meetings regarding the Transaction in Hays and Garden City on December 4, 2001, Wichita on December 5, 2001, Pittsburg on December 13, 2001, and Topeka on December 14, 2001. Persons attending were given presentations by BCBSKS, Anthem, and the Testimonial Team, and allowed to voice their opinions to the Commissioner regarding the proposed transaction. Interested persons were given the opportunity to make sworn statements to be made part of the formal record.

Pre-filed testimony and briefs were filed by BCBSKS and Anthem on December 17, 2001, and by the Testimonial Team and the Intervenors on or before December 31, 2001. On January 4, 2002, BCBSKS and Anthem filed rebuttal pre-filed testimony and briefs.

From January 7-9, 2002, pursuant to K.S.A. §§ 40-3304(d)(1), 40-4004, and 77-501 *et seq.*, the Commissioner held an Evidentiary Hearing (the “Evidentiary Hearing”) on the Transaction in the Emerald Ballroom, of the Capital Plaza Hotel, located at 1717 S.W. Topeka Boulevard, Topeka, Kansas.

At the Evidentiary Hearing, the Kansas Insurance Department was represented by the Honorable Kathleen Sebelius, as Hearing Officer, and her staff, Mr. Matthew All, Mr. Brent Getty, and Ms. Carol Foreman.

At the Evidentiary Hearing, Blue Cross and Blue Shield of Kansas, Inc. presented witnesses who gave direct testimony in support of the Plan of Conversion and who were available for questioning by Anthem, the KID Testimonial Team, and the Intervenors. BCBSKS’ witnesses were

John W. Knack, Michael M. Mattox, Paul J. Feldstein, Donald R. Lynn, Paul Adams, William H. Pitsenberger, and Henry N. Butler. BCBSKS was represented by Mr. Gary D. McCallister, Mr. Thomas Kelliher, Mr. James Scoville, Mr. Carl Micarelli, and Mr. Eric Unrein.

At the Evidentiary Hearing, Anthem presented witnesses who gave direct testimony in support of the Plan of Conversion and who were available for questioning by BCBSKS, the KID Testimonial Team and the Intervenors. Anthem's witnesses were Mr. Larry Glasscock, Mr. Michael L. Smith, Dr. Samuel Nussbaum, Ms. Donna Moore and Mr. David Frick. Anthem was represented by Mr. Randy Forbes, Mr. John Frieden and Mr. Doug Fauth.

At the Evidentiary Hearing, the KID Testimonial Team presented witnesses who gave direct testimony regarding their analysis of the Plan and who were made available for questioning by BCBSKS, Anthem, and the Intervenors. The Testimonial Team's witnesses were Ms. Kathy Greenlee, Mr. David M. Platter, Mr. Kenneth M. Beck, Ms. Denise Essenberg, Mr. Mark H. Kovey and Ms. Sandra S. Hunt. The Testimonial Team was represented by Ms. Kathy Greenlee, Ms. Linda Sheppard, and Mr. Patrick H. Cantilo.

At the Evidentiary Hearing, the Intervenors presented witnesses who gave direct testimony in opposition to the Plan and who were made available for questioning by BCBSKS, Anthem, and the KID Testimonial Team. The Intervenors' witnesses were Mr. Carl J. Schramm, Mr. Marvin M. Fairbank, and Ms. Dawn Touzin. The Intervenors were represented by Mr. Charles R. Hay, Mr. Steve Schwarm, Mr. Douglas S. Laird, and Ms. Karen A. Eager.

2. APPLICANTS' ACCELERATED SCHEDULE

The sponsored demutualization proposed by BCBSKS and Anthem is a complex and demanding transaction intended to alter fundamentally the structure and business of the State's largest health insurer. It gives rise to a variety of important issues, requiring analysis by experts in a multitude of disciplines. Transactions of this nature and magnitude normally undergo many months (if not years) of regulatory review and consideration. During such review, there is typically abundant opportunity for exchange of views and information between the applicants and the regulators. Often, that exchange results in the resolution of the regulators' concerns, at times manifesting themselves in essential changes in the proposed transaction.³ In the instant case, the Applicants were granted an

³For example, Trigon Blue Cross and Blue Shield of Virginia first proposed its conversion in the Summer of 1994. The Virginia Bureau of Insurance analyzed the proposal and expressed substantial reservations. In due course, the proposed transaction underwent substantial revision and ultimately was approved as a demutualization and initial public offering on November 5, 1996. Similarly, Blue Cross and Blue Shield of Colorado ("BCBSCO") first proposed its conversion on January 14, 1997 (following weeks of informal discussions). The initial proposal contemplated that the company become a for profit stock corporation with an initial public offering of its stock in the capital markets and conveyance of restricted stock to one or more "Qualifying Entities" intended to

expedited schedule embodied in the Commissioner's PROCEDURAL AND SCHEDULING ORDER (August 21, 2001) and SCHEDULE OF PROCEEDINGS (October 26, 2001). Under this schedule, the Evidentiary Hearing on the Plan of Conversion, (submitted first in draft form on May 31, 2001, and as finally adopted by the Board on October 26, 2001), and Form A filed on July 27, 2001, was set for January 7, 2002, just over seven months after the first filing and barely two months after the Board's adoption. In fact, the Testimonial Team was not fully organized and able to begin analysis in earnest until August, 2001.⁴ Thus, the review of the Proposed Transaction by the Testimonial Team has been completed in a scant four to five months.

The Applicants were adamant, however, that the Proposed Transaction be reviewed very rapidly and that an evidentiary hearing be held even before year-end. See, for example, the transcripts of the Status Conferences of October 25, 2001 (pp. 34 *et seq.*), and November 13, 2001 (pp. 33-34), appended as Attachment 1 to this brief. Despite the complexity of the transaction, Blue Cross pushed hard for adoption by its board of directors of a formal Plan of Conversion before the end of September, 2001. Eventually, this schedule was adjusted by one month, the Board having adopted the Plan of Conversion in late October following substantial amendments made necessary by observations of the Testimonial Team even in these initial stages. Thus, this plan was adopted by BCBSKS' board of directors even before the Testimonial Team could conclude its review.

A consequence of this accelerated schedule has been a very limited ability for the Applicants and the Testimonial Team to explore and resolve concerns to which the conversion gave rise. Nonetheless, understanding the value placed by the Applicants on an expedited proceeding, the Testimonial Team has worked vigorously to complete review of the Proposed Transaction within that time frame. Some aspects of the review undoubtedly would have been more thorough had more time been available. And, with more time, the Applicants might have provided fuller responses to the many questions and requests for information posed by the Testimonial Team. Moreover, greater participation by the Intervenors might also have been possible. But the Testimonial Team is confident that its conclusions, as expressed here, in the KID Brief, and in the testimony of its consultants, are fundamentally justified and sound.

3. THE PROPOSED TRANSACTION

While Blue Cross had earlier made informal suggestions to Kansas Insurance Department representatives that it was pursuing reorganization, the first formal step in that endeavor was its submission on May 31st of the draft plan of conversion. On July 27, 2001, Anthem filed its Form A.

satisfy applicable statutory requirements. When regulators expressed substantial concerns about these proposals, vigorous exchanges of information (and more formal proceedings) resulted in a fundamental restructuring of the proposed conversion, culminating in the sale of BCBSKO to Anthem, approved by Commissioner Kirven on November 5, 1999.

⁴As noted above, upon receipt of the draft application, it was necessary that the KID seek and satisfy applicable statutory requirements of the PSSA.

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On October 25, 2001, the board of directors of BCBSKS formally adopted a revised plan of conversion, of which Blue Cross sought the Commissioner's approval at the Evidentiary Hearing.

The Plan of Conversion proposes to convert Blue Cross from a mutual life insurance company owned by its policyholders to a stock company. In the demutualization, policyholders would receive cash consideration in compliance with K.S.A. § 40-4004(b). The Form A contemplates that all of the stock of BCBSKS created in the demutualization will be purchased by Anthem.

The parties clearly contemplate that the demutualization and acquisition (the "sponsored demutualization") be one integral transaction. In fact, part of the consideration to be paid to policyholders in satisfaction of the statutory requirement for demutualization is proposed to be a payment by Anthem. While the payment by BCBSKS to its policyholders is expected to be no more than \$131 million, Anthem is expected to add another \$142 million. Were it not for the contribution by Anthem to the policyholder distribution, the demutualization would not satisfy the statutory fairness standard set forth in K.S.A. § 40-4004(b). Though documentation of this fact is the subject of one of the conditions recommended by the Testimonial Team, the statutory surplus of BCBSKS at the time of closing is expected to be approximately \$190 million. Lynn TR at 309. The \$131 million distribution proposed to be made by BCBSKS itself obviously falls far short of this amount. It is the addition of Anthem's \$142 million that enables the Proposed Transaction to comply with this statutory requirement. This is but one illustration of the importance of treating the demutualization and acquisition as one single, and indivisible, transaction and reorganization.

It is clear that the parties themselves so intended. BCBSKS' Chief Executive Officer, John Knack, made this clear:

11 Q. I see. Thank you, sir. The
12 company has adopted a plan of conversion and
13 then entered into an alliance agreement with
14 Anthem, has it not, sir?

15 A. Yes, it has.

16 Q. Do you view those two documents
17 and the transactions to which they relate as
18 being part of one transaction?

19 A. Yes.

20 Q. You are not seeking the
21 Commissioner's approval of your plan of
22 conversion if she will not also approve the
23 Anthem acquisition of all of your stock
24 following conversion. Is that correct?

25 A. That's correct.

1 Q. And you do not contemplate that

2 the acquisition would be approved without a
3 conversion, do you, sir?
4 A. No, we do not.
5 Q. So it would be fair for the
6 Commissioner and all the parties to look at
7 both parts as part of one transaction?
8 A. Yes.

Knack TR at 58-59. Emphasis added. See also the testimony of Mr. Mattox (TR at 141); Mr. Lynn (TR at 310-311) and Mr. Glasscock (TR at 586).

The documents themselves are not ambiguous on this point. The Alliance Agreement specifies that “the Plan of Conversion provides for and is contingent on the sale (the “Sale”) of all of the shares of common stock of BCBSKS . . . immediately following the Conversion to [Anthem].” The Plan of Conversion provides for “the conversion of the Company into a stock insurance company and the sale of the newly-issued shares of Common Stock to Anthem.” The Form A provides: “The Alliance Agreement and BCBS-KS’s Plan of Conversion contemplate that, upon the effectiveness of the conversion of BCBS-KS from a mutual insurance company to a stock insurance company, the stock of BCBS-KS will be issued directly to Anthem.” It is indisputable therefore, that the Plan of Conversion, the Form A application, and the Alliance Agreement are all part of the same transaction.

