

REPORT ON EXAMINATION
OF THE
EMPIRE BLUE CROSS AND BLUE SHIELD
AS OF
DECEMBER 31, 1999

DATE OF REPORT
EXAMINER

NOVEMBER 6, 2002
WAI WONG

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STATE OF NEW YORK
INSURANCE DEPARTMENT
25 BEAVER STREET
NEW YORK, NEW YORK, 10004-2319

George E. Pataki
Governor

Gregory V. Serio
Superintendent

Date: November 6, 2002

Honorable Gregory V. Serio
Superintendent of Insurance
Albany, New York 12257

Sir:

Pursuant to the provisions of the New York Insurance Law and acting in accordance with directions contained in Appointment Number 21509 dated March 6, 2000 and annexed hereto, I have made an examination into the financial condition and affairs of Empire Blue Cross and Blue Shield, a health service corporation licensed under Article 43 of the New York Insurance Law.

A concurrent examination was made into the condition and affairs of Empire Blue Cross and Blue Shield HMO, a health maintenance organization operated by Empire Blue Cross and Blue Shield. The results thereof are included in Appendix "A" to this report.

Whenever the terms "the Company" or "Empire" appear herein without qualification, they should be understood to mean Empire Blue Cross and Blue Shield.

1. SCOPE OF EXAMINATION

Empire Blue Cross and Blue Shield was previously examined as of December 31, 1994. The current examination covered the period from January 1, 1995 through December 31, 1999. Transactions occurring subsequent to this period were reviewed where deemed appropriate.

The examination comprised a verification of assets and liabilities as of December 31, 1999, and a review of income and disbursements deemed necessary to accomplish such verification and utilized, to the extent considered appropriate, work performed by Empire's independent certified public accountants. A review or audit was also made of the following items as called for in the Examiners Handbook of the National Association of Insurance Commissioners:

- History of the Company
- Management and control
- Corporate records
- Officers' and employees' welfare and pension plans
- Territory and plan of operation
- Growth of corporation
- Loss experience
- Accounts and records

This report on examination is confined to financial statements and comments on those matters, which involve departures from laws, regulations or rules, or which are deemed to require explanation or description.

A review was also made to ascertain what action Empire took with regard to comments in the prior report on examination, dated December 31, 1994.

2. DESCRIPTION OF COMPANY

Empire is a New York corporation which is licensed under Article 43 of the New York State Insurance Law as a not-for-profit health service corporation. It is the direct successor to Associated Hospital Service of New York ("AHS"). AHS was incorporated when a Certificate of Incorporation was filed with the New York State Department of State on July 6, 1934. In 1940, the Medical Expense Fund was formed as a non-profit medical insurer for the New York City area. In 1944, the Medical Expense Fund merged with Community Medical Care, a subsidiary of AHS, to form United Medical Service Inc. ("UMS").

In 1974, AHS and UMS entered into an agreement to effect a plan of consolidation to form Blue Cross and Blue Shield of Greater New York ("BCBSGNY").

On July 26, 1977, BCBSGNY was authorized under the New York Public Health Law to operate a health maintenance organization Community Health Plan of Greater New York which was subsequently renamed as Empire Blue Cross and Blue Shield HMO ("Empire HMO"). On July 4, 1986, Empire was issued a Certificate of Authority to operate an Individual Practice Association model HMO, Empire Blue Cross and Blue Shield HealthNet ("Empire HealthNet"). In 1987, Empire HMO subscribers were notified that their contracts were being terminated and they were given the option to transfer to an Empire HealthNet contract.

On May 1, 1985, Blue Cross of Northeastern New York merged with BCBSGNY resulting in the formation of Empire Blue Cross and Blue Shield.

In February of 1996 the Company, in line with its plan to restructure as a for-profit company and to attain its objective to transition itself from an indemnity insurer to a managed care provider, organized two for-profit stock companies, Family Health Assurance Company (FHAC) and Family HealthChoice Inc. (FHI). The two companies were subsequently renamed Empire HealthChoice Assurance, Inc. and Empire HealthChoice, Inc. respectively. Empire HealthChoice Assurance, Inc. was formed as a for-profit accident and health insurer under Article 42 of the New York State Insurance Law and Empire HealthChoice, Inc. was formed as a health maintenance organization under Article 44 of the New York Public Health Law. Both companies were incorporated in February 1996 and licensed in March 1996. A holding company, Choice Holdings, Inc., was created by Empire to hold all of the stocks of the aforementioned companies. In October of 1999 a holding company Empire Health Care, Inc. was incorporated in Delaware to house Empire Blue Cross and Blue Shield if the proposed restructuring to a for profit entity occurred. Empire Health Care, Inc. merged with Choice Holdings in December of 1999. The merged entity retained the name Empire Health Care, Inc. and Choice Holdings was dissolved in the transaction.

On January 1, 2001 name changes were implemented for Empire Blue Cross and Blue Shield, Empire HealthChoice, Inc. and the holding company Empire Health Care, Inc. Empire Blue Cross and Blue Shield was renamed Empire HealthChoice, Inc., however, it will continue to do business as Empire Blue Cross and Blue Shield in order to affirm that it is still a Blue Cross and Blue

Shield Plan. Empire HealthChoice, Inc. was renamed Empire HealthChoice HMO, Inc. and the holding company Empire Health Care, Inc. was renamed WellChoice, Inc.

In 1999, Empire Blue Cross and Blue Shield submitted a Plan of Restructuring to the New York State Department of Insurance (the “Department”), which was the subject of the Opinion and Decision issued by the Superintendent of Insurance (the “Superintendent”) on December 29, 1999 (the “1999 Opinion and Decision”). However, Empire did not pursue the restructuring. In 2002, Chapter One of the Laws of 2002 (the “Legislation”) was enacted to amend various provisions of the Public Health Law, New York State Social Services Law, and New York State Tax Law to address the Health Care Reform Act of 2000, and to amend the Insurance Law to establish the procedure for converting a not-for-profit corporation such as Empire Blue Cross and Blue Shield to a for-profit insurer and distributing ninety-five percent (95%) of the fair market value of the converted corporation into a “Public Asset Fund” and five percent (5%) of the fair market value of the converted corporation in to a charitable organization.

Specifically, the Legislation added §7317 to the Section 7317(a)(1) of the New York State Insurance Law provides that “an article forty-three corporation which was the subject of an initial opinion and decision issued by the Superintendent of Insurance on or before December thirty-first, nineteen hundred ninety-nine, as the same may be amended, which seeks to convert into a corporation or other entity organized for pecuniary profit or into a for-profit organization of any kind shall submit a proposed plan of conversion to the superintendent for approval pursuant to this section.”

Section 7317(b) of the New York State Insurance Law states “the proposed plan is to include all items and address all issues as may be required by the Superintendent in order for the Superintendent to assure that the conversion process will not adversely affect the applicant’s contract holders or members; that it will protect the interest of and will not negatively impact on the delivery of health care benefits and services to the people of the State of New York; and that it results in the fair, equitable and convenient winding down of the business and affairs of the applicant. The superintendent may adopt such rules or regulations or establish such procedures as he or she deems necessary or proper to implement the provisions of this section.”

Pursuant to the legislation, on June 18, 2002, the Board of Empire Blue Cross and Blue Shield filed an Amended Plan of Conversion. This plan was further amended and re-filed with the Department on September 26, 2002 and is referred to herein as the “2002 Plan”. The 2002 Plan provides for a series of transactions to be executed substantially contemporaneously, resulting in the conversion of Empire from an Article 43 health services corporation to an Article 42 for-profit accident and health insurer, and the merger of Empire and Empire HealthChoice Assurance, Inc. The “new’ Empire is now owned by WellChoice Holdings of New York, Inc. which, in turn, is owned by WellChoice, Inc. a for profit, publicly traded holding company. The new article 42 for-profit accident and health insurer (formerly the Article 43 Empire Blue Cross and Blue Shield) owns an Article 44 HMO.

The Superintendent approved the Amended Plan of Conversion on October 8, 2002.

A. Management

The Company's boards of directors and executives have undergone a significant reconstitution during the period under examination. The Certificate of Incorporation provides that the management of the Corporation is vested in a board of directors, which shall have a minimum of 13 and a maximum of 52 members. The by-laws in effect as of examination date has set the number of directors to no more than 25 members.

As of December 31, 1999 the board of directors had been reduced to thirteen members from the twenty-one directors during the previous examination period as of December 31, 1994. There were two members elected to the board subsequent to 1994 who were not board members as of December 31, 1994. As of the date of this report the Company had fourteen members on the board of directors.

Directors are elected at the annual meeting of "voting members" for three-year terms. Empire's by-laws, as amended, prescribe 68 voting members, 55 of who are elected by the board of directors from persons proposed by the board's Nominating Committee. The thirteen remaining voting members consist of presidents of various county medical societies located throughout the Empire operating area. Effective January 1993, pursuant to Section 4301(k)(2)(C) of the New York Insurance Law, eligibility of persons nominated for election to the board is subject to the prior approval of the Superintendent of Insurance. As noted below, effective February 27, 2002 Empire's by-laws were amended to eliminate voting members; as of the date of this report, the Board of Directors is responsible for the election of new Board members from persons proposed by the board's Nominating Committee.

As of the examination date, the board is divided into three classes for the purpose of staggering their terms of office. Each class shall consist of approximately one-third of the total number of directors, as nearly as practicable, each of who shall serve for a three-year term. The Chief Executive Officer of the Company shall become a director upon the assumption of such office.

