

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

WRITTEN STATEMENT OF DONALD R. LYNN

**I. Personal Background**

I am Donald R. Lynn, Vice President of Finance of Blue Cross and Blue Shield of Kansas, Inc. (the “Company” or “BCBSKS”) since 1984 and its Treasurer since 1990. Prior to this position, I was Director of Actuarial Research from 1979 to 1984, and I served in the Actuarial Research Department from 1973 through 1979. I hold a bachelor of science degree from Kansas State University and I am a member of the American Academy of Actuaries.

This statement is submitted in support of BCBSKS’ request that the Commissioner of Insurance of the Kansas Insurance Department (the “Commissioner”) approve the Plan of Conversion, which has been unanimously approved and adopted by the Company’s Board of Directors, and the acquisition of BCBSKS by Anthem Insurance Companies, Inc. (“Anthem”), which has been unanimously approved by the Board.

**II. Background and Introduction**

BCBSKS was formed in 1983 by the consolidation of Blue Cross of Kansas and Blue Shield of Kansas and is currently the largest health insurer in Kansas. More than 715,000 Kansas residents in all Kansas counties except Johnson and Wyandotte, two counties near Kansas City, have private health coverage insured or administered by us.

Through government programs administration of Medicare and Medicaid, we administer health care coverage for 640,000 additional Kansans, some of whom also carry our Medicare Supplemental coverage. In all, more than one million residents of Kansas rely on us to administer their health care coverage. In 2000, we had premiums of \$873.0 million, surplus of more than \$328.5 million, net income of \$5.8 million and assets of \$730.8 million.

While BCBSKS is financially sound and enjoys a strong in-state market share, we are not immune to the Kansas business environment. Kansas businesses in general have experienced, and continue to experience, loss of local autonomy in making buying decisions regarding health coverage because businesses have been purchased or have merged with large national corporations. This trend has caused us a loss of enrollment and potential growth opportunities. Census forecasts suggest there will be rapid growth in population in northeast Kansas, largely outside our service area, with marginal growth in the Wichita and extreme southwest Kansas areas. The remaining market area is forecast to decline in population in future years.

In our present situation, our market and our ability to adjust to current market conditions are limited. We hold a certificate of authority to sell insurance only in Kansas, and are limited in our use of the Blue Cross and Blue Shield names and service marks. In addition to our inability to expand geographically, our potential customer base within the state shrinks every year as national corporations purchase or supplant local businesses. We are also unable to diversify our risks geographically. An adverse local illness, adverse local legislation, a natural disaster, or targeted pricing for market share by

competitors could have substantial impact on our financial soundness. However, if we are to continue to provide high quality insurance services at reasonable costs to our policyholders in a health insurance market that has become national in scope, we must spread our costs over a sufficiently large policyholder base.

These market conditions demonstrate that now is the time to affiliate with a strategic partner such as Anthem. The sponsored demutualization will address the above concerns regarding the Company policyholder base and the present market conditions in Kansas as well as nationally. Despite these market conditions, some individuals have commented that BCBSKS should take a “wait and see” approach rather than going forward with the affiliation. In management’s considered judgment such an approach is a risky one, especially in light of its possible consequences as documented in the recent history of Blue Cross and Blue Shield of Colorado.

### **III. Sponsored Demutualization**

In an effort to address changing market conditions and limitations under our current corporate form, BCBSKS plans to convert from a mutual life insurance company to a stock life insurance company organized and existing under the Kansas insurance law. Upon approval of BCBSKS’ Plan of Conversion by Eligible Policyholders and the Commissioner, we will become a stock insurance company. Anthem is sponsoring BCBSKS’ conversion under an Alliance Agreement between Anthem and BCBSKS, dated May 30, 2001, and amended as of September 28 and November 9, 2001 (the “Alliance Agreement”). The Alliance Agreement provides for, and the Plan of Conversion is contingent upon, Anthem’s purchase, through a subsidiary, of 100% of our

stock on the Conversion Date. As a result, we will become an indirect, wholly-owned subsidiary of Anthem. This process of conversion and affiliation is called a “sponsored demutualization.”<sup>1</sup>

