

BEFORE THE COMMISSIONER OF INSURANCE  
OF THE STATE OF KANSAS

In the Matter of the Plan of Conversion of  
BLUE CROSS AND BLUE SHIELD OF  
KANSAS, INC.

Docket No. 3014-DM

**BRIEF OF BLUE CROSS AND BLUE SHIELD OF KANSAS, INC. IN SUPPORT  
OF ITS APPLICATION FOR APPROVAL OF THE PLAN OF CONVERSION**

Blue Cross and Blue Shield of Kansas, Inc. (“BCBSKS” or the “Company”) submits this brief to the Commissioner in support of BCBSKS’ application for approval of its Plan of Conversion (the “Plan” or “Plan of Conversion”) pursuant to K.S.A. §§ 40-4001 to -4014 (the “Conversion Law”).

**INTRODUCTION**

The proposed conversion of BCBSKS to a stock company and acquisition of its stock by Anthem Insurance Companies, Inc. (“Anthem BCBS”) will strengthen BCBSKS’ ability to meet its commitments to policyholders by providing the Company with financial flexibility to support future growth and financial strength and ensure that policyholder interests are properly preserved and protected. *See* Knack p. 3.<sup>1</sup> Affiliating with a larger, multi-state insurer will, among other things, enable BCBSKS to take advantage of economies of scale and to respond more effectively to local risks. *See id.* pp. 5-6. In addition, in exchange for their present membership interests in BCBSKS,

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<sup>1</sup> The statements and reports submitted as pre-filed written testimony of witnesses for BCBSKS in this proceeding are cited in this brief by the last name of the witness.

policyholders will receive an aggregate cash distribution of up to an estimated \$321 million. Policyholders' existing policy and contract rights will not be changed in any respect by BCBSKS' conversion and its affiliation with Anthem BCBS. Because the conversion is fair and equitable to policyholders and satisfies all other statutory requirements, it should be approved.

In this proceeding, BCBSKS' submissions are directed primarily to establishing that the Plan satisfies the requirements of the Conversion Law. We expect that the separate submissions of Anthem BCBS will be directed primarily to establishing that the requirements of the acquisition-of-control statute, K.S.A. § 40-3304, have been satisfied. For all of the reasons set forth in this brief, in the accompanying written testimony and in the submissions of Anthem BCBS, the Plan of Conversion and the proposed acquisition satisfy all requirements of both statutes and should be approved.

### **REASONS FOR APPROVING THE PLAN**

The Conversion Law sets forth specific criteria governing the Commissioner's decision whether to approve the Plan. Specifically, the statute provides:

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.

K.S.A. § 40-4004(a). The Company's Plan of Conversion satisfies each of these criteria.

**I. The Plan is Fair and Equitable to Policyholders.**

Upon effectiveness of the Plan, all policies will remain in force in accordance with their terms, but membership interests in BCBSKS as a mutual company will terminate. *See* K.S.A. § 40-4003c. The Plan provides that Eligible Policyholders will receive a fair and equitable distribution of cash consideration in exchange for termination of their membership interests, as discussed below. For these reasons, the Commissioner should find that the Plan is fair and equitable to policyholders. Moreover, the conversion and acquisition are in the best interests of BCBSKS, its policyholders and the insurance-buying public.

**A. The Overall Amount of Consideration is Fair.**

Policyholders will be receiving, in the aggregate, a special distribution of an estimated \$131 million (consisting of the excess of BCBSKS' closing book value over \$155 million), plus a cash payment of \$142 million from Anthem BCBS. *See* Knack p. 11; Lynn pp. 4-7; Plan, introductory paragraph & §§ 6.2(d), 6.3. An additional \$48 million will be paid by Anthem BCBS into an escrow fund to cover contingent liabilities and expenses that may arise from a federal investigation, and will be distributed to policyholders if not needed to cover those liabilities and expenses. *See* Knack p. 11; Lynn pp. 5-6; Plan § 6.3 & ex. D.

K.S.A. § 40-4004(b) provides that the amount of consideration provided to policyholders “shall be deemed to be fair and equitable . . . if the consideration is at least the amount of statutory surplus attributable to the contributions of policyholders.” Because the amount of consideration distributed to policyholders is expected to exceed this amount, it is *per se* fair and equitable.