All writings that are part of the same transaction are interpreted together. Reznik v. McKee, 534 P.2d 243, 256 (Kan. 1975); Burge v. Frey, 545 F. Supp. 1160, 1169 (D. Kan. 1982); Restatement (Second) of Contracts § 202(2) (1981). Because the Plan of Conversion, the Alliance Agreement, and the Form A application are all part of the same transaction, the Commissioner must scrutinize all three pursuant to requirements of the Conversion Statute including, *inter alia*, that the plan shall be disapproved unless found to be “fair and equitable to policyholders.” K.S.A. § 40-4004(a)(1). Because the Plan of Conversion, the Alliance Agreement and the Form A application are all part of the same transaction, the Commissioner must scrutinize all three pursuant to requirements of the Insurance Holding Company Act, including, *inter alia*, that the plan shall be approved unless it is found to be “hazardous or prejudicial to the insurance-buying public.” K.S.A. § 40-3304(d)(1)(E). In short, given the indivisible nature of the transactions, and as the parties themselves have acknowledged, the Commissioner should view them as one single transaction which must satisfy all of the requirements of both, the Demutualization Statute and the Kansas Insurance Holding Companies Act.

4. PRINCIPAL STATUTORY REQUIREMENTS AND REVIEW STANDARDS

While complex transactions of this nature are subject to numerous statutory and regulatory requirements, there are key statutory provisions that will govern the Commissioner's analysis of the Proposed Transaction. The relevant statutes provide in pertinent part:

[Standard of Review, Demutualization]: K.S.A. § 40-4004.

- (a) The Commissioner shall approve the plan if the Commissioner finds that:
 - (1) The plan of conversion is fair and equitable to policyholders;
 - (2) The plan of conversion complies with the provisions of this act;
 - (3) The plan of conversion does not unjustly enrich any director, officer, agent, or employee of the insurer; and
 - (4) The new stock insurer would meet minimum requirements to be issued a certificate of authority by the Commissioner to transact business in this state, and the continued operations of the new stock insurer would not be hazardous to existing or future policyholders or the public.
- (b) The amount of consideration provided by the converting insurer to policyholders shall be deemed to be fair and equitable pursuant to subsection (a), if the consideration is at least the amount of statutory surplus attributable to contributions of policyholders.

[Standard of Review, Acquisition]: K.S.A. § 40-3304. (d)(1) The Commissioner of insurance shall approve any merger or acquisition of control referred to in subsection (a) of this section unless, after an Evidentiary Hearing thereon conducted in accordance with the provisions of the Kansas administrative procedure act, 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 financial condition of any acquiring party is such as might jeopardize the financial stability of the insurer or prejudice the interest of its policyholders;
- (C) 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 any other material changes in its business or corporate structure or management, are

unfair and unreasonable to policyholders of the insurer and not in the public interest; or

- (D) 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
- (E) the acquisition is likely to be hazardous or prejudicial to the insurance-buying public.

As first reported in its pre-filed brief, it is the view of the Testimonial Team that, subject to the conditions recommended, the Proposed Transaction complies with all of the foregoing requirements except potentially to the extent of anticipated premium rate increases which would not occur in the absence of the conversion.

5. OTHER STATUTORY AND PROCEDURAL MATTERS

The relevant statutes also impose upon the parties certain procedural and notice requirements. The Testimonial Team believes that those requirements have been met. While it is the Applicants' burden to demonstrate compliance with these requirements, the Testimonial Team observes that there is evidence in the record (or reasonably anticipated) to that effect. Thus, the evidence shows that two thirds of the entire board of directors of BCBSKS adopted the resolution contemplated in K.S.A. § 40-4002(a) and subsequently approved the Plan of Conversion. See Exhibit 28.⁵ As required by § 40-4002(c), the Plan of Conversion was submitted to the Commissioner for approval in writing. See BCBSKS Exhibit 27. The Testimonial Team has been informed that more than a majority of BCBSKS' policyholders then voted on the plan and that more than sixty percent of those voting approved the conversion. While there is not as yet evidence on the record to that effect, the Testimonial Team expects BCBSKS to furnish such evidence and the Testimonial Team's consultants to confirm that report. Similarly, the Testimonial Team anticipates that BCBSKS will file the Plan of Conversion in the office of the Commissioner as contemplated in § 40-4002 (f).

⁵References to "Exhibits" are to the exhibits admitted into evidence during the Evidentiary Hearings. ~~TESTIMONIAL TEAM'S POST-HEARING BRIEF,~~
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The Plan of Conversion filed in October (Exhibit 1) addresses the requirements of § 40-4003a(a). The Testimonial Team concurs in BCBSKS' position that a closed block as described in § 40-4003b is not appropriate in this transaction. See BPFB at 11, Exhibits 17 and 18, (opinion and pre-filed testimony of Dan McCarthy), and testimony of Dan McCarthy, Transcript of the Evidentiary Hearing⁶ at pp. 403-406.

Similarly, the Form A filed by Anthem complies with the procedural and filing requirements of K.S.A. § 40-3304.

Therefore, as was true before commencement of the Evidentiary Hearing, and assuming adoption of (and compliance with) the conditions recommended by the Testimonial Team, the singular outstanding issue is the extent to which reasonably anticipated premium rate increases result in the Proposed Transaction not satisfying all the requisite statutory provisions. More specifically, does the likelihood of premium rate increases resulting from the conversion (which would not be expected to occur in its absence) prevent the plan from meeting these conditions?

3. DETERMINATION OF FAIRNESS

In its pe-filed brief, the Testimonial Team suggested that the anticipated premium rate increases called into question whether the Proposed Transaction would be fair and equitable to policyholders or hazardous and prejudicial to the insurance-buying public. KB at 36. It was suggested therein that the anticipated premium rate increases be weighed against the expected benefits of the conversion. The relevant statutes do not offer guidance as to how the determinations should be made regarding whether the Proposed Transaction would be fair and equitable to policyholders or hazardous and prejudicial to the insurance-buying public. Balancing the obvious burden or disadvantage of such likely increases against the likely advantages of the transaction is, therefore, a logical approach for that determination. That balancing should consider:

1. The likely benefits or advantages to policyholders and the insurance-buying public of the proposed conversion;
2. the likelihood of rate increases resulting from the transaction;
3. the likelihood that the same rate increases would occur without the transaction; and
4. whether rate increase attributable only to the Proposed Transaction outweigh benefits or advantages it is expected to produce.

1. BENEFITS OR ADVANTAGES OF THE PROPOSED CONVERSION

⁶References to the transcript of the Evidentiary Hearing will hereinafter be denominated as ~~TESTIMONIAL TEAM'S POST-HEARING BRIEF,~~
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BCBSKS asserts that “*the conversion and acquisition are in the best interests of BCBSKS, its policyholders and the insurance-buying public*” (BPFB at 3) and purports to identify a number of reasons for, and perceived benefits or advantages from, the conversion. BPFB at 7, BRB at 15-20. The “evidence” upon which Blue Cross relies to demonstrate these reasons, benefits or advantages consists principally of the largely uncorroborated testimony of BCBSKS’ President and Chief Executive Officer, John W. Knack, Jr. (Knack PFT at 5-6)⁷; and of its Vice President of Finance, Mr. Donald R. Lynn (Lynn PFT at 4). The reasons offered for the conversion are:

1. Enhancing BCBSKS’ strategic and financial flexibility.
2. Spreading costs over a sufficiently large policyholder base.
3. Reducing susceptibility to adverse local illness, legislation, natural disaster or targeted competitor pricing.

Mr. Knack also identifies at page 6, and Mr. Lynn at page 4, of their pre-filed testimony the seven advantages BCBSKS expects the Proposed Transaction to produce. They identify them as:

1. Payments to policyholders,
2. access to capital,
3. economies of scale,
4. diversified geographical base,
5. access to multi-state accounts,
6. better career paths, and
7. ability to take advantage of best practices.

At page 7 of his pre-filed testimony, Mr. Knack also mentions the expectation that the sponsored demutualization “would give the Company the ability to survive and grow in the highly competitive health insurance and services industries.” Finally, at page 13 of his pre-filed testimony, Mr. Knack suggests that the transaction will enable BCBSKS to serve its policyholders better.

In balancing the burdens against the benefits or advantages of the demutualization, it is the interests of the policyholders and the insurance-buying public that are of paramount importance, not those of the corporation, its management or directors. Analysis of the benefits or advantages described by Messrs. Knack and Lynn reveals why they perceive that the transaction might be desirable from a corporate perspective. In the main, they expect it to facilitate the company’s growth and competitive potential. It is not self-evident, however, that such increased growth and enhanced competitive position necessarily inure to the benefit of policyholders and the insurance-buying public.

ENHANCED STRATEGIC AND FINANCIAL FLEXIBILITY

⁷References to the pre-filed testimony of a witness shall hereinafter be denominated as “Doe PFT at ____,” whereas references to Evidentiary Hearing testimony will be denominated as “Doe TR at ____.”

**TESTIMONIAL TEAM’S POST-HEARING BRIEF,
PROPOSED FINDINGS OF FACT AND CONCLUSIONS OF LAW**

A review of the record reveals that the perceived benefits or advantages may be overstated and largely do not inure to the benefit of policyholders and the insurance-buying public. Thus, for example, the notion that the Proposed Transaction will enhance BCBSKS' strategic and financial flexibility is open to some debate. Mr. Knack himself concedes that Anthem has not agreed to put a single penny into the company's surplus. In fact it will not even restore the \$131 million that will be distributed to policyholders. See Knack TR at 65-66. Arguably, therefore, BCBSKS will be weaker financially after implementation of the sponsored demutualization. Of course, the Applicants will argue that Anthem will offer guarantees that achieve this goal. But it is notable that no detail has yet been offered as to the terms of those guarantees. Nor are they included in the Plan of Conversion or the Alliance Agreement filed with the Commissioner.⁸ In any event, the guarantees will not extend to the company's obligations to creditors other than policyholders. Smith TR at 666-667; Frick TR at 801-802. Thus, as to reinsurers, taxing authorities, regulators' fees, trade creditors, and other non-policyholder creditors, this acquisition will not "enhance [BCBSKS]' strategic and financial flexibility." Indeed, these creditors will find themselves dealing with a company that is not as well capitalized. In that sense at least, the Proposed Transaction may actually be contrary to the public interest. In any event, no evidence has been offered indicating that BCBSKS is now financially unsound as regards policyholders and, therefore, needs Anthem's guarantees.