We believe that converting from a mutual insurance company to a stock insurance company and affiliating with Anthem, a larger multi-state insurer, will benefit our policyholders in several ways. The sponsored demutualization will (1) allow us to convert Eligible Policyholders’ illiquid Membership Interests into cash consideration; (2) provide us with sufficient capital to compete with national commercial companies and with access to a larger total capital pool; (3) enable us to take advantage of economies of scale; (4) give us increased flexibility in responding to localized adverse risk events, avoiding the twin perils of decreased financial stability and excessive increases in rates to avoid financial instability; (5) allow us to participate better in insurance offerings to multi-state accounts; (6) enable us to offer a greater variety of career paths to our employees, with the potential for greater and more varied challenges; and (7) allow us to take advantage of best practices in health insurance from Anthem and its other health insurance affiliates. Importantly, although we cannot guarantee that premiums will not increase in the future, the sponsored demutualization will not change policy and contract rights in any respect.

#### **IV. Consideration**

A principal purpose of the sponsored demutualization is that Eligible Policyholders will receive cash consideration in exchange for their otherwise illiquid

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<sup>1</sup> Capitalized terms used in this statement, unless otherwise defined herein, have the meanings set forth in the Plan of Conversion.

Membership Interests. If the Plan of Conversion becomes effective, the Membership Interests of all of our policyholders will be extinguished and they will no longer have any voting rights. In exchange for their Membership Interests, Eligible Policyholders will be entitled to receive cash consideration. Thus, Eligible Policyholders will realize real economic value from their Membership Interests that is unavailable to them under the current organizational format. The cash consideration will be comprised of two elements, the Purchase Price and a Special Distribution.

A. Purchase Price

Pursuant to the Alliance Agreement, immediately upon BCBSKS' conversion from a mutual insurance company to a stock insurance company, Anthem West, Inc., an Anthem subsidiary, will purchase 100% of BCBSKS stock for \$190 million (the "Purchase Price"). Upon closing the transaction, \$142 million of the Purchase Price will be made available for distribution to Eligible Policyholders and BCBSKS will deposit the balance of the Purchase Price, \$48 million, into an Escrow Fund. Established by the Escrow Agreement (Exhibit D to the Plan of Conversion), the Escrow Fund will address potential costs and expenses related to a matter involving a subpoena received by BCBSKS from the U.S. Department of Health and Human Services on February 28, 2001 (the "Contingent Litigation Matter"), and certain other expenses described in the Plan of Conversion, the Alliance Agreement and the Escrow Agreement. A Policyholder Committee selected by the Commissioner will oversee the Escrow Fund. The Commissioner will retain regulatory oversight over the Escrow Fund, including the investment and distribution of the assets held in the Escrow Fund, to ensure that

policyholder interests are protected and that the actions of the Policyholder Committee comply with the Escrow Agreement, the Plan of Conversion and applicable law.

Upon resolution of the Contingent Litigation Matter, the balance of the Escrow Fund, after making allowances for taxes and expenses, will be distributed to Eligible Policyholders according to the Plan of Conversion. However, should the Policyholder Committee determine that it would be impractical to distribute the remaining funds, taking into account the cost of distribution compared to the amount remaining in the Escrow Fund, no distribution would be made, but the balance would be donated to a charity.

#### B. Special Distribution

If the Plan of Conversion becomes effective, BCBSKS will make a Special Distribution to Eligible Policyholders in addition to the distribution of the Purchase Price. The Special Distribution will be equal to the amount by which the Closing Book Value of BCBSKS exceeds \$155 million, a sufficient level of capital to satisfy the capital requirements of Kansas law and the requirements of the Blue Cross and Blue Shield Association for a member plan, subject to any difference in rounding resulting from the distribution to Eligible Policyholders. We currently project that BCBSKS' surplus will be \$286 million as of January 31, 2002, and therefore, we estimate that the Special Distribution will be \$131 million if the conversion occurs on that date. This is only a projection, however, and we cannot guarantee the amount of any Special Distribution.

