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EXECUTIVE SUMMARY

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Highmark and Independence Blue Cross Part Ways—Pennsylvania Regulatory Hurdles Thwart Attempted Consolidation

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Introduction

On March 28, 2007, Highmark Inc. (Highmark) and Independence Blue Cross (IBC), both nonprofit corporations organized under Pennsylvania law, entered into an Agreement of Consolidation (Consolidation Agreement) to consolidate their businesses and operations and operate post-closing as a single, newly formed nonprofit non-stock Pennsylvania corporation (Newco).[1] The parties intended that the new corporation would be a licensee of the Blue Cross Blue Shield Association.[2]

The proposed transaction was subject to a regulatory review process at both the federal and the state levels. The transaction came on the heels of prior transactions involving WellPoint Health Networks Inc. (WellPoint) and United HealthGroup Incorporated (United), both of which encountered varying levels of state and federal regulatory scrutiny due in large part to the transactions involving consolidation of multi-state

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[1] Agreement of Consolidation dated as of March 28, 2007, between Independence Blue Cross, a Pennsylvania nonprofit, non-stock corporation, and Highmark Inc., a Pennsylvania nonprofit, non-stock corporation (Consolidation Agreement).

[2] *Id*.

operations. Nevertheless, WellPoint and United received regulatory approvals within fourteen months and six months, respectively.

Anthem Inc.'s acquisition of WellPoint, announced October 2003 and completed December 1, 2004, would form the biggest health insurance company in the United States with more than twenty-eight million members, but the regulatory process lasted only fourteen months. The review was encumbered only by the California Department of Insurance (the California Department of Managed Health Care conducted a speedy regulatory review process) over concerns about substantial bonuses for executives, leading to concessions for funding to state healthcare programs.

At an even more rapid pace, United, the parent of United Healthcare, announced receipt of final approvals for its acquisition of Pacific Health Systems Inc. (PacifiCare) on December 21, 2005, only six months after the announcement of the acquisition. Although state regulatory approvals were achieved more timely than the WellPoint transaction, the U.S. Department of Justice (DOJ) required that United divest assets from operations in Tuscon, AZ, and Boulder, CO. The DOJ also required United to modify its network access agreement with Blue Shield of California and then to terminate the agreement one year later.

Some in the industry may have believed that the relatively smooth state and federal regulatory processes of the WellPoint and United transactions laid the groundwork for an uneventful state and federal regulatory process in the Highmark/IBC transaction. A statutory loophole was expected to further streamline the otherwise cumbersome state regulatory review.

Instead, while the transaction received early termination of the applicable waiting period at the federal level by the DOJ and the U.S. Federal Trade Commission (FTC), state-level legislative changes intervened. During the pendency of the state regulatory review, the commissioner for the Insurance Department of the Commonwealth of Pennsylvania (Insurance Department), the chief regulator at the state level, changed, and the legislature passed a new law enhancing the regulatory authority over mergers such as the transaction proposed by Highmark and IBC.

On January 22, 2009, Joel Ario, the new insurance commissioner, issued a statement indicating his intention to disapprove of the proposed transaction on the grounds that the consolidation would have lessened competition.[3] Recognizing that approval was unlikely, the parties withdrew their application on January 21, 2009.[4]

The transaction illustrates the potential for aggressive regulatory oversight at the state level, frustrating efforts of health insurers to expand through acquisition. Moreover, the outcome of this proposed transaction could potentially signal a change in the regulatory landscape for health plans desiring consolidation in Pennsylvania (a trend that also could gain momentum nationally). The aggressive regulatory oversight has continued even after the thwarted consolidation, as illustrated by the insurance commissioner's press release indicating that the Insurance Department would examine the conduct of the state's four Blue Cross and Blue Shield companies, including both Highmark and IBC, to determine if they are engaging in anti-competitive conduct or unfair trade practices.[5]