ABILITY TO SPREAD COSTS OVER A "SUFFICIENTLY LARGE" POLICYHOLDER BASE

Mr. Knack next suggests that the company must convert in order to grow and, therefore, be able to spread its costs over a "sufficiently large" policyholder base. Knack PFT at 5. Presumably, this is an argument for the growth that purportedly will be facilitated by this merger. In fact, Mr. Knack concedes that the company already has a strategy for growing without the conversion, namely by offering "un-branded" products in other markets. And he concedes that the value of the Blue Cross and Blue Shield "mark" is diminishing in any event. Knack TR at 67. Again, BCBSKS offers no evidence as to why this is not a sufficient growth strategy insofar as ability to spread costs is concerned. Nor, despite repeated requests has BCBSKS explained or demonstrated how the sponsored demutualization will result in growth in enrollment, enhance efficiencies, or "spread costs" more effectively. Knack TR at 68-69. More importantly, no evidence has been offered to the effect that inability to spread costs is currently a problem and, therefore, that policyholders will benefit by increasing cost-spreading ability.

EXPOSURE TO LOCAL EVENTS

⁸In fact, On January 16, 2002, counsel for the Testimonial Team again inquired as to the terms of the guarantee and other conditions recommended to the Commissioner. This inquiry was received by counsel for Blue Cross and Anthem the next day. See Attachment 2 to this brief. However, ~~TESTIMONIAL TEAM'S POST-HEARING BRIEF~~ provided no reply in the ensuing week.

As the third reason for the conversion, Mr. Knack cites the company's susceptibility to local illness, adverse local legislation, natural disaster, or targeted pricing by competitors. But as Mr. Knack readily admits, the transaction will not lessen the company's exposure to such events. Knack TR at 68. Indeed, he concedes that the combined company would be subject to such events in nine states, rather than just Kansas. Remarkably, no evidence is offered for the implicit (but amazingly unstated) proposition that the larger resulting company will be in a better position to weather such events. Especially, not one shred of evidence has been placed before the Commissioner to the effect that the Proposed Transaction will benefit policyholders by lessening the purportedly adverse consequences of the company's exposure to local events.

PAYMENTS TO POLICYHOLDERS

More directly seeking to identify anticipated benefits of the conversion to policyholders, Mr. Knack and Mr. Lynn each discuss the proposed payments to Eligible Policyholders. Knack PFT at 3; Lynn PFT at 4-5. But as Mr. Knack readily concedes, these payments will only be made to approximately 25% of BCBSKS' insureds. Knack TR at 69-70. Moreover, these recipients are not principally the policyholders who would face the disproportionate rate increases. Hunt TR at 1147. While the Commissioner should certainly take these payments into account in weighing the benefits and burdens of the Proposed Transaction, it is material that they will only be made to less than one in four of the company's insureds, and those not necessarily the most adversely affected.

ACCESS TO CAPITAL

Mr. Knack and Mr. Lynn also tout the anticipated increased access to capital with which to grow and compete. Knack PFT at 6, Lynn PFT at 4. But as noted above, Mr. Knack admitted on cross-examination that, in fact, BCBSKS will have less capital after the transaction, with no commitment that more will be added. Indeed, asked about the anticipated surplus after the Proposed Transaction, Mr. Lynn was very clear:

- 15 Q. *If that amount of surplus that you*
16 *left behind, that's not enough to make you*
17 *feel good about this company, is it?*
18 A. *Not - not with the type of*
19 *expenditures that we see coming up in our*
20 *future.*

Lynn TR at 337. It is only the prospect of the as-yet-undocumented Anthem guarantee that enables Mr. Lynn to support this conversion. *Ibid.* Moreover, the perceived advantage of this illusory access to capital inures to the benefit of the company, not its policyholders. It is expected to enable BCBSKS to compete and grow, abilities perhaps desirable to management but of no particular value to policyholders. Thus, if as management concedes, the Proposed Transaction will not actually

strengthen the company financially, enabling its parent to make more acquisitions or compete more aggressively can hardly be characterized as a policyholder benefit.

ECONOMIES OF SCALE

Perhaps most directly on point with what has emerged as the central issue in this matter is the suggestion that the conversion will produce economies of scale. Knack PFT at 6; Lynn PFT at 4. Given its concern that the sale to a stockholder-owned, profit-motivated, parent would compel BCBSKS to realize substantially higher operating margins than it has historically, the Testimonial Team has long sought indications of savings to offset the consequent premium rate increases. Astonishingly, no adequate demonstration to that effect has yet been provided.

As has been amply documented during the Evidentiary Hearing, the Testimonial Team made its concern clear very early in its analysis of the Proposed Transaction. On September 5, 2001, it wrote to Blue Cross and Anthem asking for detailed pricing and budget information, seeking to ascertain to what extent the conversion might actually reduce operating or other costs. See Exhibit 44, pp. 6-8; Frick TR at 808-809. The response does not provide any documentation or analysis of anticipated economies of scale or cost savings. See Exhibit 45, pp. 12-14; Frick TR at 813-817. On September 19, the Testimonial Team again requested “analysis of significant synergies and cost savings expected....” In response, Anthem offered undocumented general assertions that less than \$500,000 is anticipated to be saved by the consolidation. See Exhibit 46, page 4.

In mid-October, in two separate communications, the Testimonial Team once again expressed its desire for such information and expressed concern about its paucity. See Exhibit 48, page 9. The second communication has been excluded from the evidentiary record at the request of the Applicants. However, it is undisputed that in that October 15 letter the Testimonial Team advised BCBSKS and Anthem: “Similarly, if Blue Cross has suggested or will suggest that the Proposed Transaction will produce efficiencies or cost savings, it must offer analytical evidence of that conclusion. Thus far we have seen no such indications of sufficient specificity to warrant representations to that effect.” See testimony of David Frick TR 826-827. The reply on November 9 continued to assert the absence of any such analysis or documentation. See Exhibit 49, page 3.

Later in November, representatives of the Testimonial Team and the Applicants engaged in extensive discussions regarding the proposed Policyholder Information Statement. In those discussions, Testimonial Team representatives reiterated emphatically their concerns about the probability of premium rate increases and the absence of evidence of offsetting cost savings. Ultimately, the Applicants agreed to disclose this issue in the Policyholder Information Statement. See, for example, the Policyholder Information Statement, Exhibit 23, page 12, stating, *inter alia*:

The transaction may result in future premium increases and/or other measures to return to

*profitability. *** These measures may include material premium increases, initiatives to improve operating efficiencies and cost containment measures. The nature and impact of these measures have not been identified and their efficacy cannot be assured.*

Emphasis in the original. And as the Public Comment Meetings commenced in early December, the Testimonial Team again voiced its continuing concern, both in its introductory comments and in responses to questions from policyholders or other interested persons. See, for example, the transcripts of the Public Comment Meetings on December 4, 2001, in Hays (pp. 46-48) and Garden City (page 31); on December 5, 2001, in Wichita (pp. 37-39); on December 13, 2001, in Pittsburg (page 32), and on December 14, 2001, in Topeka (pp. 44-47), relevant excerpts appended as Attachment 3 to this brief. Whatever else may be true, there can be absolutely no doubt that Blue Cross and Anthem have been made keenly aware, continuously during the pendency of this proceeding, that the possibility of premium rate increases, and the need for documentation of potential cost savings, have been paramount among the Testimonial Team's concerns. These numerous and frequent requests and expressions of concern did not succeed in eliciting any further analysis or documentation regarding anticipated economies of scale or cost savings. See, for example, Frick TR at 817-827. It is inexplicable that no evidence was adduced by the Applicants at the Evidentiary Hearing to address this overriding issue.

Perhaps in a late and feeble effort to respond to what must have by then seemed a monotonous series of such requests, in December, after the Public Comment Meetings had commenced, Mr. Forbes produced a document. What he produced was a new schedule of anticipated efficiencies purporting to summarize just over \$7 million in savings during the next several years. See Exhibit 61. But no detail or analysis was offered in support of that schedule. Its insignificance is made most clear perhaps by the fact that it had not been offered by Anthem at the Evidentiary Hearing in support of that proposition nor made part of Anthem's pre-filed testimony. In what seemed like a fitting final chapter in this lamentable saga, as part of its rebuttal filings, Anthem provided a new schedule of anticipated savings. See Exhibit 50. No opportunity had been provided the Testimonial Team to analyze that schedule first distributed Friday evening, January 4, immediately preceding the commencement of the Evidentiary Hearing on Monday January 7. Perhaps even more surprising is the fact that, as was true of Exhibit 61, this schedule provides only summary information without analysis, detail, or explanation.

The record is replete with concessions by Blue Cross and Anthem that they have not demonstrated with any degree of specificity, or documentation, an ability to produce material savings or economies of scale as the result of the Proposed Transaction. See Knack TR at 68-69 and 91-92; Mattox TR at 185-187; Smith TR at 649-652; Frick TR at 805-808; and Hunt TR at 1141-1144. See also Exhibits 44, 45, 46, 48, and 49. At most, their undocumented assertions suggest savings which may reach .7% of premium. Even if these assertions were taken as true, they constitute, at best, a

slight potential benefit or advantage to policyholders and the insurance-buying public, to be balanced against the much more significant anticipated premium rate increases discussed more fully below.

DIVERSIFIED GEOGRAPHICAL BASE

It is also suggested that the conversion will result in a diversified geographical base providing increased flexibility in responding to local events. Knack PFT at 6; Lynn PFT at 4. But as noted above, Blue Cross will remain subject to such local events following the restructuring. The consolidated Anthem companies will in fact be subject to such events in nine states rather than just Kansas. And there is no explanation about how this will be a benefit or advantage to policyholders or the insurance-buying public. More importantly, other than simply stating that the transaction will have this effect, BCBSKS and Anthem provide no analysis as to how it is a benefit and do not attempt to quantify its anticipated value.

BETTER CAREER PATHS

It is also suggested that, as part of the Anthem companies, BCBSKS will be able to offer better career paths to its current and potential employees. Again, if this is an advantage at all, its value inures to the benefit of the company and its staff, not to policyholders or the insurance-buying public. There has been no suggestion that BCBSKS has had trouble recruiting and retaining sufficient competent staff and management. Indeed, while suggesting that Topeka may not be a very luring job site, Company officials concede that the Anthem affiliation is not likely to improve its attraction for potential employees. Moreover, they concede that they have excellent staff and that this issue has not prevented them from operating safely and for the benefit of policyholders. Mattox TR at 142-145.

BEST PRACTICES

The last purported benefit or advantage is the suggestion that the conversion will enable BCBSKS to take advantage of “best practices” in use at Anthem. One more time, this may be an advantage to the company, but no effort has been made to demonstrate how, and to what quantitative extent, this will help policyholders or the insurance-buying public.