### C. Interest on Consideration

Upon consummation of the Plan of Conversion, the Special Distribution and that portion of the Purchase Price not deposited in the Escrow Fund will be distributed to Eligible Policyholders. We will distribute the funds as soon as reasonably practicable after the resolution of the Final Closing Balance Sheet used to determine the Closing Book Value, and we anticipate distribution within 90 to 120 days after the Conversion Date. In any case, the funds will accrue interest at the rate of 7% from the Conversion Date until they are distributed to Eligible Policyholders. In addition, as provided in the Escrow Agreement, the Escrow Agent will invest the monies in the Escrow Fund in obligations of or fully guaranteed by the United States of America. Therefore, we anticipate that the monies in the Escrow Funds will accrue interest until they are paid out or distributed.

### V. **Allocation of Consideration to Eligible Policyholders**

If the Plan of Conversion becomes effective, each Eligible Policyholder will be entitled to receive that Eligible Policyholder's Proportionate Share of the Special Distribution and the Purchase Price, less any required tax withholding. Eligible Policyholders are those Policyholders, as described in section 7.2 of the Plan of Conversion, that were Policyholders on the date that the BCBSKS Board of Directors adopted the Plan of Conversion, October 25, 2001. An Eligible Policyholder's Proportionate Share will equal the sum of 1) the Eligible Policyholder's pro rata share, based on the total number of Eligible Policyholders, of one-third of the amount being distributed (the "fixed share percentage"), and 2) the Eligible Policyholder's share, based

on actuarial determinations of the past and future contributions to our statutory surplus, of the remaining two-thirds of the amount being distributed (the “variable share percentage”). The determination of these percentages is discussed in greater detail in the written statement of our actuarial consultant, Daniel J. McCarthy, an independent consulting actuary associated with Milliman USA.

## **VI. Tax Issues**

Each policyholder should consult his or her own tax advisor to determine the tax consequences of the sponsored demutualization. In general, however, Eligible Policyholders will be taxed at capital gains rates on the cash paid to them that is treated as payment for Membership Interests. A portion of the amount received may be paid or treated as interest, which will be taxed at ordinary income rates. We will inform Eligible Policyholders of the amount, if any, of each payment to them that will be treated as interest, and will report to the IRS as required by law.

Eligible Policyholders will be taxed at capital gains rates on the cash paid in the Special Distribution and the distribution of the Purchase Price in the year in which it is received. As described above, if the Special Distribution and distribution of the portion of the Purchase Price that is not deposited in the Escrow Fund are paid after the Conversion Date, we are required to pay Eligible Policyholders interest at a 7% rate on the amount of cash received. The interest payments will be taxed at ordinary income rates.

Tax consequences to each Eligible Policyholder of payments from the Escrow Fund will depend on whether the Eligible Policyholder is entitled to total payments in the

conversion totaling \$3,000 or less, or more than \$3,000. If the total amount of the cash an Eligible Policyholder is entitled to receive in exchange for his or her Membership Interest will be \$3,000 or less, he or she will be taxed at capital gains rates on the full amount of cash received from the Escrow Fund in the year of receipt. If the total amount will be more than \$3,000, the Eligible Policyholder will be taxed at capital gains rates on a portion of the cash paid from the Escrow Fund in the year of receipt and the remainder of the cash paid will be treated as interest and taxed at ordinary income rates in the year of receipt.

The Plan of Conversion is contingent upon BCBSKS receiving a favorable opinion from Debevoise & Plimpton or another nationally-recognized independent tax counsel. The opinion will confirm that the principal federal income tax consequences to Eligible Policyholders resulting from their receipt of cash consideration pursuant to the sponsored demutualization are in all material respects as set forth in the Policyholder Information Statement distributed pursuant to sections 4.2 and 5.2 of the Plan of Conversion.

## **VII. Compensation of Officers and Employees**

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. 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. 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 or not the acquisition of BCBSKS by Anthem is consummated.

### **VIII. Financial Condition of Company After Conversion and Acquisition**

After the sponsored demutualization, BCBSKS will meet all statutory requirements regarding its financial condition. BCBSKS will be an indirect, wholly-owned subsidiary of Anthem, one of the nation's largest health benefits companies. Anthem serves almost eight million members, or customers, primarily in Indiana, Kentucky, Ohio, Connecticut, New Hampshire, Maine, Colorado and Nevada. It holds the leading market position in seven of these eight states and owns the exclusive right to market its products and services using the Blue Cross and Blue Shield names and marks in all eight states. In 2000, Anthem had operating revenues of \$8.5 billion, surplus of more than \$1.9 billion, net income of \$226 million and assets of \$5.7 billion.