The following individuals were members of the board of directors as of December 31, 1999:

Name and Residence

Principal Business Affiliation

Subscriber Category

William T. Lee
Roosevelt, NY

Vice President
AFL-CIO, CLC (UNITE)

Robert R. McMillan
Garden City, NY

Partner
McMillan, Rather, Bennett & Rigano, P.C.

Faye Wattleton
New York, NY

President
Center for Gender Equality

Harold Wolchok
Staten Island, NY

Professor
Empire State College

General Public Category

Philip Briggs
Shelburne, VT

Chairman of the Board
Empire Blue Cross and Blue Shield

Hermes L. Ames, III
Menands, NY

President
Fleet National Bank

Edward J. Malloy
New York, NY

President
Building and Construction Trades Council

Robert D. Paul
New York, NY

(Retired) Chairman of the Board
The Segal Company

John E. Zuccotti
Brooklyn, NY

Chairman
Brookfield Financial Properties

Name and ResidencePrincipal Business AffiliationProvider Category

John R. Gunn
Wilton, CT

Executive V.P./Chief Operating Officer
Memorial Sloan-Kettering Cancer Center

John F. McGillicuddy
Rye, NY

(Retired) Chairman of the Board and CEO
Chemical Bank Corporation

Veronica C. Santilli, M.D.
Brooklyn, NY

Practicing Physician
Brook-Island Pediatrics Group, PC

Employee-Officer Category

Michael A. Stocker, MD
Avon, CT.

President and CEO
Empire Blue Cross and Blue Shield

In 2001, William T. Lee retired from the board and was replaced by Frederick Terrell. John F. McGillicuddy moved from the Provider category to the General Public category and Stephen Scheidt was elected to take John F. McGillicuddy's vacancy in the Provider category.

Section 4301(k)(1) of the New York State Insurance Law specifies the components of the board of directors of Article 43 corporations to include employee-officers, providers, and subscribers of such corporations and the general public. This section, however, limits the number of directors for each category as follows:

- Provider representatives - no more than one-fifth of the board.
- Employee-officer representatives - no more than one-eighth of the board.
- Subscriber representatives - one-half in number, as nearly as possible, of the directors not included in the provider and employee-officers categories.

- General public representatives - one-half in number, as nearly as possible, of the directors not included in the provider and employee-officers categories.

As of the examination date, the Company's board consisted of three members representing providers, one employee-officer, four members representing subscribers and five members representing the general public. In this regard the examiner notes that one general public director, Philip Briggs, Chairman of the Board, received compensation from Empire, \$146,500 for the year 2001.

As of the date of this exam, the Company's by-laws and resolutions provided for the following standing board committees:

- | | |
|---------------------------------------|--|
| Executive Committee | - The Executive Committee is composed of the Chairman of the Board, the chairman of each of the standing committees and such other members of the board as are necessary to reflect the composition of the board. It has the authority to exercise for and on behalf of the board all powers of the board, to the extent permitted by law, between meetings of the board. |
| Nominating and Compensation Committee | - This committee is composed solely of directors who are not officers or employees of the corporation. It is responsible for the selection and nomination of persons for election to the board. It is also responsible for proposing candidates for election by the board as voting members of the corporation as provided in the by-laws. In addition, it is charged with recommending to the board the appointment, performance evaluation, compensation and benefits of company officers and employees. |
| Public Policy Committee | - It is responsible for reviewing subscriber benefits and rates. Based on reports received from management and various focus groups, it recommends to the board corporate policies involving government affairs, media relations and legislative initiatives and customer service. |
| Audit Committee | - It is composed of at least three directors who are not officers or employees of the corporation. Its primary responsibility is to provide effective |

oversight of the financial reporting functions and the Company's audit and internal control programs. It is also responsible for recommending the selection of the independent certified public accountants, reviewing the Company's financial condition, and the scope and results of independent and internal audits. It also had the authority to conduct or authorize investigations into any matter within the Committee's scope of responsibilities. It had unrestricted access to the Corporation's records and personnel, independent accountants, or other individuals deemed necessary. It was empowered to retain independent counsel and other professionals to assist in the conduct of any investigation. It was also responsible for the oversight of all ethical and legal compliance programs. It should also be noted that the Audit Committee Charter for WellChoice, Inc. was revised again in 2002 to comply with the requirements of the Sarbanes-Oxely Act and the New York Stock Exchange listing standards.

- Investment Committee - It is the responsibility of this committee to review and approve the investment policies and transactions of the Company and make regular reports thereon to the board. It is also responsible for reviewing and approving Company banking practices and relationships as conducted by management.

In addition to the foregoing committees, the board formed during the examination period, and subsequent thereto, the following special committees:

- Financial Advisory Committee - Formed in September 1994 to study, review and make recommendations to the board on proposals for a corporate financial strategy involving capital raising activities, investment banking options and other extraordinary financial undertakings.

- Continuous Quality Improvement Committee - Formed in April 1995 to monitor actions taken and improvements made in the quality of Empire's managed care efforts and organization.

- Compliance Committee The Compliance Committee was established subsequent to the release of the most recently completed Report on Examination as of December 31,

1994, the Market Conduct Review from 1995 and as a result of the stipulation entered into with NYSID in 1996. As part of Empire's obligations under that stipulation, Empire retained Pricewaterhouse Coopers to oversee its compliance with the stipulation and all recommendations contained within the Report on Examination and the Market Conduct Review. PwC provided regular updates to Empire's Compliance Committee and supplied very detailed annual reports to the New York State Insurance Department for three years. Those reports evidenced Empire's compliance with all said recommendations. The Compliance Committee was disbanded in March of 1999. When the committee was disbanded the Audit Committee was charged with monitoring any remaining open issues from the previous statutory and market conduct exams.

Foundation Committee Formed in June of 1997 to make recommendations on Empire's proposal to form a charitable foundation funded by capital raised from the company's initial stock offering when it converts to a for-profit entity.

A review of the minutes of the meetings of the board and its committees held during the period covered by this examination and subsequent to the date of this report revealed that all meetings were well attended and that each director had an acceptable attendance record.

The principal officers of the Company at December 31, 1999 were as follows:

Michael A. Stocker, M.D.	President and CEO
Peter Liria, Jr.	Corporate Secretary
John W. Remshard	Senior VP and CFO
Joseph Berardo, Jr.	Senior VP and Chief Sales Officer
Kenneth O. Klepper	Senior VP – Customer Service
Gloria M. McCarthy	Senior VP – Operations and Information, Systems
William B. O'Loughlin	Senior VP – Chief Information Officer

Connie C. Poirier	Senior VP – Medical Delivery Systems and Medicare Risk.
Donna R. Ratliff	Senior VP – Human Resources and Services
Jack Allen Smith	Senior VP – Chief Marketing Officer
David Snow, Jr.	Executive VP – Chief Operating Officer
Linda V. Tiano, Esq.	Senior VP – General Counsel
Jack Furka	VP – Internal Audit
Peter Kerr	VP – Communications
Lou Parisi	VP - Fraud Investigation and Detection

Subsequent to the examination date, the Company had undergone several major operational reorganizations. The following schedule lists the principal officers of the Company as of the date of this report:

Michael A. Stocker, M.D.	President and CEO
David Snow, Jr.	President and Chief Operating Officer
Bryan Birch	Senior Vice President, Chief Sales Officer
David A. Florman	Senior Vice President, Medical Delivery and Medicare Risk
Kenneth O. Klepper	Senior Vice President, Systems
Ronald W. Lawrence	Senior Vice President, Human Resources
Gloria M. McCarthy	Senior Vice President, Operations, Managed Care and Medicare Services
William B. O’Loughlin	Senior Vice President, Business Technology Development
John W. Remshard	Senior Vice President, CFO

Jack A. Smith	Senior Vice President, Chief Marketing Officer
Linda V. Tiano, Esq.	Senior Vice President and General Counsel
Deborah Bohren	Vice President, Public Affairs
Angelo V. Dascoli	Vice President, Utilization Management
John Early	Vice President, Chief Customer Officer
Michael W. Fedyna	Vice President and Chief Actuary
Peter Liria, Jr., Esq.	Vice President and Corporate Secretary
Grace Messina	Vice President and Chief Information Officer
Kathryn McKinnon	Vice President and Chief Underwriter
Patricia Scipio	Vice President Auditing
Tom Snyder	Vice President, National Accounts Administration
Alan Sokolow. M.D.	Vice President, Chief Medical Officer

B. Territory and Plan of Operation

As a health service corporation licensed under Article 43 of the New York Insurance Law, Empire underwrites contracts providing hospital, basic medical, major medical, Medicare Supplemental, dental and prescription drug benefits to subscribers. In addition, Empire is licensed under Article 44 of the Public Health Law to do the business of a health maintenance organization ("HMO"), under the name of Empire Blue Cross and Blue Shield Healthnet.

Empire writes Medicare at risk business for Parts A and B and administers Medicare Parts A and B pursuant to agreements with the U.S. Department of Health and Human Services. Empire's primary Medicare Part A office is located in Syracuse New York and its primary Medicare Part B

office is located in Westchester County. Empire has additional Medicare offices in Albany, Jericho, New York City and Bohemia to provide customer service support to New York subscribers.

Empire withdrew from the Medicaid market in April of 1999 and sold its Medicaid managed care business to Neighborhood Health Providers on May 1, 1999.