Blue Cross’s Executive Vice President, Mike Mattox, acknowledges that BCBSKS would seek to implement such practices, with or without the conversion, whenever it learned of them. Mattox TR at 145. Thus, the benefit, if any, would lie in informing BCBSKS of “best practices” of which it could not learn otherwise. No evidence has been offered as to the parties’ expectations regarding such practices. It may make common sense that some “best practices” may actually be good for policyholders (*i.e.*, better claims handling practices, faster case management techniques, etc.) But such speculation and musings cannot be viewed as evidence that the Proposed Transaction will produce a policyholder benefit to be balanced against the anticipated premium rate increases.

2. RATE INCREASES LIKELY TO RESULT FROM THE PROPOSED TRANSACTION

Having considered the anticipated benefits or advantages of the conversion, the analysis turns to its expected burdens. While these may be many (transaction costs, potential disruption, loss of independence, adverse changes in claims handling practices, adverse changes in provider relations, etc.), not all affect the interests of policyholders and the insurance-buying public to the same degree. The Testimonial Team sought to ascertain the likely consequences of the conversion and has provided an analysis of its findings. See Exhibit 56, pre-filed testimony and report of Sandra S. Hunt. The analysis concludes that the evidence available to the Testimonial Team does not indicate that the Proposed Transaction is likely to have material adverse consequences for policyholders and the insurance-buying public other than anticipated premium rate increases.

It is important to understand that the Testimonial Team's concern does not arise from the all-but-inevitable premium rate increases that will be made necessary by inflation and the rising costs of doing business. These increases, referred to in the industry as "trend," are likely to be the same with or without the conversion. The analysis pursued by the Testimonial Team sought to determine whether the Proposed Transaction would result in additional premium rate increases that might not have occurred without the conversion. As will be seen, the answer is in the affirmative.

To ascertain the likely impact of the conversion on premium rates it is helpful to understand the factors that influence such rates. In the main, they fall into three categories: (1) medical expenses or claims costs; (2) administrative expenses or overhead⁹; and (3) underwriting gains or profit.¹⁰ The

⁹Companies measure overhead in different ways. For purposes of the Testimonial Team's analysis, it was deemed to include all costs of doing business other than medical expenses and federal income taxes. This is the approach the Testimonial Team believes has been used by BCBSKS.

¹⁰In fact an insurer's profits consist of two principal components, gains or losses from underwriting and gains or losses from investment of its assets. It can be assumed that Anthem and BCBSKS would achieve essentially the same level of investment income from investment of BCBSKS' assets, adjusted of course, for the reduction in the amount of these assets attributable to the Special Distribution and other aspects of the conversion. Consistent with the absence of contrary evidence, the Testimonial Team assumed that Anthem would not be able to fund necessary additional profits from improvements in investment income. Thus, the premium rate increase analysis assumes that any desired increase in BCBSKS' overall profits will have to come from operating margins. No evidence has been offered by BCBSKS or Anthem to the contrary. And it is worth making the logical observation that investors buy insurance company stock for the profit potential of the insurance operation, not for the insurer's ability to generate investment income. Investors can generally invest directly in all the same instruments in which insurers do without exposing themselves to the insurance risk.

analysis of the Testimonial Team did not indicate that the conversion would have a material effect on the first two components.

It does not appear probable that Anthem will reduce medical expenses, which typically requires more aggressive contracting with providers than has been BCBSKS' practice. Anthem has consistently emphasized that provider contracting will be left in the local hands of BCBSKS. See Glasscock TR at 617; Nussbaum TR at 709 and 734-735. In short, the Applicants have produced no evidence to support a proposition that the conversion will reduce medical costs and the analysis of the Testimonial Team did not so indicate. Neither did it appear that an increase in medical costs would inevitably follow implementation of the transaction. For purposes of its analysis of the probable impact of the transaction on rates, the Testimonial Team, therefore, assumed that medical costs would not be affected materially. This is consistent with the Applicants' explanations and evidence.

As has been seen, neither does it appear that the Proposed Transaction will have the effect of achieving material reductions in administrative expenses. Despite numerous requests for information to that effect, the Applicants never provided documentation of any such anticipated result. Telling and illustrative is the testimony of Anthem's Executive Vice-president and Chief Legal and Administrative Officer, David Frick:

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11 Q. *There has been some criticism in*
12 *papers filed by Anthem, especially in*
13 *rebuttal of the work done by Sandra Hunt of*
14 *PricewaterhouseCooper's. Have you seen*
15 *that, sir?*

16 A. *I have.*

17 Q. *And among the criticism level [sic] at*
18 *Miss Hunt is that she did not assume that*
19 *your company would realize operating margins*
20 *as a result of savings as a result of*
21 *economies of scale. Is that right, sir?*

22 A. *That's correct.*

23 Q. *Are you aware, sir, of material*
24 *that has been provided to us that could have*
25 *been the basis for such an assumption by*

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1 *Miss Hunt?*

2 A. *Would you repeat the question,*
3 *please?*

4 Q. *Are you aware of any material*
5 *provided by Anthem before Miss Hunt*

6 completed her analysis that could have been
7 the basis for Miss Hunt making such an
8 assumption?
9 A. The only material would have been
10 the pattern and practice and success that
11 the company has had in the four states that
12 she examined where we achieved substantial
13 savings in each of those states. I'm not
14 aware of any information that Anthem
15 directly provided to you that she utilized.
16 Q. And in fairness to Miss Hunt, she
17 actually does describe your savings in other
18 states, doesn't she?
19 A. She does.

TR at 805-806. Emphasis added. Contrary to the Applicants' suggestions, the Testimonial Team gave full consideration to the possibility that increased underwriting margins might be produced by reduced costs. Unfortunately, despite persistent efforts, they could elicit no calculations or evidence of cost reductions from BCBSKS or Anthem. See the detailed testimony of Sandra S. Hunt on this subject. TR at 1141-1144. And as noted above, Blue Cross and Anthem have not provided any evidence or satisfactory explanation of how premium rate increases will be avoided by other means, such as increased revenues or more favorable arrangements with health care providers.

Attempting to avoid the consequences of this inevitable aspect of their proposed sponsored demutualization, Blue Cross does suggest that competition will keep them from implementing the premium rate increases suggested by the Testimonial Team. And they offer "expert testimony" on this issue. Or do they? For example, one might have expected expert testimony to address:

1. who are BCBSKS' competitors,
2. what market share each holds,
3. in what product lines they compete,
4. which of these are the most price sensitive,
5. the price differences among their product offerings, and
6. economic analysis and projections of how a particular rate increase would affect the volume of a particular product retained or lost by BCBSKS.

One would have been disappointed! The "expert" economic evidence offered by BCBSKS and Anthem consisted of two California college professors. It commenced with Economics Professor Paul Feldstein. This gentleman provided meandering speculation about non-profit to for-profit conversions (clearly not an issue in this proceeding). But he was compelled to admit upon cross examination that he had done no research into, and knew nothing about, the Kansas insurance market. Most notably,

Professor Feldstein was completely incapable of informing the Commissioner about the economic limitations that might actually (not theoretically by reference to other states) apply to premium rate increases in the Kansas small group and individual markets. Feldstein TR at 265-278.

The balance of the Applicants' economic evidence consisted of the testimony of Professor Henry Butler, at least a former Kansan. Alas, he also had nothing to offer about the matter before the Commissioner. He explained in vivid detail, antitrust issues which are not involved in this matter. But, like Professor Feldstein, Professor Butler actually had not researched the Kansas market. His opinion was simply that the Proposed Transaction would not increase the ability of BCBSKS to raise premium rates. He conceded readily, that any ability to raise premiums that BCBSKS might already have (though voluntarily not exercised), would not be diminished by the Proposed Transaction. Butler TR at 488-493. Whether one chooses to accept Professor Butler's theory, or elects to disregard it, the fact is, that it has no significance to the issues before the Commissioner. Neither the Testimonial Team nor any other party has suggested that the conversion would enable BCBSKS to raise rates it could not have raised otherwise. The concern is that the Proposed Transaction will compel BCBSKS to raise rates it would not have raised otherwise. The Testimonial Team does not doubt that BCBSKS has had the ability to raise those rates. It simply has not previously had the need. Anthem would furnish that need. That is the problem.

While interesting to some, the testimony of the California professors is unfortunately completely irrelevant and uninformative in this case. In short, BCBSKS and Anthem have failed miserably if their goal was to demonstrate that the market would keep them from raising rates in the manner feared by the Testimonial Team. They have simply presented NO EVIDENCE on that point.

Thus, the Testimonial Team concluded that any desired increases in operating margins would have to come from increases in premium rates. It becomes necessary, then, to analyze the magnitude of this potential impact. To do so, it is helpful to ascertain the company's historical and anticipated underwriting margins, determine the level of underwriting margins necessary to achieve the converted company's target, and consider what is necessary to achieve that result.

BCBSKS' HISTORICAL AND ANTICIPATED UNDERWRITING MARGINS

As noted in Ms. Hunt's report and confirmed at the Evidentiary Hearing, historically BCBSKS has not realized substantial underwriting gains from its operations. Not having been required to pay shareholder (or policyholder) dividends, and having accumulated a considerable statutory surplus, the company was not compelled to maximize operating profits, and has operated at a loss. Lynn TR at 324-325. As a result, neither was it compelled to charge the highest premium rates the market (and applicable regulatory constraints) would have permitted. The result is that for the last five years, BCBSKS has averaged operating margins of -2% of total premiums. Hunt TR at 1135.

Determining what the operating results would have been for BCBSKS without the transaction is more difficult for a variety of reasons. Historical performance is an indicator, but not perfect predictor, of future management behavior. It is clear that BCBSKS has been considering a strategic restructuring for some time. See Knack TR at 43. To make itself more attractive to potential strategic partners, one assumes that BCBSKS would have wanted to enhance its operating performance. Thus, it is difficult to separate BCBSKS management's goals in the context of a desire to implement some strategic restructuring from those it would have had if it had simply chosen to remain the independent insurer it has been historically. The Testimonial Team elected not to engage in this somewhat speculative analysis. Instead, the Testimonial Team relied on the company's own estimates of anticipated results in the absence of the transaction. These were contained in a set of projections provided by BCBSKS to its investment advisors and those of the Testimonial Team to be utilized in ascertaining the range of fair market values for the company. See Exhibit 41. They were prepared by BCBSKS. Lynn TR at 321. They were represented to be management's best estimate. Platter TR at 1057. The Testimonial Team, therefore, assumed that the projections should be taken as true. They suggest that the company would seek to achieve an underwriting margin of .4% by 2005. See Exhibit 41; Lynn TR at 325-326. Mr. Lynn did note a deterioration in the company's performance (TR at 327), and a break-even target (TR at 319), that would justify assumptions of a 0% underwriting margin for non-conversion operations. As will be seen, the whether it should be assumed that, without the conversion, BCBSKS would merely reach break-even, or that it would attain a .4% underwriting gain is immaterial to the Testimonial Team's analysis and conclusions. The Testimonial Team simply assumed a 2.5% target premium rate increase. If the company would actually only have reached break-even, the Testimonial Team's analysis is understated by a .5% pre-tax underwriting margin. That is, rates should be presumed to increase an additional .8% after taxes across the board above those demonstrated in Ms. Hunt's report. If only small group and individual rates were affected, the increase would be more pronounced.