In any event, the overall consideration is fair and equitable even apart from this statutory standard. The total of \$190 million in cash consideration that Anthem BCBS is paying for the stock of BCBSKS represents a \$35 million premium above the \$155 book value that BCBSKS will retain under the Plan. The terms of the agreement between BCBSKS and Anthem, including the amount of consideration to be paid, were the product of a thoroughgoing sales process in which BCBSKS evaluated alternatives and other potential buyers (including stock and mutual companies), as well as extensive, arm’s length negotiation between BCBSKS and Anthem BCBS. *See* Mattox pp. 2-4.

The fact that Anthem BCBS’ offer was the product of arm’s length negotiations between sophisticated companies that are leaders in their industry, following a very deliberate and fair sale process, provides compelling evidence that the transaction price is fair to the policyholders of BCBSKS. The Blue Cross and Blue Shield plans that are proven and successful consolidators (including both mutual and for-profit companies) were invited to express their interests in the acquisition of BCBSKS. Several of them did just that. *See* Mattox pp. 2-3. Anthem BCBS presented the best offer at the end of the selection process and was recommended and selected as the strategic alliance partner. *See* Mattox pp. 3-4. In addition, the Alliance Agreement between BCBSKS and Anthem

BCBS contains a “fiduciary out” provision, which provides a mechanism for the Board of Directors to consider and act upon a superior offer in the event one is received by BCBSKS. *See* Alliance Agreement § 10.01(b)(ii). The companies’ intentions were publicly announced in May 2001, and since then not one company—Blue Cross plan or otherwise—has come forward to make any competing offer, much less one that is superior to the agreement with Anthem BCBS.

BCBSKS has hired the independent investment banking firm of Dresdner Kleinwort Wasserstein (“DrKW”) to evaluate the fairness of the aggregate amount of consideration. DrKW has rendered an initial opinion in May 2001, supplemented by a later opinion in November 2001, that (subject to certain assumptions and limitations set forth in the opinion) the aggregate cash consideration to be paid to Eligible Policyholders is fair from a financial point of view. *See* Adams p. 14. In reaching this conclusion, DrKW conducted, among other things, a comparable company analysis, a comparable transaction analysis, and a discounted cash flow analysis, to determine an enterprise value for BCBSKS. *See* Adams pp. 10-14. The negotiated \$190 purchase price is within the range calculated by DrKW under each of these three analyses. *See id.* A copy of DrKW’s opinion letter dated November 9, 2001 is included in the Policyholder Information Statement mailed to all BCBSKS policyholders (pp. A-103 to A-105) and will be offered in evidence at the public hearing.

We understand that the fairness of the purchase price and the aggregate amount of consideration has also been reviewed by the Kansas Insurance Department Testimonial Team, assisted by its own independent financial advisor, Bear Stearns. The professional

opinions of DrKW and Bear Stearns have followed exhaustive analysis of all relevant market factors and represent the considered judgment of investment banking firms that are actively engaged in transactions such as the instant transaction.

**B. The Allocation of Cash Consideration  
Among Eligible Policyholders Is Equitable.**

Under the Plan, each policyholder will receive a fixed component of consideration and a variable component of consideration. *See* Plan § 8.1(b); McCarthy p. 5. The fixed component is allocated in an equal amount to each policyholder, while the variable component is allocated among policyholders on the basis of past and projected future actuarial contribution to the Company's surplus. *See* Plan §§ 8.1(b)(i), 8.2; McCarthy pp. 5-6. This method of allocation has been widely used in recent insurance company demutualizations in the United States, and is recognized in the authoritative actuarial literature as an appropriate allocation method. *See* McCarthy pp. 5-6.

BCBSKS retained an independent actuarial consultant, Daniel J. McCarthy of Milliman USA, Inc., to assist it in developing the allocation and to review whether the allocation is fair and equitable to policyholders. Mr. McCarthy has delivered an opinion that (on the basis of certain assumptions set forth in the opinion) the allocation of consideration is reasonable and appropriate, is consistent with the Kansas Conversion Law, and is fair and equitable to policyholders. *See* McCarthy p. 9. A copy of Mr. McCarthy's opinion letter is included in the Policyholder Information Statement mailed to all BCBSKS policyholders (pp. A-160 to A-163) and will be offered in evidence at the public hearing. We understand that the fairness of the allocation has also been reviewed

by the Kansas Insurance Department Testimonial Team, assisted by its own independent financial advisor.