In addition to the above, Empire has entered into various Administrative Service Only ("ASO") arrangements to administer health insurance programs for certain self insureds. It also participates through its HMO operations in various programs including "Child Health Plus" and "Medicare Plus Choice."

At the end of 1999, the Company provided health insurance coverage to more than 3 million subscribers. The Company also had more than 800,000 subscribers under ASO or ASC contracts. Approximately 563,225 subscribers have community-rated coverage, either through an employer-sponsored group of 2 to 50 employees or who have purchased coverage on a direct-payment open enrollment basis. Under the community-rated contracts, all subscribers are charged the same rates regardless of sex, age, and health status or occupation based upon the performance of similar contracts aggregated into pools for rating purposes. Under these contracts, subscribers are billed premium rates and issued contracts of coverage, both of which are subject to prior approval by the Department. In 1995, the Insurance Law was amended to allow, effective January 1, 1996, Article 43 corporations and HMOs to "file and use" community rated premium adjustments of not more than 10% in any twelve month period in lieu of the current prior approval/public hearing process. Effective January 1, 2000 the

ten-percent limitation was removed in accordance with Section 4308 (g)(2) of the New York State Insurance Law.

The remaining 2.55 million subscribers hold either incentive-rated or experience-rated contracts. Incentive-rated groups are defined as groups of from 51 to 249 subscribers whereby a combination of the actual experience of the individual group and the average experience of all incentive-rated groups determine premiums. Experience-rated business is defined as groups with 250 or more subscribers whereby Empire sets premiums based upon each group's experience and experience rated formulae. Empire's experience-rated business is divided between local experience-rated groups and national experience-rated groups. Local experience-rated groups are comprised of groups where all subscribers work within Empire's service area. National experience-rated groups consist of groups whose members are situated both inside and outside of Empire's service area. The premium rates on both incentive and experience-rated contracts do not require the approval of the Insurance Department. Empire adjusts these rates at each contract renewal date.

From 1994 to 1996 Empire had significant losses in enrollments which resulted in a substantial decline in the Company's premium income. Enrollment and premium income began to stabilize from 1997 through 1998 and by 1999 both enrollment and premiums written were increasing. Enrollment and premium income, however are still approximately 30% less than the 1994 level. In 1999, Empire derived approximately 7% of its premium income from its non-HMO under 65 community-rated contracts. Empire derives an additional 22% of its premium income from its community-rated Empire Healthnet HMO contracts. Medicare supplement business accounts for more

than 7% of premium income. The remaining premium income, about 64%, is derived from experience-rated and incentive-rated contracts.

The following schedule shows the annual premiums written, (000 omitted), by market segment during the period covered by this examination and the year 2000:

	<u>1995</u>	<u>1996</u>	<u>1997</u>	<u>1998</u>	<u>1999</u>	<u>2000</u>
Non HMO under 65						
Community-rated	\$ 651,003	\$ 432,246	\$ 286,089	\$ 300,672	\$ 219,446	\$ 182,649
Experience-rated	2,917,620	2,533,050	2,170,568	1,962,709	2,154,596	2,397,346
Medicare supplement	353,906	307,678	281,374	275,111	229,419	251,495
HMO	<u>140,088</u>	<u>202,187</u>	<u>343,816</u>	<u>550,607</u>	<u>741,551</u>	<u>862,596</u>
Total premiums written	<u>\$4,062,617</u>	<u>\$3,475,161</u>	<u>3,081,847</u>	<u>\$3,089,099</u>	<u>\$3,345,013</u>	<u>\$3,694,086</u>

Subscribers may utilize the facilities of area hospitals, which have entered into participating hospital agreements. From to January 1, 1988 to December 31, 1996 participating hospitals accepted payment from Empire based on the Diagnosis Related Groups ("DRG") payment system set under the New York Prospective Hospital Reimbursement Methodology (NYPHRM). DRGs, which are approved by the Department of Health, are based on such factors as a patient's medical diagnosis, sex, age and procedures performed. In 1996, the New York Public Health Law was amended to allow, effective January 1, 1997, payers of inpatient hospital services to negotiate the reimbursement rates they pay to hospitals rather than utilizing the DRG rates set under NYPHRM, which expired on December 31, 1996.

When a subscriber utilizes a non-participating hospital, Empire is obligated to pay benefits for covered services as determined by the issued contract's provisions. Subscribers may utilize the services of physicians who have signed participating physician agreements with Empire. These

physicians accept payment for services rendered based on fees set forth in agreed upon schedules. Non-participating physicians bill the subscriber directly and Empire reimburses subscribers up to the amount allowed for covered services in accordance with usual, customary and reasonable charge schedules as determined by Empire or with a schedule of allowance.

When subscribers travel to areas outside of Empire's area of operations and require hospitalization or medical care, the Blue Cross Plan or Blue Shield Plan which services the area where the benefits are provided will pay the hospital or physician charges incurred by Empire's subscriber and request reimbursement from Empire.

The method of providing hospitalization and medical benefits to out-of-area subscribers is accomplished through the Blue Card program, which is administered by The Blue Cross and Blue Shield Association, located in Chicago, Illinois. The Blue Cross and Blue Shield Association is a national organization which coordinates the efforts of Blue Cross and Blue Shield Plans throughout the United States. The Blue Card program channels out-of-area claims to the Blue Cross Plan or Blue Shield Plan liable for such claims.

As set forth in the Certificate of Authority, Empire solicits business in the following twenty-eight counties of the State of New York, grouped according to the regions to which the counties belong for community rating purposes:

New York Region

Bronx
Kings
Nassau
New York

Albany Region

Albany
Clinton
Columbia
Delaware

Mid-Hudson Region

Montgomery
Rensselaer
Saratoga
Schenectady
Dutchess
Putnam
Orange
Sullivan

Queens
Richmond
Rockland
Suffolk
Westchester

Essex
Fulton
Greene

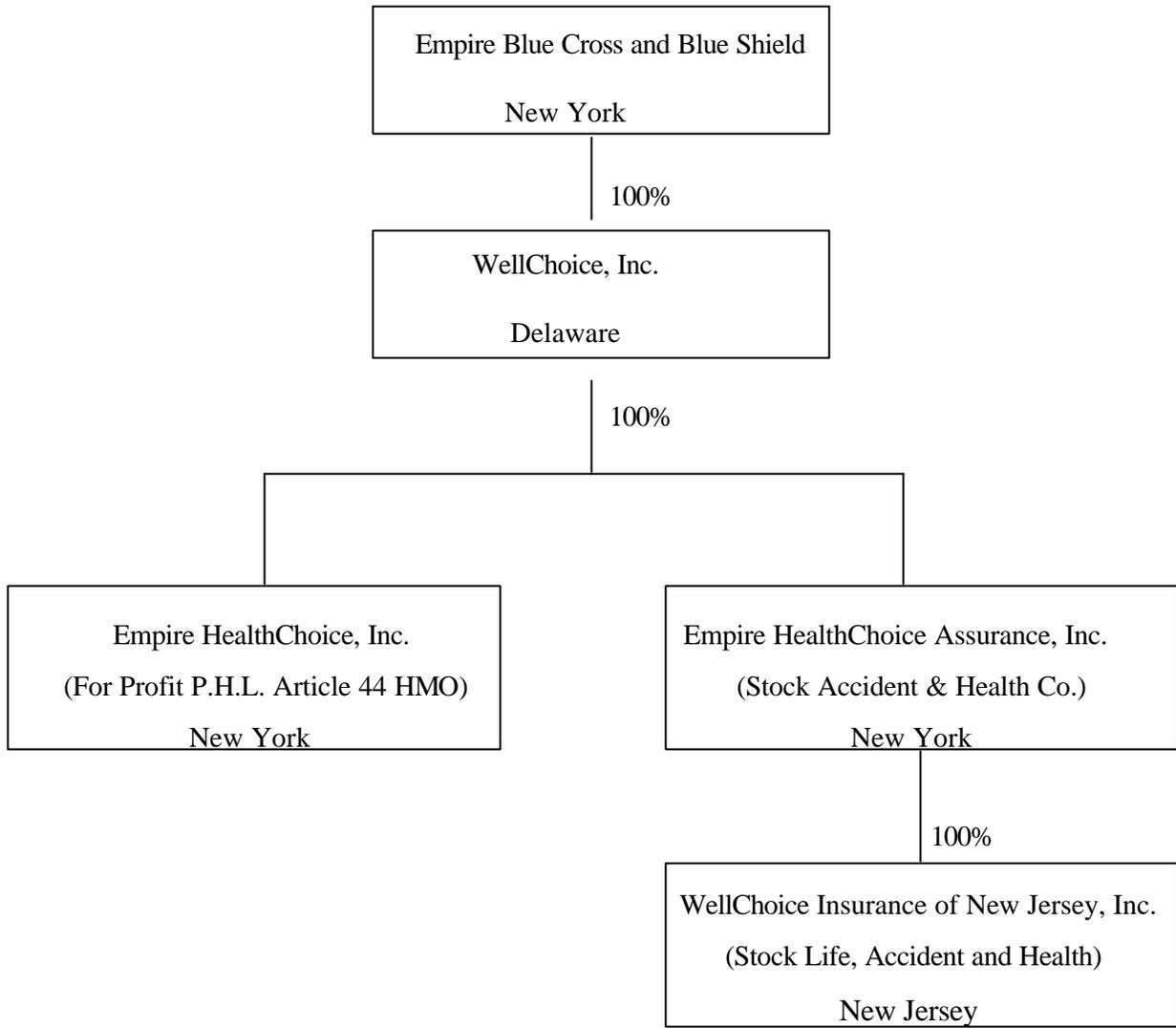
Schoharie
Warren
Washington

Ulster

C. Holding Company System

The following shows the Company's organizational chart at December 31, 1999:

ORGANIZATIONAL CHART



D. Investments in Subsidiaries:

Section 1705(a)(2) of the New York State Insurance Law states:

“Unless the superintendent shall have given prior written approval, neither the parent corporation nor any subsidiary (other than a separate account subsidiary or any subsidiary referred to in subsection (c) of section one thousand seven hundred and four of this article) may make any investment in any subsidiary (not at the time exempt from this paragraph), if, after giving effect to such investment, the investment value of such subsidiary would aggregate more than fifteen percent (but not more than two percent in the case of the parent corporation of the type described in subsection (b) of section one thousand seven hundred one of this article) of the parent corporation’s admitted assets.”