TARGET MARGIN AFTER CONVERSION

Ascertaining what operating margins Anthem hopes to achieve after the conversion has been somewhat less difficult. By contrast to BCBSKS, Anthem has historically generated more substantial operating margins. In a confidential business plan, Anthem demonstrates a higher expected overall operating margin for 2001. See sealed Exhibit 42 at page 18. It has communicated its targets to BCBSKS with clarity: after the conversion, its goal is to achieve operating margins of at least 3%. See Exhibit 43, "Anthem's Response to [BCBSKS'] Request for Expression of Interest," at page BC005792. And having just completed the initial public offering of its stock, it can be anticipated to strive for even better results so as to satisfy shareholder expectations. Indeed, Anthem strives, at a minimum, to realize after tax operating margins of 3%, but sets its goals at 4%-5% in order to match its competitors. Glasscock TR at 571-576. Thus, the evidence establishes conclusively that Anthem's plans are to produce operating margins of at least 3% after the conversion. The evidence even supports an assumption of margins as high as 4% or 5%. But the Testimonial Team did not incorporate those higher 4-5% targets in its analysis.

REACHING ANTHEM'S TARGET OPERATING MARGINS

Armed with just these facts, one might conclude that, following the demutualization, BCBSKS will have to improve its operating results by at least 5% of premium (from the current -2% to +3%) to attain Anthem's minimum goals.¹¹ But, the Testimonial Team based its analysis on the stated goal of BCBSKS management that it would strive to reach break-even in the absence of the conversion. Lynn TR at 319. Thus, it assumed that the additional underwriting gains need only be 2.5% - 3%. This conservative approach, therefore, does not include projections of the impact of the possible required increase of as much as 6.6% - 8.2% necessary to achieve Anthem's goals of 3% to 4% from the position in which the company now finds itself.¹²

Assuming, then, that the conversion would require an increase in underwriting gains of 2.5% to 3% for the entire block of BCBSKS' business, the next step is to ascertain how that would manifest itself in the company's premium rates. The Testimonial Team's analysis is necessarily based on assumptions because neither Anthem nor BCBSKS have provided a plan for achieving this result. The analysis does assume, however, that BCBSKS would not increase premium rates for its large group business, both because it is more competitive than the small group and individual business, and because it is experience-rated in any event. Moreover, that business will be profitable, or at least close to break-even, once BCBSKS takes the steps necessary to achieve company-wide break-even. Similarly, the Medicare Supplement business is more competitive than the small group and individual markets, and already profitable. Thus, the obvious places in which BCBSKS might try to achieve the necessary gains are the small group and individual blocks of business. See Exhibit 56, report of Sandra Hunt, at page 60. Table 6.3, Exhibit 56, page 60 of the PricewaterhouseCoopers analysis of this issue, demonstrates the result of this assumption with a "tax effected" goal of increasing underwriting margins to 2.5%. Even with these conservative assumptions, it can be seen that the affected premiums would increase by at least 7% above trend.

¹¹Of course, once the company begins to experience net income, it will be required to pay federal income taxes on such amount, at an average rate of 35%. Thus, a target of 3% operating margins after taxes requires approximately a 4.6% pre-tax margin. To achieve this result, BCBSKS would have to increase its operating margins by 6.6% from current levels.

¹²To achieve 3% from the current -2% requires a pre-tax increase of 5%. The federal income tax on the 3% net income would add an additional 1.6% ($3\%/65\%=4.62\% - 3\% = 1.62\%$), requiring a total increase of 6.62%. Using the same approach, to achieve pre-tax operating margins of 4% would require an after tax increase of 8.15% ($4\%/65\%=6.15\% - 4\%=2.15\% + 6\%= 8.15\%$). It is assumed that the company would not pay federal income tax until it reached break-even and, therefore, started reporting net income.

There are additional facts that are important in evaluating these conclusions. The Testimonial Team analysis assumes that Anthem will not seek to reach its goals for at least three years. Clearly, if it felt pressured to realize them more quickly, the results would be more burdensome to policyholders and the insurance-buying public. In addition, it is important to observe that the recipients of these rate increases are disproportionately not the likely recipients of payments in the demutualization. First, only one in four insureds are Eligible Policyholders. Second, among the Eligible Policyholders, approximately 56% of the demutualization consideration would go to holders of Medicare Supplement policies, and approximately 21% would go to large groups, leaving less than 24% for the small group and individual policyholders. See “Blue Cross Clients OK Sale” The Wichita Eagle, January 15, 2002, quoting BCBSKS spokesman Graham Bailey, Attachment 4 to this brief. See also Hunt TR at 1147.

BCBSKS and Anthem may quarrel vigorously with this analysis and the resulting conclusion. But the assumptions are entirely supported by the evidence adduced at the Evidentiary Hearing. And, more importantly, neither applicant has denied the essential fact that Anthem will seek operating results at least 3% better than BCBSKS’ projections and 5% better than BCBSKS’ current performance. BCBSKS and Anthem simply have not shown how they will achieve these goals without these additional premium rate increases.

It is possible that Anthem will now suggest that BCBSKS does not operate so efficiently when analyzed on the basis of results per member per month. They may argue that, viewed on that basis, it is clear that costs savings are possible. Obviously, such an argument still would fall far short of providing evidence of expected savings. But the best response is Mr. Smith’s own testimony:

1 Q. And that's what we used to call
2 profit, isn't it?
3 A. Actually, we are strongly aligned
4 with your view that the operating gain or
5 the underwriting margin is the most
6 meaningful measure of these metrics that
7 have been brought to be used during these
8 hearings.

Smith TR at 649. The Commissioner, therefore, would be entirely justified in finding these to be conservative assumptions of the consequences of the conversion.

Anthem and BCBSKS have taken an extraordinary step. More than two weeks after the close of the Evidentiary Hearing, on the afternoon of the very day on which the briefs were due to be filed, without any notice to the Testimonial Team or the Intervenors, they propose what they characterize as a “safety net”. Specifically, they apparently will propose in their brief a Small Business Rate Stabilization Fund of \$25 million over five years. The proposal is most significant for what it indicates about the Applicants’ cynicism! If it is a safety net, it is one with a hole the size of a circus tent right in

the center. Only the simplest analysis is necessary to show how penurious and misleading is this 15th hour proposal. The Small Business Rate Stabilization Fund will enable the Commissioner to request that Anthem forego a total of \$25 million in rate increases over five years, \$10 million being available in the first year, the balance thereafter on a sliding scale. As demonstrated conclusively by Ms. Hunt (and without competent rebuttal by Anthem or BCBSKS), the reasonably anticipated premium rate increases that will result from the Proposed Transaction amount to 3.85% of the total of BCBSKS premiums every year beginning in year one.¹³ See Table 6.3, Exhibit 56, page 60 of the PricewaterhouseCoopers report. BCBSKS management has projected its premium income for a five year period and asked the investment bankers to rely on these projections for purposes of valuing the company. See Exhibit 41; Lynn, TR at 320-322. The premium projected by BCBSKS for the five year period is:

2001: \$1,014,500,000
 2002: \$1,136,400,000
 2003: \$1,279,700,000
 2004: \$1,427,300,000
 2005: \$1,580,200,000

The rate increase reasonably anticipated from the Proposed Transaction as demonstrated conclusively by Ms. Hunt's work, at the rate of 3.85% per year, amounts to:

2001: \$39,100,000
 2002: \$43,800,000
 2003: \$49,300,000
 2004: \$55,000,000
 2005: \$60,800,000
TOTAL: \$247,900,000

Against this conservatively estimated, yet staggering, quarter billion dollar total, Anthem and BCBSKS have the temerity to offer \$25 million, a paltry 10%! This extra-evidential, post-last-minute, maneuver should be seen for what it is. It is nothing short of an insult to the intelligence of the people of this state and of the Commissioner. It speaks volumes about the philosophy that will guide Anthem's responses to difficult challenges. What it does not do is to redress the imbalance of the premium rate increases that Anthem's acquisition will necessitate against the illusory benefits and advantages they tout as the likely legacy of the Proposed Transaction.

3. BALANCING

As stated previously, the applicable statutes do not provide a formulation for the analysis by which the Commissioner should determine whether:

¹³This is based on the conservative assumption that Anthem will only seek a 2.5% after tax rate increase. $2.5\% / .65 = 3.85\%$.

TESTIMONIAL TEAM'S POST-HEARING BRIEF
 PROPOSED FINDINGS OF FACT AND CONCLUSIONS OF LAW

The plan of conversion is fair and equitable to policyholders;

the plans or proposals which the acquiring party has to [...] to make any other material changes in its business [...] are unfair and unreasonable to policyholders of the insurer and not in the public interest; or

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

The Testimonial Team believes and submits respectfully that at least one permissible approach to making that determination is balancing the anticipated benefits and burdens of the conversion. Having analyzed the benefits or advantages of the Proposed Transaction as explained by BCBSKS and Anthem in the light of the evidence, and considering the likelihood that it would produce premium rate increases above those that would occur otherwise, the Commissioner can now balance the benefits and burdens of this proposed conversion for policyholders and the insurance-buying public.

It is expected that the Applicants will again argue that such balancing is beyond the Commissioner's discretion and that she cannot consider what is in the best interest of policyholders. See BRB at 5-10. The Testimonial Team respectfully disagrees with these propositions for which BCBSKS cites no relevant authority.

The Conversion Statute requires that, in order for the plan to be approved, the Commissioner must find, *inter alia*, that the plan is "fair and equitable to policyholders." K.S.A. § 40-4004(a)(1). Other than as to the amount of policyholder consideration, the Conversion Statute does not define the terms "fair" or "equitable." K.S.A. § 40-4000. The Conversion Statute does provide, however, that in reviewing a plan, the Commissioner has broad authority, and the procedures and criteria to be applied by the Commissioner are flexible within the parameters of the act. K.S.A. § 40-4001.

