

**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

**PREFILED TESTIMONY OF MARK H. KOVEY**

**Credentials**

Q. Please state your name.

A. Mark H. Kovey.

Q. Please identify your employer and state your position.

A. I am a partner with the law firm of Scribner, Hall & Thompson, LLP (AScribner@). Scribner is a Washington, D.C. based law firm which specializes in providing advice on federal income tax matters involving insurance companies.

Q. Please describe your professional background.

A. I have almost 30 years experience in substantive tax law which began in the Corporate Tax and Reorganization Branch of the Internal Revenue Service (AIRS@) where, among other assignments, I issued rulings on corporate tax matters. I have been with Scribner over 25 years and my practice has focused primarily on corporate tax issues for insurance and other financial service clients. My speciality is in tax issues where corporate taxation rules overlap with insurance taxation principles. I have advised major corporations on acquisitions and dispositions of insurance companies, blocks of insurance, and other businesses. Many times I have represented state insurance departments in connection with rehabilitation and liquidation of insurance companies. Also, I represented Pacific Mutual Life Insurance Company in its conversion under California law to a stock life insurance company in a mutual holding company structure. I have led efforts for tax regulations on consolidated return, Internal Revenue Code (A.I.R.C.@) ' 338, and other corporate tax matters on behalf of trade associations and corporate clients. I am Founder and Co-Coordinator of the Insurance Tax Seminar, the largest professional tax law conference involving the insurance industry, and I also served on the IRS Commissioner=s Advisory Committee from 1986 to 1988.

I received an A.B. from Columbia University in 1964, a J.D. from New York University in 1967, and an L.L.M. from George Washington University in 1970. I am admitted to practice law in New York, Massachusetts, the District of Columbia, the U.S. Court of Federal Claims, the U.S. Tax Court, and the U.S. Supreme Court. I am also a member of the Federal Bar Association, where I served as Chairman of the Section on Taxation from 1985 to 1987, and a member of the American Bar Association.

Q. Have you been engaged by the Kansas Insurance Department Testimonial Team (ATestimonial Team@) to assist it in the evaluation of the proposed Plan of Conversion of Blue Cross and Blue Shield of Kansas, Inc. (ABCBSKS@) dated October 25, 2001 (the APlan@)?

A. Yes.

**Summary of Testimony**

Q. Specifically, what were you asked to review with respect to the Plan?

A. Scribner was asked to act as an independent advisor to the Testimonial Team in connection with the proposal for BCBSKS to convert from a mutual insurance company to a stock company, and for simultaneous acquisition of all outstanding stock of BCBSKS by Anthem Blue Cross and Blue Shield (AAnthem@), such transactions together referred to as a sponsored demutualization. In particular, we were asked to:

1. assist the Testimonial Team in the analysis of the sponsored demutualization;
2. evaluate and analyze the information provided to the Testimonial Team and Scribner by BCBSKS and Anthem for appropriateness and credibility;
3. evaluate the consequences under federal income tax concepts and rules of the sponsored demutualization to BCBSKS and its policyholders;
4. evaluate the tax opinions and memorandum regarding the transaction submitted to the Testimonial Team by BCBSKS and Anthem;
5. assist the Testimonial Team in conducting tax due diligence on BCBSKS and Anthem;
6. assist the Testimonial Team in assessing the merits and fairness of the transaction from the perspective of the BCBSKS policyholders; and
7. respond to other requests for assistance to the Testimonial Team on matters related to the review of the sponsored demutualization.

Q. Are you prepared to provide testimony in connection with that work?

A. Yes.

Q. Please summarize your review briefly.

A. Other Scribner representatives and I, acting as advisors to the Testimonial Team, participated in meetings and telephone conferences with other members of the Testimonial Team and BCBSKS and Anthem representatives. We interviewed the independent tax counsel and tax accountant for BCBSKS as well as Anthem's Vice President for Tax Management. We reviewed and analyzed numerous actuarial, accounting, and tax related documents, as well as the various drafts of the Plan documents. To the extent I employ the use of undefined capitalized terms, I intend to ascribe the same meaning to such terms as does the Plan, the Alliance Agreement between BCBSKS and Anthem Insurance Companies, Inc. dated May 30, 2001 (as amended), and the exhibits to both documents.