Section 1705(a)(2) of the New York State Insurance Law limits investment by an article 43 corporation parent in its subsidiary to 2% of its admitted assets without the superintendent of insurance’s prior approval. Empire’s investment in its subsidiary, Empire HealthChoice Assurance, Inc. (“ECHA”), exceeded the 2% limitation in 2000 and 2001 by \$24,243,406 and \$24,468,728 respectively.

In the years 2000 and 2001 Empire infused \$38.8 million and \$26.5 million respectively into ECHA. The excess investments previously mentioned are included in these infusions. The table below shows Empire’s filed financial data for the years 2000 and 2001 and the data adjusted for the excess investments disallowed as not admitted assets:

	As per Annual Statement December 31, 2000	As per Annual Statement December 31, 2001
Admitted Assets	\$ 1,804,477,443	\$ 1,906,041,052
Liabilities	1,272,341,094	1,295,262,131
Statutory Reserves	461,734,770	501,874,061
Unassigned Funds	532,136,349	610,778,921
Net Income/(Loss)	106,675,549	98,428,278
	Adjusted for not admitted excess investments December 31, 2000	Adjusted for not admitted excess investments December 31, 2001
Admitted Assets	\$ 1,780,234,037	\$ 1,881,572,324
Liabilities	1,272,341,094	1,295,262,131
Statutory Reserves	461,734,770	501,874,061
Unassigned Funds	507,892,934	586,310,193
Net Income/(Loss)	106,675,549	98,428,278

As per the above financial data, Empire's Statutory Reserve remained unencumbered after the excess investments were disallowed pursuant to Section 1705(a)(2) of the New York Insurance Law. Further, Empire's "Risk Based Capital" continues to be over 400% of the authorized control level for both years.

Empire engaged in multiple discussions with the Department in 2001 and 2002. Empire explained its position as follows: Empire HealthChoice, Inc. was an Article 43 corporation that established Empire HealthChoice Assurance, Inc. as an Article 42 subsidiary in 1996. The investment by Empire HealthChoice, Inc. into Empire HealthChoice Assurance, Inc. was made pursuant to Article

17 of the Insurance Law. When the Article 42 Corporation was originally funded, Empire HealthChoice, Inc. believed that this investment in the Article 42 subsidiary was governed by Insurance Law section 1704(c) and that there was no limit on the amount that could be invested in the Article 42 subsidiary. Subsequent to the discussions with the Department in early 2002, Empire HealthChoice, Inc. requested Insurance Department approval of the additional investments by Empire HealthChoice, Inc. into Empire HealthChoice Assurance, Inc. under Insurance Law Section 1705(a)(2).

E. Subsidiaries and Affiliated Companies

As of examination date, the Company has the following subsidiaries and affiliated companies:

- | | |
|--|--|
| BCS Financial Corporation("BCS") | - Empire owns 8.62% of the total number of shares of this Delaware corporation. Through its insurance company subsidiaries, BCS Insurance Company and BCS Life Insurance Company, BCS is engaged in writing group accident, health, life and professional liability business insurance directly and indirectly to Blue Cross and Blue Shield plans. |
| Business Systems Corporation of America | - It is a Delaware corporation engaged in developing, maintaining and enhancing health insurance software programs for Blue Cross and Blue Shield plans. Empire owns 8.87% of the voting shares of the company. |
| Empire National Account Service Co. ("ENASCO");
National Account ServiceCompany ("NASCO") | - ENASCO is a New York holding company wholly-owned by Empire. It was organized to manage Empire's investment in NASCO, which is a partnership of four Blues plans, including ENASCO, each owning 24.975% and with the Blue Cross and Blue Shield Association ("BCBSA") owning the remaining .10%. NASCO provides national account data processing services for those plans in the BCBS system utilizing the Electronic Data System ("EDS") claims system. |

Blue Care New York Benefits Agency, Inc. - Blue Care New York Benefits Agency, Inc. is owned by the three New York Blue Cross and Blue Shield Plans to engage in joint product development and marketing activities. Empire Blue Cross and Blue Shield has a 20% ownership interest in the agency.

Empire Community Delivery Systems, LLC (“ECDS”) ECDS is a limited liability company, which is a management service organization for Medicaid risk. Empire had owned 66.67% of this company. On May 1, 1999 Empire sold its Medicaid managed care business to Neighborhood Health Providers, LLC for \$1.075 million dollars. ECDS ceased operations in April 1999 and was dissolved in 2000.

Reliance Safeguard Solutions, Inc. Incorporated in 1998 for the purpose of providing Medicare program safeguard services (fraud investigations) under contracts with Centers for Medicare and Medicaid (CMS).

EHC Benefits Agency, Inc. Incorporated in 1997 as a sales agency into which all EHC sales personnel were transferred effective January 1998. Sales for all parent/subsidiary products are accomplished through this entity.

Empire Health Plans Assurance, Inc. Empire Health Plans Assurance, Inc. is a wholly owned subsidiary of Empire HealthChoice Assurance, Inc. which in turn is wholly owned by the holding company Empire Health Care Inc. a subsidiary of Empire Blue Cross and Blue Shield. It is a New Jersey incorporated Life, Accident and Health insurance organization licensed in eleven states including its state of incorporation.

The Health Information Network Connection, LLC (“THINC”) - THINC was a joint venture owned by Empire and four other plans. It was organized for the development of a community health information network for the metropolitan New York, New Jersey, and Connecticut region. In January of 1999 CareInsite acquired a 20% interest in THINC in exchange for cash and a warrant to purchase shares of

CareInsite stock. In January 2000 CareInsite acquired the remaining 80% of THINC from the plans in exchange for additional warrants to purchase CareInsite stock. In February of 2000 Healtheon/WebMD corp. agreed to purchase CareInsite and its parent, Medical Manager Corp. in an exchange of stock. The transaction was completed in September 2000.

- Empire Health Care Inc. (“EHC”) - The holding company EHC is a wholly –owned subsidiary of Empire which is incorporated in Delaware. This holding company was created to house the for-profit entity Empire HealthChoice, Inc. after Empire’s planned restructuring into a for- profit entity is completed. In December of 1999 EHC merged with Choice Holdings Inc. The merged entity was renamed Empire WellChoice, Inc. as of January 1, 2001, and renamed again to OldChoice, Inc. in 2002 and has since been dissolved.
- Empire HealthChoice Assurance, Inc. - This company was incorporated in February 1996 as a stock accident and health insurance corporation under Article 42 of the Insurance Law with an initial paid-in capital and contributed surplus of \$19,000,000.
- Empire HealthChoice, Inc. - It was incorporated in February 1996 as a for-profit HMO under Section 402 of the New York Business Corporation Law and subject to the provisions of Article 44 of the New York Public Health Law with a paid-in capital of \$20,000,000. It was renamed Empire HealthChoice, HMO Inc. in January 2001.
- WellChoice Insurance of New Jersey, Inc. Formerly Empire Health Plans Assurance, Inc. and originally incorporated in New Jersey as Central National Life Insurance Company in 1989 as a licensed Life, Accident and Health company. Empire HealthChoice Assurance, Inc. purchased Central National in 1997. It is also licensed (and inactive) in Pennsylvania and a number of other, more distant, states.
- NexxtHealth, Inc. Incorporated in Delaware in March 2000 to house EHC’s e-health plan initiative. Was controlled 100% by EHC (through

WellChoice/OldChocie). Dissolved in 2002.

F. Significant Operating Ratios

Expense Ratios

<u>Year</u>	<u>Net Premiums Written</u>	<u>Expenses Paid</u>	<u>Expense Ratio</u>
1995	\$4,062,616,783	\$481,760,722	11.86%
1996	\$3,475,161,418	\$460,442,782	13.25%
1997	\$3,081,846,560	\$441,697,376	14.33%
1998	\$3,089,098,732	\$375,666,082	12.16%
1999	\$3,345,012,709	\$374,508,037	11.20%
2000	\$3,694,086,233	\$404,533,052	10.95%

The company's expense ratios exceeded the 12.5% limit prescribed by Section 4309(a)(2) of the New York Insurance Law during the years 1996 and 1997. However Empire received the permission of the Superintendent of Insurance to exceed the expense limit for the two years mentioned above. In the subsequent years 1998 through 2000, the expense ratio was once again within the 12.5% limit.

3. FINANCIAL STATEMENTS

A. Balance Sheet

The following shows the assets, liabilities and total reserves and unassigned funds as determined by this examination and as reported by the Company as of December 31, 1999.