The Insurance Holding Company Act requires that the Commissioner approve the plan unless the Commissioner finds, *inter alia*, that the acquisition is likely to be "hazardous or prejudicial to the insurance-buying public." K.S.A. § 40-3304(d)(1)(E). The Insurance Company Act does not define the terms "hazardous" or "prejudicial."

When construing the statutes in question, the Commissioner should give words in common usage their natural and ordinary meaning. State v. Neufeld, 926 P.2d 1325, 1347 (Kan. 1996). The words "fair," "equitable," "hazardous," and "prejudicial" are all in common usage and have accepted meanings. "Fair" and "equitable" both mean free from favor toward either or any side. Merriam Webster's Collegiate Dictionary (10th ed. 1995) (discussing synonyms under definition of "fair"). "Fair" implies an elimination of one's own feeling, prejudice, and desires so as to achieve a proper balance of conflicting interests. Id. "Equitable" suggests equal treatment for all concerned. Id.

“Hazardous” means involving or exposing one to risk (as of loss or harm). “Prejudicial” means tending to injure or impair. Therefore, for example:

- (1) the Commissioner shall disapprove the Plan unless she finds that the Plan achieves a proper balance of conflicting interests between BCBSKS and Anthem, on the one hand, and the policyholders on the other hand, and she has broad authority and flexibility to apply criteria on which to base this necessary finding;
- (2) the Commissioner shall disapprove the Plan unless she finds that the Plan treats all equally situated policyholders equally, and she has broad authority and flexibility to apply criteria on which to base this necessary finding;
- (3) the Commissioner shall approve the acquisition proposed by the Plan unless she finds that it would expose the insurance-buying public to risk (as of loss or harm); and
- (4) the Commissioner shall approve the acquisition proposed by the Plan unless she finds that it would tend to injure or impair the insurance-buying public.

As demonstrated above, a finding that the Plan is “fair” requires that the Commissioner find that it achieves a proper balance of conflicting interests between BCBSKS and Anthem, on the one hand, and the policyholders on the other hand. In other words, the Commissioner must balance the purported benefits of the Plan to BCBSKS and Anthem (e.g., access to capital, economies of scale) to the costs to policyholders of increased rates. Moreover, if the Plan would harm the insurance-buying public (e.g., through higher rates as a result of the acquisition) more than it would benefit the insurance-buying public (through economies of scale, etc.), then in the balance the insurance-buying public would be prejudiced (i.e., injured or impaired).

If the Commissioner disapproves the Plan based on her finding on either of the first two issues, her negative finding should not be disturbed on appeal absent proof of an arbitrary disregard of undisputed evidence or some extrinsic consideration (e.g., prejudice, passion, or bias). Thomason v. Stout, 978 P.2d 918, 920-21 (Kan. 1999). If the Commissioner disapproves the Plan based on her finding on either the third or fourth issue, her finding should not be disturbed on appeal unless the appellant proved that the finding is not supported by evidence that is substantial when viewed in light of the record as a whole. Mobil Exploration & Producing U.S. Inc. v. State Corp. Comm’n, 908 P.2d 1276, 1287-88 (Kan. 1995). The reviewing court would not substitute its judgment for that of the Commissioner, even though there might be conflicting evidence which would support a contrary result. Id. at 1288. Only if the evidence showed that the Commissioner’s determination was “so wide of the mark as to be outside the realm of fair debate” could such a fact finding be set aside. Id. Within the limits of the natural and ordinary meanings of the phrases “fair and equitable to policyholders” and “hazardous or prejudicial to the insurance-buying public,” the Commissioner has

broad discretion in evaluating the Plan and her findings will be entitled to the deference required by the applicable standards of review.

Given the complete absence of sufficient compelling evidence to the contrary (despite the Applicants having been given fair warning about the overwhelming importance of this issue), the Testimonial Team believes that the record before the Commissioner compels a finding that the likelihood of material premium rate increases resulting from the Proposed Transaction outweighs its supposed benefits or advantages.

4. CONDITIONS

If upon the balancing described above, the Commissioner nevertheless concludes that the likely premium rate increases resulting from the Proposed Transaction would not render it unfair and inequitable to policyholders, or hazardous or prejudicial to policyholders and the insurance-buying public, the Testimonial Team believes that any approval should be conditional. More specifically, the Testimonial Team believes that in order for the conversion to be fair and equitable to policyholders, it should satisfy the conditions recommended at pages 36-38 of its pre-hearing brief.

4. PROPOSED FINDINGS OF FACT

The Testimonial Team offers the following proposed findings of fact, each of which is established conclusively by competent evidence admitted during the Evidentiary Hearing:

1. Anthem admits that its first strategic objective is to meet or exceed the performance of its comparable competitors across several criteria, including operating gains. Glasscock TR at 571:6-572:8.
2. Anthem admits that operating margins of its comparable competitors average from 4.5% to 5%. Glasscock TR at 572:9-576:5.
3. Because of Anthem's need to increase operating gains above what they have historically been at BCBSKS, the Proposed Transaction would likely result in increases in BCBSKS' premium rates at least by 6% to 7% in the individual and small group markets, above the levels that might be expected in the absence of the Anthem acquisition ("additional rate increases"). Hunt PFT at 7; Hunt TR at 1133:20-23, 1136:20-1139:11, 1146:17-1147:8.
4. Whereas policyholders in the small group and individual product lines will likely bear the brunt of additional rate increases if the Transaction is approved, most of the consideration paid in the Transaction would go to Eligible Policyholders in the large group product line and the Medicare supplement product line. Hunt TR at 1147:9-21.

5. Neither Blue Cross nor Anthem has provided documentation of any clear benefits to policyholders from the conversion other than the cash consideration. Despite the Testimonial Team's specific requests for documentation of benefits to policyholders that are likely to result from the Transaction, BCBSKS and Anthem have provided only conclusory summaries without supporting data. See, e.g., Glasscock PFT at 6-9; Knack PFT at 2, 6; Lynn PFT at 4; Smith PFT at 5-7; Hunt TR at 1141:10-1144:21; Smith TR at 649:9-663:2.
6. Moreover, many of the principal justifications articulated for the Transaction are much more focused on traditionally corporate interests, such as accumulation of capital for acquisitions and other corporate needs, preservation of market positions, enhancing career paths, and the like. Greenlee PFT at 9-10; see, e.g., Knack PFT at 6; Lynn PFT at 4.
7. Anthem admits that its administrative expense ratio is more than 25% higher than BCBSKS' administrative expense ratio, Smith PFT at 9, which sheds further doubt on Anthem's ability to avoid additional rate increases if it is to reach its target operating margins. Hunt TR at 1143:17-1144:5.
8. The additional rate increases associated with the acquisition likely will outweigh any benefits expected from the conversion. Greenlee PFT at 2; Greenlee TR at 1021:21-1022:14.
9. If the Proposed Transaction is implemented, BCBSKS will seek to increase its underwriting margins to at least 3% of premium. Exhibit 43. Glasscock TR at 571-576.
10. BCBSKS and Anthem have not demonstrated that they can achieve increases in underwriting margin in ways other than by increasing premium rates.
11. BCBSKS and Anthem have not demonstrated that competition will prevent them from implementing substantial premium rate increases in the small group and individual markets.

In addition, even if the likely rate increase did not preclude the Commissioner from approving the Transaction, the Commissioner would be required to impose the following conditions to ensure that the Transaction would be fair and equitable to policyholders, due to the noted findings:

12. It is necessary for Blue Cross to demonstrate that the amount of consideration to be provided by BCBSKS to Eligible Policyholders will be at least the amount of its

statutory surplus on the Effective Date. Greenlee PFT at 10; Greenlee TR at 891:2-892:10.

13. It is necessary that Anthem confirm in writing that it will guarantee all insurance obligations of BCBSKS. Although Anthem has expressed its intent to adhere to the conditions of the Blue Cross Blue Shield Association licensing agreement, a more precise commitment would be appropriate, which would not be dependent on changes that may be made by Blue Cross Blue Shield Association in the future. Greenlee PFT at 10; Smith TR at 666:2-667:9; Frick TR at 801:23-802:15; Greenlee TR at 891:10-893:21.
14. Contrary to Section 6.3(f) of the Plan of Conversion, the appointments by the Commissioner to the Policyholder Committee should not be required to “*be reasonably acceptable to*” Anthem.
15. Anthem as the purchaser cannot demonstrate a stake in the management of these policyholder funds that justifies such an overarching “veto” power. Greenlee PFT at 10; Greenlee TR at 893:22-895:2.
16. Anthem has agreed that the provision of the Alliance Agreement requiring Anthem’s approval of the Commissioner’s appointments to the Policyholder Committee can be removed. Glasscock TR at 588:24-590:22; Frick TR at 833:12-25.
17. The Policyholder Committee should have the power to review the tax returns filed for at least the first three tax years following the Conversion Date to ensure that no amount of taxes paid during the last year preceding the Conversion Date is refunded to BCBSKS when, if those taxes had not been paid prior to the Conversion, a larger Special Distribution would have been paid to the Eligible Policyholders under the formula. Greenlee PFT at 10; Kovey PFT at 6-7; Kovey TR at 1100:20-1105:9.
18. All tax refunds received by BCBSKS after the Conversion for taxes paid in tax years preceding the Conversion should be deposited into the Escrow Fund to benefit the Eligible Policyholders unless the amount of such refund was reflected as an asset on the Closing Balance Sheet. Greenlee PFT at 11; Kovey PFT at 7; Kovey TR at 1100:20-1105:9.
19. BCBSKS and Anthem should develop an acceptable method for handling the requirement that interest paid to the Eligible Policyholders be reported to the IRS. Greenlee PFT at 11; Kovey PFT at 7; Kovey TR at 1105:10-1106:23.
20. Anthem should advise unequivocally whether it intends to deduct for tax purposes the Special Distribution or the Purchase Price paid to the Eligible Policyholders. While such a deduction is improbable, if it is obtained, there will be a material issue

concerning to whose benefit it should inure. Greenlee PFT at 11; Kovey PFT at 7; Kovey TR at 1106:24-1108:12. Anthem states in its brief that it will not seek such a deduction. ARB at 11.

21. The allocation of consideration to the Eligible Policyholders should be implemented in accordance with the actuarial model, principles, and formulas upon which the consulting actuaries for the Testimonial Team and BCBSKS have agreed. Greenlee PFT at 11.