**C. The Conversion and Acquisition Is In the Interests of BCBSKS, Its Policyholders and the Insurance-Buying Public.**

The Conversion Law does not specifically call for the Commissioner to consider potential effects on the insurer's future performance in evaluating a plan of conversion. Those concerns are matters for the business judgment of the Board of Directors and the judgment of the policyholders in voting on the Plan. *See* K.S.A. § 40-4002(a), (d).

In any event, even if they were a matter for the Commissioner to consider, the concerns voiced by some objectors that conversion to a for-profit stock company will adversely affect future performance are unfounded.<sup>2</sup> The written statement of BCBSKS CEO John Knack discusses in detail the ways in which affiliation with Anthem BCBS will better position the Company for future strength and stability, for the benefit of all of its policyholders and the insurance-buying public. *See* Knack pp. 5-7. As Mr. Knack explains, the Company sees the sponsored demutualization as enhancing the Company's commitment to excellent customer service, by improving its strength and flexibility. *See id.* pp. 13-14. As a matter of good business sense, the Company's future success as a stock company depends on satisfying its customers. *See id.* p. 13.

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<sup>2</sup> Contrary to what some objectors mistakenly have suggested, BCBSKS is not currently a non-profit company but is organized as a mutual life insurance company. It previously converted from a non-profit to a mutual company, with the Commissioner's approval, in 1992. *See* Knack p. 4. At that time, it discharged its nonprofit obligations by making a charitable contribution. *See id.*

Indeed, as set forth in the expert witness report of Dr. Paul Feldstein, for-profit Blue plans perform better, on balance, than non-profit Blue plans on commonly used measures of performance. *See* Feldstein p. 32. The extent of competition has a greater influence on health plan performance than does the form of corporate organization, and for-profit insurers may have an advantage in exploiting opportunities for efficiencies. *See id.* pp. 9-13, 34. As Dr. Feldstein’s expert report demonstrates, the empirical evidence shows that BCBSKS’ conversion to a for-profit stock company will have no adverse effect on the performance of BCBSKS.

Further, as set forth in detail in the expert witness report of Dr. Henry Butler, the transformation from a mutual insurer to a stock insurer does not necessarily mean that the stock insurer will charge premiums higher than would have been charged by the mutual insurer under the same market conditions. *See* Butler pp. 14-15. Premiums are driven by competitive factors; and as long as medical costs continue to rise, prices will rise, regardless of the organizational form of the insurer. *See id.* p. 15. The important point is that the change in organizational form does not change the ability of the insurer to increase prices above those of the competition. *See id.*

The conversion will not have any adverse effects on competition. As set forth in Dr. Butler’s report, the Kansas health-care insurance market is strongly competitive, and the acquisition of Anthem BCBS—which currently is not a participant in the Kansas market—will have no adverse effect on competition. *See* Butler pp. 5-12. The “contestability” of BCBSKS’ position as Kansas’s leading health insurer—*i.e.*, the ability of other insurers to enter the market or increase their market share if BCBSKS’ premiums

cease to be competitive—and the price-sensitivity of insurance consumers will ensure that the transaction does not adversely affect competition or consumer welfare. *See id.* pp. 3, 5, 13-14. If, as some of the intervenors have suggested, the Commissioner were to impose restrictions that hobble BCBSKS’ ability to compete with other health insurers, the result would be reduced competition in the market. *See id.* p. 16. This could have the unintended consequence of producing higher health insurance premiums for all Kansans. *See id.*

Any effect of the conversion on providers and other parties who may have contracts with BCBSKS can have no relevance to whether the plan meets the criterion of being fair and equitable to *policyholders*, and also has nothing to do with whether the proposed transactions would harm the insurance-buying public. Those providers’ legitimate interests are fully protected by their contracts and by their bargaining power in a competitive marketplace. The special-interest groups representing health-care providers appear to be engaged in what economists call “rent seeking”—*i.e.*, the self-interested use of political pressure to gain advantages for themselves that they would not be able to earn through normal market exchanges—rather than efforts to promote the public welfare or the interests of health-care consumers. *See Butler* p. 11. When physicians, nurses and hospitals express concern about reimbursement for their services, these concerns should be seen for what they actually are: their proprietary financial interests, not necessarily the public interest.