Assets	Ledger Assets	Non-Ledger Assets	Not Admitted Assets	Net Admitted Assets
Bonds	\$ 897,345,320	\$	\$	\$ 897,345,320
Preferred stocks	17,056,000			17,056,000
Common stocks	34,555,019	12,719,588		47,274,607
Real estate (less encumbrances)	39,316,286			39,316,286
Cash on hand and on deposit	(125,665,488)			(125,665,488)
Short-term investments	341,198,073			341,198,073
Other invested assets	37,272,726			37,272,726
Investment Guaranty Fund (Blue Cross Blue Association)	5,536,815			5,536,815
Uncollected premiums	346,379,491		6,001,026	340,378,465
Amounts receivable relating to uninsured A&H plans	48,752,062			48,752,062
Electronic data processing equipment	18,928,599			18,928,599
Interest and other investment income due and accrued		11,224,952		11,224,952
Receivable from parent, subsidiaries and affiliates	2,208,439			2,208,439
Other assets non-admitted	9,861,507		9,861,507	
Aggregate write-ins for other than invested assets	<u>122,349,934</u>		<u>44,106,090</u>	<u>78,243,844</u>
Total assets	<u>\$1,795,094,783</u>	<u>\$23,944,540</u>	<u>\$59,968,623</u>	<u>\$1,759,070,700</u>

<u>Liabilities</u>	<u>Amount</u>
Claims unpaid	\$ 566,899,085
Unpaid claims adjustment expenses	112,370,788
Unearned premiums	221,721,791
Taxes, licenses and fees	83,362
Federal income taxes (excluding deferred taxes)	(3,996,622)
Other expenses due and accrued	73,422,831
Amounts withheld or retained for account of others	111,854,751
Unclaimed disbursements	11,191,067
Unapplied cash	7,698,505
Capitalized lease obligation	53,482,238
Miscellaneous payable	<u>66,006,174</u>
Total liabilities	<u>\$1,220,733,970</u>
 Reserves and unassigned funds	
Statutory reserve	\$ 418,126,589
Unassigned funds	<u>120,210,141</u>
 Total reserves and unassigned funds	<u>\$ 538,336,730</u>
 Total liabilities and surplus	<u><u>\$1,759,070,700</u></u>

B. Underwriting and Investment Exhibit

Reserves and unassigned funds increased \$329,773,527 during the five-year examination period January 1, 1995 through December 31, 1999, detailed as follows:

Statement of Income**Underwriting Income**

Premiums earned		\$ 17,046,622,627
Deductions:		
Claims incurred	\$ 15,165,974,772	
Claims adjustment expenses incurred	1,025,932,088	
Other underwriting expenses incurred	<u>985,937,694</u>	
Total underwriting deductions		<u>\$(17,177,844,554)</u>
Net underwriting gain (loss)		\$ (131,221,927)

Investment Income

Net investment income earned	\$ 267,358,535	
Net realized capital gains	<u>82,723,153</u>	
Net investment gain		\$ 350,081,688

Other Income (Loss)

Gain/Loss On Disposition of Assets	\$ (10,446,792)	
Net gain/(loss) from agents or premium balances charged off.	(2,208,817)	
Miscellaneous income (loss) –net	<u>86,987,585</u>	
Net other income (loss)		<u>\$ 74,331,976</u>
Net gain before federal income taxes		\$ 293,191,737
Federal income taxes incurred		<u>13,295,503</u>
Net income (loss)		<u><u>\$ 279,896,234</u></u>

Reserves and Unassigned Funds

Reserves and unassigned funds, per Report on Examination as of December 31, 1994

\$208,563,203

	<u>Gains in reserves and unassigned funds</u>	<u>Losses in reserves and unassigned funds</u>
Net income	\$ 279,896,234	
Net unrealized capital gains/losses	23,378,827	
Change in non-admitted assets	<u>26,498,466</u>	
Total increases and decreases	<u>\$ 329,773,527</u>	
Net increase to reserves and Unassigned funds		<u>\$329,773,527</u>
Reserves and unassigned funds December 31, 1999, per report on examination		<u>\$538,336,730</u>

4. HOSPITAL ADVANCES

This item consists primarily of cash advances made to member hospitals under the concurrent payment program to offset, in part, the processing cycle time needed by Empire to process claims submitted by member hospitals. Adjustments to the program were ended in 1994 and Empire began collecting the outstanding advances from the hospitals in 1996.

Empire had \$229,433,763 in outstanding hospital advances in 1996. As of the examination date, the Company had \$20,779,930 in hospital advances still outstanding. This amount has been further reduced to \$6,063,872 as of September 1, 2001.

5. EXPERIENCE RATING FORMULA, RATE STABILIZATION AGREEMENTS AND FUNDING ARRANGEMENTS

Empire does not appear to have filed for approval of all of its experience rated formulae. Formulae as used here is defined to include both transfer business formula (including all supporting tables or algorithms used to determine rates for new business based partly or entirely on prior carrier experience) and the experience rating formula for renewal business. This appears to be a violation of New York State Insurance Law Section 4308(b) which requires the Superintendent's approval of rating formula and Insurance Department Regulation 62 (11NYCRR Part 52) Section 52.40(g)(1) which requires in part that, "Contracts of master group insurance may be experience-rated only in accordance with a formula or plan previously furnished to the department."

It is recommended that Empire submit its complete inventory of experience rated formulae to the Department.

Circular Letter Number 3, dated February 14, 1977, following both the Insurance Law and an October 16, 1973 decision of the Appellate Division of the New York State Supreme Court, further requires that, "... a retrospective rate credit or refund must be based upon an objective formula which is set forth explicitly and in writing, which is approved by the board of directors ... ". It is noted that during the board meeting of June 25, 1997 a resolution was adopted approving Empire's "experience rated accounts refund formula."

Certain insured groups were subject to rate stabilization agreements, which have since been terminated. These agreements are not in writing and have not been filed with this Department. This

appears to be a violation of Insurance Department Regulation 62 (11NYCRR Part 52) Section 52.40(g)(2) which states,

“ Any such plan or formula of experience rating may include provision for a rate stabilization reserve provided that the terms under which the rate stabilization reserve is created are included in the master group contract or separate written agreement previously approved by the department and which upon termination of the group contract impose an obligation on the plan in respect to the application of the funds represented by such reserve.”

The examiner notes that upon conversion to a stock accident and health insurer the provisions of §52.40(g) will no longer be applicable.

For its experience rated groups, Empire uses “funding arrangements” to apply experience rating formulae or to provide cash flow relief to its insureds. Empire has provided samples of five funding arrangements pertaining to insured groups. They operate in the following manner:

1. Financial and Service Agreement for Closed End Experience Rated Groups

- a. A closed-end contract is an experience-rated contract whereby Empire assumes all financial risk.
- b. The group pays a fixed premium, which includes the cost of incurred claims and retention. Within the context of this report, retention is defined as expenses, commissions and profit margin.
- c. When the claims plus retention exceed the annual maximum premium, the result is a deficit, which can be recouped in future years. Conversely, when the claims plus retention is less than the annual maximum premium, the result is a refund to the group.

2. Amendment to Financial and Service Agreement for Closed End Experience Rated Groups Opting for a Cash Flow Advantage (Referred to by Empire as “Payment of Charges Rider” or “POCR”)

- a. The POCR provides for cash flow relief to closed end experience rated groups. Instead of paying 100% of the maximum billable premium, the group is billed and pays a portion, for example, 90-95%, of the maximum billable premium during the contract year.
- b. At the end of the contract year, if the billed premium is greater than incurred claims plus retention, the group will receive a refund for the difference.
- c. If the billed premium is less than the incurred claims plus retention, the group will receive a “due” settlement letter, asking for the lesser of the difference between the billed premium and the maximum billable premium or the billed premium and incurred claims, plus retention.
- d. If the maximum billable premium is less than the incurred claims, plus retention, the group will be in a deficit position that will be carried over to the next year.

3. Financial and Service Agreement for Open End Experience Rated Groups

- a. The open-ended contract is an arrangement whereby Empire assumes minimal financial risk for claims. Claims experience is matched to premium billed.
- b. A premium rate is established for the contract period, utilizing Empire experience rated formula. This premium rate is paid monthly.

- c. The cumulative premium may be adjusted any time during the year or at settlement to reflect cumulative paid claims. This may result in either the group reimbursing Empire or Empire giving the group either a refund or a credit.

4. Financial and Service Agreement for Required Operating Fund arrangements

- a. The term “Required Operating Fund” (“ROF”), means the amount required by Empire for advance payments to providers for services rendered to members of a group and for payments to members of a group for hospital benefits.
- b. The group deposits with Empire x/360 days paid claims during the most recent twelve months.
- c. The amount of premium shall be based on paid claims plus retention and pooling charges during the month proceeding the invoice date.

5. Financial and Service Agreement for Minimum Premium Arrangements

- a. The group authorizes Empire to establish and maintain a bank account in the group’s name. The group is required to maintain sufficient funds in the account to cover the payment of premiums and claims presented for payment. This funding, in turn, will be used to fund a disbursement account established and maintained by Empire from which the payment of claims shall be made.
- b. At least sixty days prior to the end of each Agreement Year, Empire will provide the group with a “Budget” for the forthcoming Agreement Year (i.e., the renewal contract period). This Budget is the product of the monthly “Trigger Rate” and the previous Agreement Year’s enrollment. The Trigger Rate is the amount estimated by Empire to be the group’s claims

liability on a per contract per agreement month basis. It must be noted that while the Trigger Rate is fixed for the forthcoming Agreement Year, the estimated annual premium determined by this Budget is essentially for presentation purposes during the renewal process.