Anthem's product portfolio includes a diversified mix of health insurance products. In addition to offering traditional indemnity products, Anthem operates Health Maintenance Organizations (HMOs), Preferred Provider Organizations (PPOs), and Point of Service (POS) plans. It also offers a broad range of administrative and health insurance services and partially insured products, and several specialty products including group life, disability, prescription management, workers compensation, dental and vision plans.

Anthem's customer base primarily includes large employer sponsored groups, small groups and individuals. The remainder of Anthem's membership is primarily federal employees or enrollees under other federal programs, and Medicaid recipients. Anthem principally markets products through an extensive network of independent agents and brokers who are compensated on a commission basis for new sales and retention of existing business.

Anthem's reportable segments are strategic business units delineated by geographic areas within which Anthem offers similar products and services. It manages each segment with a local focus to address each geographic region's unique market, regulatory and health care delivery characteristics. In addition to its geographic regions, Anthem has a Specialty segment and an "Other" segment that includes a large Medicare fiscal intermediary operation.

On November 2, 2001, Anthem converted from a mutual insurance company to a stock company. Anthem conducted an initial public offering and became a public company. The principal reason for the conversion was to increase Anthem's financial flexibility through improved access to capital. As a public company, Anthem is subject to the ongoing reporting requirements of the Securities Exchange Commission. You can obtain more information regarding Anthem by visiting the Securities and Exchange Commission website at [www.sec.gov](http://www.sec.gov) or Anthem's website at [www.anthem.com](http://www.anthem.com).

## **IX. Valuation**

In conjunction with its fairness opinions with respect to the sponsored demutualization, our financial advisor, the investment bank of Dresdner Kleinwort

Wasserstein, Inc., performed valuation analyses of BCBSKS. As explained in more detail in the written testimony of Mr. Paul Adams, Dresdner Kleinwort Wasserstein performed substantial analysis of BCBSKS' business and market conditions, reviewed the pertinent agreements and plans establishing the sponsored demutualization, and conferred with BCBSKS management, committees and directors. A significant part of its analysis was the creation of estimated valuation ranges of BCBSKS.

Dresdner Kleinwort Wasserstein estimated value ranges for BCBSKS using three methods: comparable company analysis; comparable transaction analysis; and discounted cash flow analysis. Using the comparable company analysis, it selected four companies engaged in businesses that it considered comparable to our business. It used publicly available information to develop multipliers that it applied to BCBSKS' premiums and fees and to its health membership to determine a value range for BCBSKS. Applying the comparable transaction analysis, Dresdner Kleinwort Wasserstein analyzed five merger and acquisition transactions over the past three and one-half years involving Blue Cross and Blue Shield companies targets. Using the acquisition value of the targets, it again developed multipliers that it applied to BCBSKS' premiums and fees and to its health membership to determine a value range for BCBSKS. Dresdner Kleinwort Wasserstein also performed a discounted cash flow analysis to determine a range of net present values of estimated future cash flows of BCBSKS.

Under each analysis, the aggregate cash consideration provided for under the Plan of Conversion was within the resulting value ranges. Based in large part on these analyses, Dresdner Kleinwort Wasserstein opined that the aggregate of the Purchase Price

and the Special Distribution payable to Eligible Policyholders and into the Escrow Fund for the benefit of Eligible Policyholders pursuant to the Plan of Conversion is fair to Eligible Policyholders from a financial point of view.

**X. Conclusion**

For the reasons described above, we are confident that the Plan of Conversion is fair and equitable to our policyholders and in the best interests of our policyholders and the Company. Therefore, we respectfully request that the Commissioner approve the Plan and the acquisition of BCBSKS by Anthem.

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Donald R. Lynn

Dated: December 17, 2001  
Sworn to before me this 17<sup>th</sup> day of December, 2001

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Notary Public