## **II. The Plan of Conversion Complies with the Provisions of the Conversion Law.**

The Conversion Law sets forth a number of specific requirements as to what must be included in a plan of conversion. It also sets forth specific procedural requirements relating to the adoption of a plan and its submission for approval by the policyholders and the Commissioner. All of these requirements have been satisfied, as discussed below.

### **A. The Plan Contains the Specific Elements Required by the Conversion Law.**

The Kansas Conversion Law permits three alternative types of plan of conversion. *See* K.S.A. § 40-4003a. BCBSKS' Plan is adopted in accordance with the first of these types, set out in K.S.A. § 40-4003a(a), which authorizes an exchange of policyholders' membership interests for cash or other consideration.

K.S.A. § 40-4003a(a) specifically requires a number of terms and conditions to be included in a plan of conversion. BCBSKS' Plan of Conversion satisfies all of these requirements. In particular, the Plan of conversion specifies:

- A description of the structure, forms and allocation of the proposed consideration to the policyholders, in accordance with K.S.A. § 40-4003a(a)(1)(A). *See* Pitsenberger p. 10; Plan §§ 6.2(f), 8.1-8.3.
- A description of the number of shares of capital stock to be issued by BCBSKS, in accordance with K.S.A. § 40-4003a(a)(1)(A). *See* Pitsenberger p. 10; Plan § 6.2(e).
- A description of amendments to BCBSKS' articles of incorporation, in accordance with K.S.A. § 40-4003a(a)(1)(B). *See* Pitsenberger p. 10; Plan § 6.2(c) & ex. B.
- Provisions establishing the method by which the initial board of directors of BCBSKS as a stock insurer will be selected, in accordance with K.S.A. § 40-4003a(a)(1)(C). *See* Pitsenberger p. 10; Plan § 9.1.

K.S.A. § 40-4003b provides that the Commissioner *may* require a plan of conversion to contain a closed block for participating individual life insurance policies, but a closed block is not required by the statute. BCBSKS has not issued any participating individual life insurance policies and has not historically paid experience-based dividends on individual policies. *See* McCarthy p. 8. For that reason, a closed block is not necessary or appropriate in these circumstances, as it would not serve the purpose that closed blocks are designed to address. *See id.* p. 8-9.

**B. The Procedural Requirements of the Conversion Law Have Been Satisfied.**

The Conversion Law sets out the procedures required for adoption of a plan of conversion, submission of the plan to the Commissioner for her review, and submission to the policyholders for a vote, as well as certain other procedural requirements. All of these requirements are satisfied here.

**1. Submission to the Commissioner.**

K.S.A. § 40-4002(b) optionally permits a draft of the Plan to be submitted to the commissioner for preliminary examination and review. Under K.S.A. § 40-4002(c), the final Plan as adopted by the Board must be submitted to the Commissioner for her approval. Pursuant to this provision, the Company submitted the Plan of Conversion to the Commissioner for her approval on October 26, 2001. In accordance with K.S.A. § 40-4004, the Commissioner is holding a public hearing on the Plan, and BCBSKS has given at least 20 days written notice of the hearing.

## **2. Adoption by the Board.**

In particular, § 40-4002(a) requires that the Board adopt by two-thirds vote a resolution stating the reasons that conversion would benefit the insurer and be in the best interests of its policyholders. It also requires that the Plan itself be adopted by a two-thirds vote of the directors.

This requirement is satisfied here. In accordance with K.S.A. § 40-4002(a), BCBSKS' Board of Directors unanimously approved the proposed Plan of Conversion on October 25, 2001, and made the required findings. *See* Pitsenberger pp. 2, 4. A copy of the Board's resolution will be offered in evidence at the hearing on the Plan.

## **3. Submission to a Policyholder Vote.**

K.S.A. § 40-4002(d) requires the Plan to be submitted to a vote of the policyholders at a meeting called for that purpose pursuant to the bylaws of the Company. K.S.A. § 40-4005 requires that the meeting be called by a majority of the Board of Directors, the chairperson of the Board or the President. These provisions were fully complied with, as the Board of Directors has called a Special Meeting and Vote to be held on January 11, 2002, in Topeka, Kansas. *See* Pitsenberger p. 3.

K.S.A. § 40-4005 requires that the notice of the policyholder meeting be accompanied by "a copy of the plan and any information that the commissioner deems necessary to policyholder understanding, including a comprehensible summary of the plan in a form approved by the commissioner." This requirement was satisfied by mailing to policyholders a Policyholder Information Guide and Policyholder Information Statement containing notice of the meeting, a copy of the plan, a summary of its terms,

and other information, all of which was approved by the staff of the Department acting on behalf of the Commissioner. *See* Pitsenberger pp. 4-5. A copy of all of these materials will be offered in evidence at the hearing on the Plan.