- c. The initial Budget is replaced by cumulative “Monthly Triggers” as each month is completed during the agreement year. Monthly Triggers are defined as the Trigger Rate times each contract that existed in the second preceding month.
- d. Empire invoices the group each month for premium that consists of : a) a service charge and, b) “Pooling Charges” for the groups participation in a stop loss program. Empire also credits the group through invoices for the cumulative excess of paid claims over the cumulative Monthly Triggers.
- e. The cumulative Monthly Triggers represent the maximum claims liability for a given cumulative month. Any cumulative paid claims in excess of the cumulative Monthly Triggers shall be carried forward and applied to any subsequent month.
- f. To the extent that the sum of the cumulative paid claims, and any prior deficits exceed the cumulative Monthly Triggers for the Agreement Year, this amount will be carried forward as a deficit.
- g. Upon termination, the group is liable to Empire for its estimated IBNR. The calculation of the IBNR is prescribed by the funding arrangement.

The above funding arrangements do not exist independent of insurance contracts issued by the Plan. They require execution by both the group and the Plan. They are, in essence, side agreements which are not part of the insurance contract. In addition to both applying and modifying experience rated formula, the funding arrangements also contain provisions covering diverse areas such as interest penalties for late payment, general underwriting rules for the furnishing of information, audits, enrollment, non-solicitation, termination, including termination and reinstatement fees, and compliance with federal and state law, including the COBRA continuation. It is noted that each type of funding arrangement contains the contractual language, "In the event of any conflicts between this agreement and the Group Policy, the provisions of this agreement shall control." Thus, the funding arrangements may obviate provisions included in approved policy forms.

Empire has not filed for approval of its funding arrangements for its insured group contracts. This appears to be a violation of the following sections of the New York Insurance Law:

- Section 4308(a) which provides that, "No corporation subject to the provisions of this article shall enter into any contract unless and until it shall have filed with the superintendent a copy of the contract or certificate and of all applications, riders and endorsements for use in connection with the issuance or renewal thereof, to be formally approved by him as conforming to the particular provisions of this article and not inconsistent with any other provision of law applicable thereto." Inasmuch as the funding arrangements do not exist outside of the insurance contracts to which they pertain, are executed by both parties and contain provisions impacting many different areas concerning the contractual relationship between Empire and its insured, the funding arrangements require prior approval as policy forms.

- Section 4308(b) which provides that, “No corporation subject to the provisions of this article shall enter into any contract unless and until it shall have filed with the superintendent a schedule of the premiums or, if appropriate, rating formula from which premiums are determined, to be paid under the contracts and shall have obtained the superintendent’s approval thereof.” Regardless of funding arrangement requested, Empire’s experience rated formula is used as the work-up for all experience-rated renewals or quotations. Inasmuch as the funding arrangements modify the terms of the experience rating formula by extending cash flow benefits to the groups, the funding arrangements require prior approval as part of part of Empire’s experience rate manual.
- Section 4313(a) states,

"Except as otherwise provided and except as the context otherwise requires, every medical expense indemnity corporation, dental expense indemnity corporation, health service corporation and hospital service corporation shall be subject to all requirements of this chapter made applicable to insurance companies generally, and to rules and regulations of the superintendent except in so far as said laws, rules and regulations may be inconsistent with other provisions of this article.”
- Section 4313(a) extends Section 2324 of the Insurance Law to Article 43 Corporations. Section 2324 provides that, “No authorized insurer... shall make, procure or negotiate any contract of insurance other than as plainly expressed in the policy.... or shall directly or indirectly ... pay or allow or offer to pay or allow... either as an inducement to the making of

insurance or after insurance has been effected, any rebate from the premium which is specified in the policy, or any special favor... or other benefit... inducement of any kind, directly or indirectly, which is not specified in such policy or contract..." The issuance of the funding arrangements containing provisions contrary to filed rates which cause pecuniary benefit to the insured in excess of that attendant to policies issued in accordance with filed rates appears to constitute an "inducement" or "rebate" to the insureds. Funding arrangements, such as the payment of charges rider, are "cash flow" programs that extend payment of the manual premium under the experience rating formula beyond the policy terms.

It is recommended Empire submit its funding arrangements for its insured group contracts to the Superintendent for approval.

6. ADMINISTRATIVE SERVICES ONLY (ASO)

A review of the Plan's annual statement supplement for the years 1994 through 2001 reveals cumulative losses on administrative services only contracts ("ASO") to be \$123.1 million. These results are detailed as follows:

<u>Year</u>	<u>Administrative Fee</u>	<u>Administrative Expense</u>	<u>ASO Net Loss</u>
1994	\$ 41,705,000	\$ 54,287,000	\$12,582,000
1995	31,632,430	45,526,749	13,894,319
1996	42,822,384	59,936,952	17,114,568
1997	54,161,515	63,649,326	9,487,811
1998	75,601,372	90,533,163	14,931,791
1999	97,478,520	113,979,865	16,231,345
2000	118,775,890	143,371,182	24,595,292
2001	164,485,991	178,797,326	14,311,335
Cumulative ASO Losses (1994-2001)			<u>\$123,148,471</u>

The Plan's cumulative net underwriting gain for the same period, 1994 through 2001, including the impact of the \$123.1 in cumulative ASO losses, was \$48.1 million. The Plan's continuing ASO losses are a continuing drain on the Plan's financial resources and insured policyholders. The Plan's officers and directors have a fiduciary responsibility with respect to ensuring that the ASO business be profitable. The financial results of the Company's administrative services only ("ASO") business improved over the past two years. Reported losses for 2002 are projected to be \$9.9 million,

a \$14.7 million or 59.6% improvement from 2000. Empire reports that it expects ASO business will be profitable in 2003.

7. CLAIMS UNPAID

The following is a comparison of the claim reserves as determined by this examination and as reported by the Company as of December 31, 1999:

<u>Line of Business</u>	<u>Examination</u>	<u>Company</u>	<u>Savings (Deficiencies)</u>
Hospital Only	\$ 229,008,377	\$ 210,219,806	(\$18,788,571)
Hospital/Medical	134,571,694	142,699,460	8,127,766
Dental and Prescription Drugs	3,136,726	3,147,263	10,537
Healthnet (HMO)	44,175,061	65,807,764	21,632,703
Medicare Supplemental	48,248,552	43,500,856	(4,747,696)
Medicare Risk	28,798,427	33,900,751	5,102,324
Medicaid Risk	105,288	600,213	494,925
FEP	<u>26,917,217</u>	<u>34,337,946</u>	<u>7,420,729</u>
Subtotal	\$ 514,961,342	\$534,214,059	\$19,252,717
Supplemental Reserves	976,352	1,615,026	638,674
Litigation Reserves	<u>41,831,432</u>	<u>31,070,000</u>	<u>(10,761,432)</u>
Total claims unpaid	<u>\$557,769,126</u>	<u>\$566,899,085</u>	<u>\$9,129,959</u>

The examination reserves for claims unpaid were determined based on a one and a half-year loss development through June 30, 2001 and the reserves held at June 30, 2001 for claims, which occurred prior to January 1, 2000. This determination resulted in a redundancy in the reserves amounting to \$9,129,959. The redundancy was considered immaterial therefore no adjustment were made to the financial statements in the examination report for the excess reserves

8. UNPAID CLAIMS ADJUSTMENT EXPENSES

The examination liability of \$112,370,788 is the same as that reported by the company in its filed 1999 annual statement. The balance reported by the company appears reasonably stated.

Included in this liability is the amount of \$19,059,313, which represents an actuarially calculated claim adjustment expense reserve established to provide for the administrative expenses of paying for claims incurred but unreported.

9. ANNUAL STATEMENT REPORTING

The December 31, 1999 New York Supplement to Hospital, Medical and Dental Service or Indemnity Corporations Annual Statement, page NY41, Schedule P-Part 3(NY), requires experience rated earned premiums to be developed each subsequent year to reflect audit findings, retrospective adjustments based on claim experience, accounting lags and other miscellaneous items. The instructions printed on page NY48 state, "The objective is to develop earned premiums by calendar year of coverage consistent with the claim and claim adjustment expense by incurral year in Schedule P-Part 1 and Schedule P-Part 2." The December 31, 1999 Schedule P-Part 3(NY) provides for the development of 1996, 1997 and 1998 experience rated earned premium.

Contrary to the aforementioned instructions the December 31, 1999 Schedule P-Part 3(NY) contains the following errors in its preparation:

- Each year's earned premiums have not been recalculated for audits, accounting lags and other miscellaneous items.
- Calendar years 1998 and prior earned premiums were erroneously adjusted for claim developments on prospective and incentive rated contracts. While the prospective and incentive rated contracts are experience rated contracts, claim developments pertaining to them have no impact on earned premiums inasmuch as these contracts do not provide for retrospective adjustments.
- The development of claim adjustment expenses has been erroneously included in Schedule P-Part 3(NY).

It is recommended that Schedule P-Part 3(NY) be completed in accordance with its instructions.

10. COMPLIANCE WITH PRIOR REPORT ON EXAMINATION

The prior report on examination contained comments and recommendations as follows (page numbers refer to the prior report):

ITEM NO.