### **Description of Work Performed**

Q. Please describe the nature of the work that you have performed as a result of your engagement by the Testimonial Team.

A. The Scribner representatives and I, acting as advisors to the Testimonial Team, completed several tasks including those described below. Review of the listed documents included a review to (a) identify tax issues, (b) determine the accuracy of any description of federal income tax consequences, and (c) locate information necessary to determine whether the Plan of Conversion was fair to the BCBSKS's policyholders.

1. review of the Plan and Alliance Agreement, including multiple drafts of, and exhibits to, both said documents;
2. review of Purchaser Preliminary Disclosure Statement filed by Anthem with the Testimonial Team as of May 31, 2001;
3. review of BCBSKS's Disclosure Statement, with exhibits, filed by BCBSKS with the Testimonial Team, dated July, 2001;
4. review of the draft Form A filed by Anthem;
5. review of tax related documents from Anthem's due diligence review of BCBSKS;
6. analysis of the federal income tax consequences to policyholders, the Escrow Fund, BCBSKS, and Anthem of the structure, timing, and consideration to be paid in the proposed transaction;
7. review of the tax elements of the Contingent Litigation Matter Costs;
8. review of Anthem's Plan of Demutualization;

9. review of Anthem=s Consolidated Federal Income Tax Sharing Agreement to which Anthem would add BCBSKS after acquisition;
10. review of Anthem=s five-year Business Plan;
11. review of BCBSKS= request, attachments, and supplemental submissions for an IRS private letter ruling concerning the deductibility of payment to a charitable organization;
12. review of various BCBSKS= Annual Statements with respect to transactions undertaken in earlier years;
13. review of the Application for Exemption under ERISA, dated August 22, 2001, submitted by BCBSKS to the Department of Labor in connection with its demutualization;
14. review of the Proposed Exemption under ERISA for Anthem in connection with its demutualization, dated August 3, 2001;
15. review of several drafts of memoranda prepared by Debevoise & Plimpton (AD&P@) concerning the federal income tax considerations applicable to policyholders of BCBSKS upon the receipt of consideration for their mutual membership interests, including receipt of consideration out of Escrow Fund and taxability of amounts deferred under installment reporting rules of I.R.C. until actual receipt by policyholders of any such amount, character of amounts received either as capital gain or ordinary (interest type) income, and non-taxability of policyholders when amounts are contributed to, or earned by, the Escrow Fund;
16. review preliminary prospectus filed October 15, 2001, by Anthem with the U.S. Securities and Exchange Commission concerning its offering to public of common stock and equity security units;
17. review of the BCBSKS history of notices received from the IRS concerning errors, etc. made in filing information reports required under the I.R.C. in connection with policyholder and claim administration matters;
18. review multiple drafts and final versions, as submitted by BCBSKS, of the Policyholder Instruction Guide, Policyholder Notice, Policyholder Information Statement and related materials;
19. review of federal income tax returns of BCBSKS and affiliated entities (for open tax years) as part of financial due diligence and in preparation for interviews of BCBSKS= tax accountant and tax counsel;

20. analysis of the tax aspects of possible changes to the Plan, documents required from BCBSKS and Anthem, and expected due diligence procedures on tax matters;
21. interview of Seth Rosen, Partner of D&P, the firm serving as independent tax counsel to BCBSKS concerning major tax issues in transaction, particularly the timing and character of taxation of BCBSKS= policyholders who will receive consideration for their mutual membership interests in BCBSKS;
22. interviews of Gary Dudley, Tax Partner-In-Charge with Deloitte & Touche LLP representing BCBSKS, along with Seth Rosen and others, concerning tax due diligence and tax history of BCBSKS;
23. interviews of Seth Rosen and Matthew Saronson, Tax Associate with D&P, regarding additional tax matters including the treatment of expenses related to the Escrow Fund, treatment of tax refunds received after Closing that relate to taxes paid by BCBSKS for pre-Closing years, the lack of a definition of Anet after tax@ in the documents, which could lead to avoidable disputes, and the possibility that the tax provisions in the Escrow Agreement and Alliance Agreement do not adequately protect the interests of policyholders as to the handling of tax matters;
24. interviews of Seth Rosen and Gary Dudley concerning outstanding claim for tax refund by BCBSKS on deductibility of amounts allocated to various intangible assets, which issue is part of industry joint efforts; review reserve posted for such issue and its materiality to BCBSKS;
25. interview of Douglas Gettelfinger, Anthem=s Vice President for Taxation, as part of due diligence and tax history of IRS audits, return filings, and qualification of BCBSKS after acquisition under I.R.C. ' 833; and
26. provision of recommended changes to the Plan and related documents to improve the overall fairness to policyholders of BCBSKS of the transactions from a tax point of view.