5. PROPOSED CONCLUSIONS OF LAW

The Testimonial Team offers the following suggested conclusions of law:

1. BCBSKS did not meet its burden of showing that the Plan of Conversion is fair and equitable to policyholders. K.S.A. § 40-4004(a)(1).
2. The acquisition is likely to be hazardous or prejudicial to the insurance-buying public. K.S.A. § 40-3304(d)(1)(E).
3. Because the proposed conversion and the proposed acquisition are contingent upon each other and part of a single Proposed Transaction, the entire Proposed Transaction must be scrutinized under both the Demutualization Statute, K.S.A. §§ 40-4001 *et seq.*, and the Insurance Holding Company Act, K.S.A. §§ 40-3301 *et seq.*
4. In determining whether the Transaction would be fair and equitable to policyholders, it is reasonable to balance the likely benefits to policyholders against the likely cost to policyholders, as determined by evidence in the record.
5. In determining whether the Transaction would be prejudicial or hazardous to the insurance-buying public, it is reasonable to balance the likely benefits to the insurance-buying public against the likely cost to the insurance-buying public, as determined by evidence in the record.

6. CONCLUSION

The Testimonial Team recognizes that its recommendation against approval of the Proposed Transaction is likely to be controversial or to provoke virulent reaction. This recommendation should not be interpreted as a criticism of Anthem generally nor as an indication that no merger between BCBSKS and Anthem could meet the applicable legal requirements. Rather, it is the conclusion of the Testimonial Team that the evidence before the Commissioner establishes that this proposed sponsored demutualization will impose a greater burden upon policyholders and the insurance-buying public than it will confer benefits or advantages. Given the magnitude of those burdens: \$248 million in additional premiums during the next five years alone, the Proposed Transaction cannot

satisfy the fairness, equity, prejudice and hazard to policyholders and the insurance-buying public tests promulgated in the relevant statutes.

Respectfully submitted,

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COUNSEL TO THE KANSAS INSURANCE
DEPARTMENT

NOTIFICATION OF SERVICE

A true and correct copy of the foregoing has this 25th day of January 2002, been sent to the below identified counsel or parties electronically and by over night delivery.

Patrick H. Cantilo

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ATTACHMENT 1

Status Conference: October 25, 2001

34

7 It's not that we're
 8 being defiant by any means, it's just
 9 the fact that our view of schedule and
 10 what I'm now hearing Mr. Cantilo's view
 11 of schedule remains different. For
 12 example, I would expect that we would be
 13 in a position to ~ if we adopted a plan
 14 today ~ that we would begin the process
 15 in allowing ourselves yet another week
 16 to continue our dialogue to resolve some
 17 of these issues so that by the time
 18 we're at the printer on the 1st of
 19 November with a clear, fair and accurate
 20 description of the plan of conversion so
 21 that the public can make an informed
 22 decision as to whether or not to come to
 23 a comment meeting and whether or not to
 24 vote for or against the policy or for or
 25 against the plan should give us time to

35

1 accomplish the resolution of the issues
 2 that we have. That would then allow us
 3 to provide our written testimony to Your
 4 Honor by the 20th of November. That is
 5 accelerating our schedule from this
 6 so-called T schedule that we would have
 7 ~ the Department have its same
 8 opportunity, have actually a day or two
 9 more, so that they could be on paper
 10 advising of their position by the 5th of
 11 September ~ or excuse me, 5th of
 12 December ~ that we would then have
 13 rebuttal testimony to you by the 17th of
 14 December. And we would respectfully
 15 request that a hearing on this matter

16 occur on the 20th of December, the
 17 public hearing, that we would build in
 18 the public comment meetings the week
 19 after Thanksgiving, so the 26th, 27th,
 20 28th of November, to cover the western
 21 part of the state, and then on the 3rd
 22 and the 4th we would have the public
 23 comment meetings that would relate to
 24 Pittsburg and Topeka, trying to do it
 25 that way. Recognizing that you reside

36

1 in Topeka so that it would minimize your
 2 travel in conducting that public comment
 3 meeting. Allow the testimonial team to
 4 have its testimony to you on the 5th
 5 before they depart for the NIC meeting
 6 in Chicago on the 6th.

36

12 COMMISSIONER SEBELIUS: So
 you're
 13 expediting the initial schedule? The
 14 initial schedule that I'm reading is
 15 several weeks later than what you've
 16 just described. So if I hear you
 17 correctly, in spite of the fact that the
 18 Department says they're not ready to
 19 even complete this, your suggestion is
 20 that we expedite the schedule that I'm
 21 looking at?

37

17 As I've told
 18 Assistant Commissioner All, some of our
 19 more astute trial judges, and I don't
 20 perceive this as a trial, but what often
 21 happens is that the way those trial

22 judges handle these kind of situations
24 hearing on this date, now let's see how
25 it is that we're going to get our work

38

1 done. And respectfully, Your Honor,
2 that's what I'm asking for here.

44

18 Commissioner,
19 I'd like to respond to one thing. The
20 schedule that I laid out here, and I'd
21 be happy to go over it slower for you
22 again, kept in all respects the intent
23 of the Department and the companies to
24 maximize public access, first of all.
25 None of those provisions have been

45

1 shortened. In fact, I think we've given
2 eight days rather than seven for the
3 first notice. Everything in my schedule
4 is keyed off of giving the public a
5 minimum of one week, seven days, notice
6 in advance of the first public comment
7 meeting. So as you go into the
8 meetings, the notice period goes longer.
9 We agreed that we would use display
10 advertising rather than a legal notice
11 advertising, so that will be more
12 available. And there will be a huge
13 mailing that is going out to all the
14 policy holders simultaneously with this.
15 I have avoided Saturdays in my schedule.
16 I have avoided holidays. And we have
17 very sophisticated advisors on all sides
18 of this transaction who are seeming to
19 work 24 hours a day. I mean, these
20 people work around the clock. And so

23 is they say counsel, we're have a

21 when we are listening to what our
22 advisors say to us, including the
23 testimonial team, and then act upon that
24 advice, it's not like we have to do
25 anything. The advisors are really

46

1 providing a lot of this information. We
2 have to process it, obviously, but this
3 schedule that I have proposed is
4 essentially the same schedule that I
5 proposed the very first day we sat down
6 at the first status conference and the
7 mechanisms that Kathy described and the
8 processing and the sequencing.

**Status Conference TWO November 13,
2001**

33

19 COMMISSIONER SEBELIUS: But if
20 indeed a party wishes their comments to
21 be considered part of the public record,
22 which would then subject to them to
23 rebuttal or challenge, they would submit
24 that statement under oath and we'd
25 proceed from there and then that record

34

1 would be available to review by the
2 other parties.

3 MR. McCALLISTER: And that's
4 fine. I'd think what I would like for
5 us to do if we could, and we're

6 speculating if this were to occur, but
7 you built in a three day time frame that
10 proper hearing. And so perhaps ~ we
11 should have more than adequate time, I
12 would hope, to be able to deal with it
13 at the time. It would be a normal trial
14 issue, but we may want to approach it in
15 that way so that we'll allow opportunity
16 to rebut right on the spot and/or
17 cross-examine if it's appropriate rather
18 than necessarily waiting for the ten-day
19 runout to occur. So I raise that
20 question, and it's not something that
21 necessarily needs to be dealt with
22 today, but it was an issue that I felt
23 was worthy of consideration.

8 I hope would be far in excess of the
9 time that would be necessary for the

ATTACHMENT 2

To: Frick, David R. (E-mail); McCallister, Gary D. (E-mail)
Cc: 76-3 B (INTERNAL & KID KG, LS, SLH, JMW, DLF, PJR, JWD)
Subject: Proposed conditions

Gentlemen:

Set out below are the 8 conditions the Testimonial Team recommended in its pre-filed brief. They were much discussed during the hearing but I am not certain that we brought them to closure. To do that, it would be very helpful to have a written confirmation from Anthem and Blue Cross as to their final position on each. With respect to the guarantee, please provide the exact terms proposed by Anthem. Thank you for your help.

1 That Blue Cross demonstrate that the amount of consideration to be provided by BCBSKS to Eligible Policyholders will be at least the amount of its statutory surplus on the Effective Date.

2 That Anthem confirm in writing that it will guarantee all insurance obligations of BCBSKS.

3 That, contrary to section 6.3(f) of the Plan of Conversion, the appointments by the Commissioner to the Policyholder Committee not be required to “*be reasonably acceptable to*” Anthem.

4 That the Policyholder Committee have the power to review the tax returns filed for the first three or so tax years following the Conversion Date to ensure that no amount of taxes paid during the last year preceding the Conversion Date is refunded to BCBSKS when, if those taxes had not been paid prior to the Conversion, a larger Special Distribution would have been paid to the Eligible Policyholders under the formula.

5 That all tax refunds received by BCBSKS after the Conversion for taxes paid in tax years preceding the Conversion be deposited into the Escrow Fund to benefit the Eligible Policyholders unless the amount of such refund was reflected as an asset on the Closing Balance Sheet.

6 That BCBSKS and Anthem develop an acceptable method for handling the requirement that interest paid to the Eligible Policyholders be reported to the IRS.

7 That Anthem advise unequivocally whether it intends to deduct for tax purposes the Special Distribution or the Purchase Price paid to the Eligible Policyholders.

8 That the allocation of consideration to the Eligible Policyholders be implemented in accordance with the actuarial model, principles and formulas upon which the consulting actuaries for the Testimonial Team and BCBSKS have agreed.

Regards,
Patrick

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=====

From: Gary D. McCallister [gdm@gdmlawfirm.com]
To: 'Patrick'
Sent: Thursday, January 17, 2002 12:43 PM
Subject: Read: Proposed conditions
Your message

To: David R. Frick (E-mail); Gary D. McCallister Esq. (E-mail)
Cc: Jennifer M. Wilkerson (E-mail); 'Kathy Greenlee (E-mail)'; Leanne Foster (E-mail); 'Linda Sheppard (E-mail)'; Pierre J. Riou...
Subject: 1/16/02 6:51 PM

was read on 1/17/02 12:41 PM.

=====

From: David.Frick@Anthem.com
Sent: Thursday, January 17, 2002 6:43 AM
To: Patrick
Subject: Proposed conditions

Return Receipt

Your Proposed conditions
document
:

was David Frick/IN001/AICI/US
received
by:

at: 01/17/2002 07:40:56 AM

=====

ATTACHMENT 3

December 4: Hays

Page 46

11 MS. SHIRLEY GREEN: I had several
12 questions. One is I wanted to know how the
13 rates will compare if Anthem takes over.
Will

14 we be paying the same amount or will it be
15 greatly increased? I know when a company
goes

16 public, they must make money for the
17 shareholders.