PAGE NO.

Management

- | | | |
|----|---|---|
| A. | It is recommended, as it was in the prior examination, that the Company reconstitutes its board to conform to the requirements of Section 4301(k)(1)(A) of the Insurance Law. | 9 |
|----|---|---|

The Company has complied with this recommendation.

- | | | |
|----|--|----|
| B. | It is recommended, as it was in the prior examination that the public member category of the board adequately represents, on an aggregate basis, all the geographic areas served by Empire as required under Section 4301(k)(1)(B) of the Insurance Law. | 10 |
|----|--|----|

No longer applicable. This requirement was deleted from Section 4301(k)(1)(B) of the Insurance Law.

11. SUMMARY OF COMMENTS AND RECOMMENDATIONS

<u>ITEM NO.</u>		<u>PAGE NO.</u>
	<u>Management</u>	
A.	Section 1705(a)(2) of the New York Insurance Law limits investment by an article 43 corporation parent in its subsidiary to 2% of its admitted assets without the superintendent of insurance's prior approval. Empire's investment in its subsidiary, Empire HealthChoice Assurance, Inc. ("EHCA"), exceeded the 2% limitation in 2000 and 2001 by \$24,243,406 and \$24,468,728 respectively.	20
B.	Empire does not appear to have filed for approval of all of its experience rated formulae. This appears to be a violation of Insurance Law Section 4308(b) which requires the Superintendent's approval of rating formula and Insurance Department Regulation 62 (11 NYCRR Part 52) Section 52.40(g)(1) which requires in part that, "contracts of master group insurance may be experience-rated only in accordance with a formula or plan previously furnished to the department." It is recommended that Empire submit its complete inventory of experience rated formulae to the Department.	30
C.	Certain insured groups were subject to rate stabilization agreements. These agreements were not in writing and were not filed with this Department. This appears to be a violation of Insurance Department Regulation 62 (11 NYCRR Part 52) Section 52.40(g)(2).	30-31
D.	Empire's has not filed for approval of its funding arrangements for its insured group contracts. This appears to be in violation of Sections 4308(a), 4308(b), and 2324 of the Insurance Law.	35
E.	It is recommended that Empire submit its funding arrangements for its insured group contracts to the Superintendent for approval.	37
F.	It is recommended that Schedule P-Part 3(NY) be completed in accordance with its instructions.	41

Respectfully submitted,

Wai Wong
Associate Insurance Examiner

STATE OF NEW YORK)
) SS.
)
COUNTY OF NEW YORK)

WAI WONG, being duly sworn, deposes and says that the foregoing report submitted by him is true to the best of his knowledge and belief.

Wai Wong

Subscribed and sworn to before me

this __ day of _____ 2003.

APPENDIX - A

REPORT ON EXAMINATION OF

EMPIRE BLUE CROSS AND BLUE SHIELD HEALTHNET

AS OF DECEMBER 31, 1999

ITEM NO.

PAGE NO.

1.	Scope of examination	A-1
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1. SCOPE OF EXAMINATION

As part of the Department's examination of Empire, an examination has been made of its line of business health maintenance organization (HMO), Empire Blue Cross and Blue Shield Healthnet ("Healthnet"). Effective January 1, 2001, Healthnet's name was changed to Empire HealthChoice, Inc. The HMO was previously examined by the Department as of December 31, 1994 as part of the Department's examination of Empire as of that date, however, no separate report on examination was issued for Healthnet. This examination covered the five-year period January 1, 1995 to December 31, 1999. Transactions subsequent to the date of examination were reviewed where deemed appropriate by the examiner.

A review or audit was made of the following items:

- HMO history
- Territory and plan of operation
- Growth of HMO
- Accounts and records

2. DESCRIPTION OF HMO

The HMO was originally incorporated as Community Health Plan of Greater New York. On July 26, 1977, pursuant to Section 4403 of Article 44 of the New York Public Health Law the HMO was issued a Certificate of Authority to operate in Queens and Nassau counties. The sole medical group provider at the time of certification was Community Health Program of Queens-Nassau, Inc. (CHPQ-N).

The certificate was amended effective November 30, 1977 to add the Montefiore Hospital Medical Group to service the Bronx, portions of Manhattan and Westchester. An amendment effective December 15, 1979 expanded the service area of CHPQ-N to include all of Queens and Nassau counties.

The name of the HMO was changed to Blue Cross and Blue Shield of Greater New York HMO in 1980. The Health Department authorized expansion of the service area to include Suffolk County through the addition of Community Health Plan of Suffolk on November 23, 1981. Another amendment to the Certificate, effective July 1, 1982, added the West Park Medical Group. This expanded the HMO's service area to include all of Manhattan and Roosevelt Island. The HMO changed its name again in 1985 to Empire Blue Cross and Blue Shield HMO ("Empire HMO").

Empire created another HMO, named Healthnet, which was issued a certificate of authority on June 4, 1986. Healthnet and Empire HMO operated concurrently with different premium and benefit structures. The latter entity was phased out, with expiring contracts renewed under Healthnet. Healthnet became the sole HMO on April 1, 1987 servicing 27 counties in New York State. Healthnet expanded to 28 counties as of January 15, 1999. Effective January 1, 2001, Healthnet's name was changed to Empire HealthChoice, Inc. (hereafter referred to as "Empire HealthChoice, Inc. HMO or "HMO")

Although under the jurisdiction of the Health Department as a provider of health care, the HMO is subject to regulation by the New York State Insurance Department through the application of specific provisions of Article 43 of the New York Insurance Law as well as specific provisions of Article 44 of the New York State Public Health Law.

The HMO is accounted for as a line of business in Empire's annual statements.

Upon conversion to a for profit–entity, Empire Blue Cross and Blue Shields discontinued the Empire HealthChoice, Inc. HMO line of business and transferring it to its for-profit HMO subsidiary, Empire HealthChoice HMO, Inc.

As of May 1, 2002 the Empire’s HealthChoice, Inc. HMO ceased to enroll any new members, all new members were enrolled in Empire HealthChoice HMO, Inc. Empire HealthChoice, Inc. HMO’s existing members were transferred to Empire HealthChoice HMO, Inc. on July 1, 2002 unless the member objected. Member groups that objected to the transfer were canceled on July 31, 2002 and individual members who objected to the transfer were canceled on September 30, 2002.

A. Territory and Plan of Operation

As set forth in its certificate of authority Empire HealthChoice Inc. HMO serves the following twenty-eight counties of the State of New York listed below grouped by rating regions as of December 31, 1999:

New York Region

Bronx	Brooklyn	Dutchess	Manhattan
Nassau	Putnam	Queens	Richmond
Rockland	Suffolk	Westchester	

Albany Region

Albany	Clinton	Columbia	Delaware
Essex	Fulton	Greene	Montgomery
Orange	Rensselaer	Saratoga	Schenectady
Schoharie	Sullivan	Ulster	Warren

Washington

Empire has filed with the Department changes to the current rating regions. These changes were approved by the Department on April 1, 2002 and divides the 28 counties into three rating regions, as shown below instead of the two currently used:

New York Region

Bronx	Brooklyn	Manhattan	Queens
Richmond	Nassau	Suffolk	Westchester
Rockland			

Mid-Hudson

Dutchess	Orange	Putnam	Sullivan
Ulster			

Albany Region

Albany	Clinton	Columbia	Delaware
Essex	Fulton	Greene	Montgomery
Rensselaer	Saratoga	Schenectady	Schoharie
Warren	Washington		

As of the date of this Report, Empire HealthChoice, Inc. HMO provides prepaid comprehensive health care including hospital, medical and surgical services. Benefits covered and premium cost differs with each product sold by Empire HealthChoice, Inc. HMO.

B. Loan Agreement

In September of 1981 Empire HealthChoice, Inc. HMO had entered into a contract with Community Health Plan of Suffolk, Inc. (CHPS) whereby CHPS would become a medical provider of Empire HMO. As part of the agreement Empire agreed to repay a loan on behalf of CHPS to the Department of Health and Human Services. The outstanding amount to be repaid to HHS was \$3,174,000. The principal was to be paid by scheduled installments beginning in 1982 and ending in 2002.

The loan balance as of December 31, 1999 amounted to \$536,000 and was reported as a liability on the books of Empire. Empire's contract with CHPS was terminated in 1991 and CHPS has since ceased operations. The remaining loan payment were completed in 2002 and the loan is completely satisfied.

C. Risk Sharing

As of December 31, 1999, Empire HealthChoice Inc. HMO had two risk sharing agreements in place. Both of these agreements had expired by the date of this report:

Magellan Behavioral Health, Inc.: The Magellan agreement includes a sharing of any surplus or deficit of the claims component of the capitation payment when compared to actual claims incurred.

South Shore-Rockaways IPA, Inc.: Empire's risk sharing agreement with South Shore-Rockaways IPA, Inc. terminated in March of 2000.

All individual medical providers are reimbursed on a fee-for-service basis.