### **Changes to the Transaction**

Q. Have changes been made in the proposed transaction as a result of the work you performed?

A. Yes.

Q. Could you describe those changes briefly?

A. The following changes were made as a result of the work we performed:

1. The transaction has been changed to require that BCBSKS must deposit into the Escrow Fund, and thereby make available for the benefit of Eligible Policyholders, the net after tax amount of all tax savings to BCBSKS from tax deductions for any interest added by BCBSKS to the payments to be received by the Eligible Policyholders under the Plan. Previously, BCBSKS was allowed to retain the full benefit of the tax deduction.
2. The review process that will be followed by the Policyholder Committee for items that will be paid from the Escrow Fund to BCBSKS for reimbursement of expenses, which expenses reduce the funds available to be paid to the Eligible Policyholders, has been improved by virtue of certain definitions added to the documents to clarify the tax treatment of the expenses and the reformation of the Policyholder Committee process. By virtue of such changes there likely will be far fewer disputes which should result in the payment of a larger amount to the Eligible Policyholders with fewer delays.
3. The portion of the purchase price that will be paid to the Eligible Policyholders, without being made subject to the risks of nonpayment and delays in payment that encumber amounts deposited in the Escrow Fund, has been increased in part because the Testimonial Team requested that BCBSKS and Anthem give consideration to alternative forms of payment to Eligible Policyholders that would not be taxable when received.
4. Independent counsel for BCBSKS provided the Testimonial Team a legal memorandum that supported the federal income tax law opinion issued to BCBSKS and was included in the Policyholder Information Statement.

### **Outstanding Issues and Unfulfilled Document Requests**

Q. Are there any outstanding issues and or unfulfilled document requests that have not been fulfilled, and if so, could you please explain them?

A. Yes.

1. The Policyholder Committee should 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 are 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.
2. In general, 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. The parties have argued that it is fair for such refunds not to be deposited because the Escrow Fund is not bearing the risk of any additional taxes that have to be paid for pre-Conversion years. That is, the parties argue that they are bearing the risk of additional taxes due and thus should get the benefit of any refunds payable. Despite the surface appeal of that argument, the two periods of time do not pose equality of risk of loss and opportunity for gain because the parties have it within their control to reduce or eliminate any risk of additional taxes for pre-Conversion years, subject to the review by the Testimonial Team of the Closing Balance Sheet and the review by the Policyholder Committee of the post-closing tax returns recommended above.

3. BCBSKS and Anthem advised the Testimonial Team that they were still in the process of developing a method for handling the requirement that interest paid to the Eligible Policyholders must be reported to the IRS. We have not received a report on their methodology.
4. We requested Anthem to represent that it would not deduct for tax purposes the Special Distribution or the Purchase Price paid to the Eligible Policyholders. We have not received any such representation.
5. We must still review the tax accruals portion of the Closing Balance Sheet of BCBSKS.

### **Conclusion**

Q. Have you made any observations or reached any conclusions in connection with your work?

A. Yes.

1. A principal part of Scribner=s assignment was to review, by examination of documents and interviews of the tax representatives of BCBSKS and Anthem, the tax history and status of both companies. Our observation is that there do not appear to be any outstanding tax issues that raise a material concern as to the financial capacity of the parties to undertake the transactions and fulfill their obligations under the Plan.
2. We have concluded that the tax related representations contained in the Policyholder Information Statement, which detail the expected tax consequences to Eligible Policyholders generally, are accurate and should provide the policyholders with sufficient information to make the necessary decisions or to consult with their tax advisors, as is recommended in the statement. We are also satisfied that the memorandum prepared by D&P provides reasonable support for the legal opinion of the firm that is attached to the Policyholder Information Statement.

Q. Does this conclude your testimony?

A. Yes it does.

Thank you Mr. Kovey.