#### **4. Other Procedural Requirements.**

Upon approval of the Plan by the Commissioner and by a vote of the requisite number of eligible policyholders, K.S.A. § 40-4002(f) requires that the Plan be filed in the office of the Commissioner. In addition, K.S.A. § 40-4014 requires the amended articles of incorporation to be filed with the Kansas Secretary of State within twenty four hours after the Commissioner issues a certificate of authority to the converted insurer. The Company intends to comply fully with these provisions. *See* Pitsenberger p. 4.

In addition, in accordance with K.S.A. § 40-4013, the Company is bearing the expenses of the outside advisors and consultants retained by the Kansas Insurance Department testimonial team in connection with the demutualization. *See* Pitsenberger p. 9.

In accordance with K.S.A. § 40-4004(c), BCBSKS has provided all documents and information requested by the Commissioner or the Department. *See* Pitsenberger p. 12.

### **III. The Plan of Conversion Will Not Unjustly Enrich Any Director, Officer, Agent or Employee of the Insurer.**

In accordance with K.S.A. § 40-4004(a)(2), the Plan of Conversion does not unjustly enrich any director, officer, agent or employee of BCBSKS. The compensation of persons who are executive officers of BCBSKS immediately prior to the conversion

and the acquisition will not change solely as a result of the sponsored demutualization. *See* Lynn p. 9; Pitsenberger p. 11.<sup>3</sup> In particular, none of the officers or directors of BCBSKS will receive any stock, stock options, stock appreciation rights or other equity interests in Anthem as a result of the transaction. *See* Lynn p. 9. To the extent Anthem BCBS or its subsidiaries continue to employ BCBSKS' current officers, agents and employees in the future, they will be compensated for their ongoing services on the terms agreed between them and their employer, as is true with officers, agents and employees of any company.

**IV. BCBSKS Will Meet the Requirements for Issuance of a Certificate of Authority, and the Continued Operations of BCBSKS After Conversion Will Not Be Hazardous to Existing or Future Policyholders or the Public.**

Upon conversion, the Company will have the capital and surplus that is required of a domestic stock insurer. In particular, the Plan provides that BCBSKS will retain \$155 million in book value after making the Special Distribution, which will be more than sufficient to meet the capital and surplus requirements of an insurance company under Kansas law. *See* Lynn p. 6. BCBSKS is currently transacting the business of insurance in Kansas and satisfies all requirements for doing so. It will continue to meet these requirements after conversion. *See* Pitsenberger p. 11; Lynn p. 6.

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<sup>3</sup> BCBSKS' employment agreements with certain officers include severance arrangements. The terms are comparable to arrangements in place for senior management of similar companies. Under these officers' employment agreements, termination of employment under certain conditions, including in certain circumstances a change of control of BCBSKS, will entitle the officer to receive certain severance payments. These arrangements will remain in place regardless of whether the acquisition of BCBSKS by Anthem BCBS is consummated. *See* Lynn pp. 9-10.

The conversion and acquisition is expected to improve policyholders' and the public's security by providing the Company with greater flexibility, financial strength and improved access to capital. *See* Knack pp. 5-7. For that reason, the continued operation of BCBSKS after conversion will not be hazardous to policyholders or the public. Moreover, as discussed above in Part I.C, the conversion and acquisition will have no adverse effect on competition, and is not likely to have any adverse effect on health insurance premiums.

### **CONCLUSION**

For the reasons described in this brief and in the accompanying written statements, BCBSKS' Plan of Conversion satisfies all of the requirements for approval set forth in the Conversion Law, K.S.A. §§ 40-4004, and, moreover, is in the best interests of the Company and its policyholders and not detrimental to the public. In addition, for the reasons described in the submissions of Anthem BCBS, the proposed affiliation of BCBSKS with Anthem BCBS satisfies all requirements of the acquisition-of-control statute, K.S.A. § 40-3304.

BCBSKS therefore respectfully requests that the Commissioner approve the Plan.

BLUE CROSS AND BLUE  
SHIELD OF KANSAS, INC.

By: \_\_\_\_\_  
One of its attorneys