9 MS. KATHY GREENLEE: What's going to
10 happen to the rates is your question? That is
11 by and large the primary question that's been
12 asked to us in the nearly 100 letters we've
13 received from the general public. There are
14 three answers to your question, so we'll start
15 with the simplest one.

16 Any of you who have a Blue Cross and
17 Blue Shield contract right now within a
18 twelve-month contract period, because of this
19 transaction, if this transaction is approved,
20 nothing in your current contract will change.
21 Your current rates, your current premiums,
22 will be the same. You might get new
paperwork

23 and a new card, but your current policy will
24 be no different. If this transaction is not
25 approved and Blue Cross and Blue Shield is
not

Page 47

4 The other thing that Anthem will
5 probably do is look to cut costs, and in that
6 respect, we've not been able to find any
7 specific ideas that they have, other than a
8 general concept that Anthem wants to gain
9 economies of scale and try to find some

1 sold, your rates will go up. I mean, we are
2 seeing in this marketplace escalating
3 insurance costs, so regardless of what happens
4 in the future, we are looking at that down the
5 road, but I think that gets to the third
6 question.

7 What is the additional impact or
8 overlay from this transaction? We can't
9 predict that exactly. We know that Blue Cross
10 and Blue Shield has lost money recently,
11 especially in the small group marketplace.
12 They have a plan in place to restore small
13 group to profitability. They're starting to
14 figure out how much they can adjust their
15 rates; what the market will bear in the state
16 of Kansas.

17 When Anthem comes to town, if they
18 are allowed to do that by the policy holders
19 and the Commissioner, they will need to find
a
20 way to make this company profitable, because
21 Anthem will be owned by stockholders, and
they

22 are likely to do that two ways: They will
23 either look to change rates if they can. They
24 won't know whether that's successful until
25 they get to Kansas and figure out what the

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1 market will bear. If they raise the rates and
2 everyone drops their policy, that's not
3 effective.

10 efficiencies in the company, so that's my
11 long-winded answer.
12 Rates may be impacted because of the
13 fact that you have ownership that's
14 stockholders, rather than those of you who
are

15 mutual policy holders, but we cannot give
you

16 definitive answers on what margin that will
be

17 or how likely it is to be significant, but
18 it's there and it may be significant. We just
19 can't predict exactly.

December 4: Garden City:

Patrick Cantilo, Page 31:

10 Simply the company, as it becomes a
11 shareholder or stockholder owned company,
will have to

12 increase its profitability to satisfy the
expectation of

13 its investors. That's the way it is in the
United States

14 of America, that's what free enterprise
means. And there

15 are a fine line for a limited number of ways
that

16 can be accomplished. An obvious one is to
the extent

17 that the market will allow it; that is to the
extent that

18 it can be done without losing the amount of
business the

19 company has it can increase premiums.

December 5: Wichita

Patrick Cantilo, Page 37:

5 I'll mention a few of the more
6 critical ones. The first is perhaps a
7 fundamental aspect of any of these

17 renegotiating compensation arrangements
18 with providers, or perhaps by

19 restructuring provider networks to

20 increase competition. There are other

8 transactions. This company historically
9 has not generated a lot of profit. We

10 believe it hasn't needed to generate a
11 lot of profit. It will if this

12 transaction goes forward become part of
13 an enterprise owned by investors and

14 those investors will expect to receive
15 money for their investment. Those

16 stockholders will want return on their
17 stock. To accomplish that, the company

18 will have to improve its profitability.
19 Insurance companies realize profits

20 principally in two ways. From the money
21 they make on their investment, that is,

22 the stock and bonds that they buy, the
23 investment income that all companies

24 make, and from operations. They collect
25 a certain amount of premium, pay a

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1 certain amount in claim and a certain
2 amount in expenditures and what's left

3 over is called underwriting gain. It is
4 difficult for a well run company like

5 Blue Cross to improve its investment
6 return in the stock market. It can't

7 control the stock market and unless it's
8 engaged in bad investment practices, it's

9 difficult to eke out more money from a
10 quantity invested, so the natural place

11 for the company to look to improve
12 profitability is in underwriting gains.

13 The principal ways that that

14 can be accomplished are by increasing
15 premiums, by reducing participation in

16 unprofitable lines of business, by

21 ways, but these are among the ways that
22 most commonly are utilized by insurance

23 company management to increase

24 underwriting gain and, therefore,

25 profitability.

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1 You as the owners of the
2 company need to know that although it is
3 not a certainty and I'm not sitting
4 here - or standing rather here and
5 telling you it will happen. There is a
6 probability that in order to achieve the
7 expectation of investors, this company
8 will have to engage in one or more of
9 these devices. They are described, as I
10 say, in the booklet but we on the
11 testimonial team believe it's important
12 that you recognize that.

December 13: Pittsburg

Patrick Cantilo, Page 32

14 We all know that
15 prices are going up across the country
regardless of
16 whether or not this transaction happens so
the
17 likelihood is that premiums will increase.
Will they
18 increase more because of this transaction, we
believe
19 that is a distinct possibility but we cannot
give you
20 a quantity for that additional increase.

December 14: Topeka

Patrick Cantilo, Page 44

23 However, it is likely that this
24 transaction will result in some changes.
25 And one of the things that we feel

11 same assets can produce a materially
12 greater rate of return. That is, we

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1 compelled to you is to assist you in
2 understanding the things you ought to
3 take into account in deciding how to
4 vote. And so I'm going to summarize
5 here some risks and potential
6 disadvantages of the transaction which
7 are explained in much more detail in the
8 policyholder information statement
9 distributed by Blue Cross in the last
10 couple of weeks.
11 One of those risks or potential
12 disadvantages is the likelihood that the
13 company will have to increase
14 profitability after the transaction.
15 This company has not operated very
16 profitably because it hasn't needed to.
17 Once it is sold and becomes a
18 publicly-owned company's subsidiary, that
19 is a subsidiary of a company owned by
20 shareholders, it is likely to be
21 expected by its owners to generate
22 market rates of profit.
23 Now, there are a limited number of
24 ways in which insurers can do that.
25 One, obviously, is to reduce expenses,

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1 but our review leads to us conclude that
2 this company operates very efficiently
3 right now. There is not a lot of fat to
4 be cut from this operation.
5 It can also make money by investing
6 its assets in the stock and equity
7 market and corporate income markets.
8 But again, those investments are being
9 made now and there is no reason to
10 believe that after this transaction the
13 don't think it can make a lot more money
14 on investments. And, of course, it can

15 make more money on insurance operations
16 by improving underwriting gains. That
17 is the difference between premiums on
18 the one hand and claims and expenses on
19 the other. And that can be accomplished
20 by increasing premiums, by reducing the
21 company's position and non-profitable
22 lines of business, or by reducing its
23 overall medical expense ratio.
24 It is likely that after this
25 transaction is made, in our view, some

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1 or all of these measures will have to be
2 implemented to some degree to improve
3 the company's profitability, but we
4 don't have a crystal ball and we can't
5 tell you how much and how soon each of
6 these will be implemented. It is our
7 firm view that premiums will increase
8 with or without this transaction for
9 this company and for all the other
10 health insurance companies in the
11 country, but we do believe that there is
12 a high likelihood that premiums will
13 increase somewhat more for this company
14 if this transaction is implemented than
15 if it is not. We just can't tell you
16 how quickly and how much.

ATTACHMENT 4

Wichita Eagle, The (KS)
January 15, 2002
Section: BUSINESS & MONEY
Edition: main
Page: 4B

BLUE CROSS CLIENTS OK SALE
-- INSURANCE COMMISSIONER KATHLEEN SEBELIUS STILL MUST
APPROVE THE DEAL
WITH AN INDIANA COMPANY.

PHYLLIS JACOBS GRIEKSPoor, The Wichita Eagle

Policyholders of Blue Cross and Blue Shield of Kansas have said yes to their company's acquisition by Anthem Insurance Cos. of Indianapolis. The merger still needs the approval of state Insurance Commissioner Kathleen Sebelius.

More than 100,000 Blue Cross policyholders, about 58 percent of those eligible, cast their votes on the issue. About 63.4 percent, or 63,504, of them cast ballots in favor of the merger.

Policyholders had to approve the deal because they are the company's owners in Kansas. The acquisition would convert Blue Cross - the state's largest health insurance company - from a mutual, or policyholder-owned, company into one owned by stockholders.

"Our board of directors unanimously approved the conversion, and now our policyholders have overwhelmingly approved it," said John Knack, president and chief executive of Blue Cross and Blue Shield of Kansas. "The final decision now rests with the Kansas Insurance Commissioner. It is our hope that she will see the merits of our position and will render a positive decision for us."

Sebelius is expected to decide by Feb. 25.

If Sebelius approves the merger, about \$321 million would be distributed to policyholders. An estimated \$131 million would be paid from Blue Cross and Blue Shield of Kansas' reserves. Anthem would provide the other \$190 million.

The payout would be made this way, Blue Cross spokesman Graham Bailey said:

-- About \$179 million would be divided among 124,000 individuals older than age 65 who have individual supplemental Medicare policies from Blue Cross - about \$1,500 to each.

-- About \$45 million would be divided among 29,000 people who have individual Blue Cross policies and are not members of a group - about \$1,500 to each.

-- About \$67 million would be divided among more than 500 large employers of more than 50 people who have contracts with Blue

Cross for health coverage for their employees - about \$100,000 to each group. The group would then decide whether the money would be used or divided among members.

-- About \$13 million would be divided among 10,000 small employers who have fewer than 50 employees.

-- About \$16 million would be divided among the 9,000 individual who have auxiliary policies with Blue Cross, coverage such as a cancer-only policy.

"I think this return would be significant for those senior citizens on a fixed income. For them, this amounts to about a free year of premiums,"

Bailey said. "That's a big deal."

Sebelius held three days of hearings last week in Topeka to hear arguments from the insurance company and from patient health advocacy groups who oppose the merger, mostly on fears that patient care will take a back seat to profits under Anthem's ownership.

Blue Cross and Blue Shield of Kansas insures about 715,000 people in Kansas, about one-third of the population in 103 of the state's 105 counties. Johnson and Wyandotte counties are served by Blue Cross and Blue Shield of Kansas City. Blue Cross also administers Medicare and Medicaid benefits to another 640,000 Kansans.

Blue Cross has argued that it needs to affiliate with a national company because more and more Kansas corporations are national and they want to work with a company that serves their needs in several states. Anthem has about 7 million customers and affiliations in eight states. It converted from a mutual company to a stock company earlier this year.

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Illustration:PHOTO

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