The following is a summary of Empire HealthChoice Inc. HMO's non-risk sharing financial arrangements:

<u>Provision</u>	<u>Merit Behavioral Care Corporation</u>	<u>Montefiore Medical Center</u>
Effective date	September 1, 1995	September 1, 1986
Risk arrangement	No risk sharing	No risk sharing
Method of capitation	Prepaid	Prepaid
Source of capitation Payments	Capitation calculated on a per member per month and product basis.	Capitation calculated on a per member per month and product basis.
Method of increasing Schedule after current schedule expires	Negotiated with group Model based upon costs and inflation indices.	Negotiated with group Model based upon costs and inflation Indices.
Stop-loss protection	None	None

D. Accounts and Records

Empire maintains records for Empire HealthChoice Inc. HMO's operations covering premiums received, capitation payments to the medical groups and participating physicians, hospital payments for subscribers and administrative expenses charged to the HMO. Expenses paid by the medical groups and

participating physicians are reported to Empire which compiles aggregate totals for Empire HealthChoice Inc. HMO's Revenue and Expenses Statement reported in filed financial statements.

3. **FINANCIAL STATEMENTS**

The following are Empire HealthChoice Inc. HMO's Statement of Revenue and Expenses for the period under review and the year 2000. A review was performed of the data contained in the 1999 statement to determine its accuracy.

Empire HealthChoice Inc. HMO reports no balance sheet because its assets and liabilities are incorporated in Empire's financial statements.

The following shows the Statement of Revenue and Expenses for the period covered by the examination and the year 2000:

	1995	1996	1997	1998	1999	2000
Member Months	1,171,843	1,717,634	2,482,523	3,503,840	3,905,198	3,884,692
Revenues						
Premium	\$135,624,890	\$194,641,295	\$292,802,596	\$419,809,598	\$521,641,440	\$ 559,812,181
Medicare	0	3,047,282	43,835,123	107,167,288	214,961,044	295,265,683
Medicaid	<u>3,688,458</u>	<u>2,238,064</u>	<u>2,151,845</u>	<u>9,068,299</u>	<u>3,944,802</u>	<u>0.00</u>
Total revenues	<u>\$139,313,348</u>	<u>\$199,926,641</u>	<u>\$338,789,564</u>	<u>\$536,045,185</u>	<u>\$740,547,286</u>	<u>\$855,077,864</u>
Expenses						
Medical and Hospital:						
Physician services	\$ 34,284,723	\$ 52,404,119	\$ 98,130,703	\$125,694,560	\$160,557,220	\$181,476,887
Outside referrals	4,939,500	10,938,220	19,435,633	23,319,259	22,619,693	22,122,975
Emergency room and out-of-area	9,886,506	15,949,707	44,601,053	77,940,229	85,237,400	100,692,192
Inpatient	17,272,754	27,696,877	65,675,207	116,406,757	139,556,067	178,242,340
Drugs	9,727,847	16,904,538	36,725,351	63,105,328	73,913,202	90,749,141
Capitation fees	17,743,538	16,664,419	11,282,327	12,435,947	12,095,133	9,902,731
Miscellaneous expenses	<u>15,016,823</u>	<u>25,670,247</u>	<u>61,073,878</u>	<u>91,525,482</u>	<u>137,506,173</u>	<u>146,467,352</u>
Total Medical and Hospital	<u>\$108,871,691</u>	<u>\$166,228,127</u>	<u>\$336,924,152</u>	<u>\$510,427,562</u>	<u>\$631,484,888</u>	<u>\$729,653,618</u>
Administration						
Salaries, Wages	\$ 9,842,923	\$ 15,853,980	\$ 28,539,430	\$ 36,876,370	\$ 42,622,064	\$ 46,483,240
Other administrative expenses	<u>16,381,280</u>	<u>29,548,461</u>	<u>43,214,560</u>	<u>50,985,220</u>	<u>43,446,094</u>	<u>\$ 61,375,727</u>
Total Administration	<u>\$ 26,224,203</u>	<u>\$ 45,402,441</u>	<u>\$ 71,753,990</u>	<u>\$ 87,861,590</u>	<u>\$ 86,068,158</u>	<u>\$107,858,967</u>
Total expenses	<u>\$135,095,894</u>	<u>\$ 211,630,568</u>	<u>\$ 408,678,142</u>	<u>\$598,289,152</u>	<u>\$717,553,046</u>	<u>\$837,512,585</u>
Net Income (Loss)	<u>\$ 4,217,454</u>	<u>\$(11,703,927)</u>	<u>\$(69,888,578)</u>	<u>\$(62,243,967)</u>	<u>\$ 22,994,240</u>	<u>\$ 17,565,279</u>

It is noted that Empire HealthChoice Inc. HMO's cumulative underwriting loss from 1986 (inception) to its final June 30, 2002 statement was \$103,912,016. In its licensing application Empire HealthChoice Inc. HMO projected that it would reach breakeven in January 1988 with a cumulative underwriting loss of only \$11,416,732. Breakeven was finally reached during the quarter ending March 31, 1992 with a cumulative underwriting loss of \$120,494,909.

4. UNDERWRITING

A. Enrollment

Enrollment for the years under examination and the year 2000 follow:

	<u>1995</u>	<u>1996</u>	<u>1997</u>	<u>1998</u>	<u>1999</u>	<u>2000</u>
Groups	62,194	115,113	157,212	209,508	191,561	171,329
Individual	2,814	8,205	15,478	15,407	16,920	18,930
Medicare risk		2,274	9,455	20,073	31,362	41,002
Medicaid	2,506	1,950	3,332	7,991	0	0
Child Health Plus	<u>33,502</u>	<u>38,093</u>	<u>49,219</u>	<u>67,411</u>	<u>85,773</u>	<u>94,606</u>
Total membership	<u>101,016</u>	<u>165,635</u>	<u>234,696</u>	<u>320,390</u>	<u>325,616</u>	<u>325,867</u>

B. Premium Rates

Premium rates vary with the type of product, benefits covered, by region, co-payments and other underwriting factors. Premium rates billed and contracts of coverage's issued by Empire HealthChoice Inc. HMO were subject to prior approval by the Department prior to 1996. In 1995, the Insurance Law was amended to allow, effective January 1, 1996, Article 43 corporations and HMOs to "file and use" community rated premium adjustments of not more than 10% in any twelve month

period in lieu of the current prior approval/public hearing process. Effective January 1, 2000 the ten-percent limitation was removed in accordance with Section 4308(g)(2) of the New York Insurance Law.

From December 1, 1995 to September 30, 1998 Empire HealthChoice Inc. HMO provided guarantee rates based on the “annual level subscriber rate” methodology for its BlueChoice HMO contract. Under this methodology subscriber rates remained in effect until the next contract anniversary date subject to a prospective or retroactive adjustment in the event the Superintendent of Insurance approved a decrease and/or increase to the current BlueChoice HMO rate being charged.

On December 26, 1996 Empire HealthChoice Inc. HMO submitted a file and use rate increases for this contract effective February 1, 1997. Empire HealthChoice Inc. HMO did not apply the new rates for their subscribers until their renewal dates on or after February 1, 1997 and failed to collect the retrospective adjustment from the groups for the February 1, 1997 rate increase. On November 25, 1997 Empire HealthChoice Inc. HMO submitted another file and use filing effective February 1, 1998. Again the groups were not charged the new rates until their renewal date and Empire HealthChoice Inc. HMO failed to collect the retrospective adjustment.

Effective October 1, 1998 Empire HealthChoice Inc. HMO changed their guarantee rates to a quarterly rolling rate structure. This is a method that establishes a scale of annual subscriber rates that vary by quarter of issue. The premium rate in effect at each quarter remains constant for a stated period of time.

In a stipulation dated December 24, 1999 Empire agreed to a fine of \$1.25 million for rating violations which occurred during the period from January 1, 1997 to December 31, 1998. According

to the stipulation, the company violated the Insurance Law and Department regulations for failing to make the proper adjustments between guaranteed rates and approved rates within 12 months after the end of the contract year or contract termination if earlier for certain Blue Choice HMO Group contracts.

In addition to paying the fine, the company agreed to fully comply with the provisions of Section 4308 of the Insurance law and Department Regulation No. 62 (11 NYCRR 52).

5. SUMMARY OF COMMENTS AND RECOMMENDATIONS

ITEM NO.

PAGE NO.

Management

A.

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A-10-11

In addition to paying the fine, the company agreed to fully comply with the provisions of Section 4308 of the Insurance law and Department Regulation No. 62 (11 NYCRR 52).

Appointment No. 21509

STATE OF NEW YORK
INSURANCE DEPARTMENT

I, NEIL D. LEVIN, Superintendent of Insurance of the State of New York,
pursuant to the provisions of the Insurance Law, do hereby appoint:

Wai Wong

as a proper person to examine into the affairs of the

Empire Blue Cross & Blue Shield

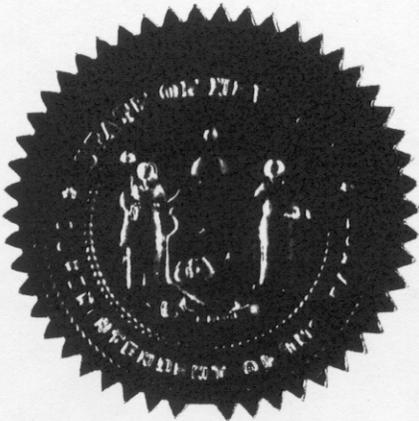
and to make a report to me in writing of the condition of the said

Company

with such other information as he shall deem requisite.

*In Witness Whereof, I have hereunto subscribed by the
name and affixed the official Seal of this Department, at
the City of New York,*

this 6th day of March 2000



NEIL D. LEVIN

Superintendent of Insurance

A handwritten signature in black ink, appearing to read "Neil D. Levin", written over a horizontal line.

(by) Deputy Superintendent