Background

At the time of the proposed consolidation, Highmark was licensed by the Insurance Department pursuant to the Health Plan Corporations Act[6] to operate a hospital plan and a professional health services plan and also to provide traditional indemnity healthcare insurance to groups and individuals.[7] IBC was a Pennsylvania nonprofit corporation licensed to operate a nonprofit indemnity hospital plan.[8] In addition to other service lines, Highmark provided a full service health plan in twenty-nine western Pennsylvania counties, twenty-one central Pennsylvania counties, and Lehigh Valley.[9] Highmark also was a party to joint operating agreements with Blue Cross of Northeastern Pennsylvania and provided professional health services coverage in

[3] Pennsylvania Insurance Department, Press Release, Insurance Department Welcomes Withdrawal of Proposed IBC/Highmark Consolidation (Jan. 22, 2009), *available at* www.portal.state.pa.us/portal/server.pt?open=514&objID=585572&mode=2.

[4] Correspondence from Buchanan Ingersoll & Rooney PC to Commonwealth of Pennsylvania Insurance Department (Jan. 21, 2009).

[5] Pennsylvania Insurance Department, Press Release, Insurance Department Examinations to Focus on Health Insurance Competition (July 17, 2009).

[6] 40 Pa. C.S. §§ 6101-6127, 6301, 6335.

[7] Form A Statement Regarding the Acquisition of Control of or Merger with a Domestic Insurer by QCC Insurance Company, et al. filed with the Insurance Department of the Commonwealth of Pennsylvania (Apr. 27, 2007) (QCC Form A Filing); Form A Statement Regarding the Acquisition of Control of or Merger with a Domestic Insurer by First Priority Life Insurance Company, Inc. et al. filed with the Insurance Department of the Commonwealth of Pennsylvania (Apr. 27, 2007).

[8] 40 PA. CONS. STAT. § 6102.

[9] QCC Form A Filing, at 3.

Northeastern Pennsylvania and provided professional health services coverage in northeastern Pennsylvania.[10] IBC's service area primarily consisted of five eastern counties including Bucks, Chester, Montgomery, Delaware, and Philadelphia.[11] A map highlighting the geographical location of each of the parties' operations is attached for clarity.

Legal Analysis

Several authorities had jurisdiction to review the proposed transaction. At the federal level, the transaction was subject to review by the DOJ and the FTC. At the state level, the transaction was subject to review by the Insurance Department.

Federal Standard of Review

Section 7A of the Clayton Act, also known as the Hart-Scott-Rodino Act (HSR Act), establishes the federal "Premerger Notification Program" and grants enforcement authority to the DOJ and FTC for transactions that meet certain thresholds.[12] Specifically, the HSR Act requires parties to submit pre-merger notification to the DOJ and the FTC prior to consummating the proposed acquisition or consolidation.[13] Generally, the HSR Act notification requirement only applies if the value of the transaction or the size of the parties exceeds certain dollar thresholds, adjusted over time.[14]

After filing premerger notification, the parties must wait at least thirty days[15] while the enforcement agencies review the proposed transaction for anticompetitive effects. The parties may request "early termination" or termination of the waiting period before the statutory period expires.[16] Such a request will be granted only after compliance with the Premerger Notification Rules (i.e., at least one party specifies the request for early termination on the Premerger Notification Form and both forms are compliant with the rules) and if both enforcement agencies have completed their review and determined

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10 *Id*.

11 *Id*. at 4.

12 15 U.S.C. § 18a(a).

13 *Id*. § 18a(d)(1).

14 *Id*. § 18a(b). The thresholds are *available at* www.ftc.gov/os/fedreg/2009/january/090113 section7aclaytonact.pdf.

15 The waiting period may be extended by issuance of a request for additional information and documentary material prior to the expiration of the thirty-day waiting period. 15 U.S.C. § 18a(e)(1)(A).

16 Hart-Scott-Rodino Premerger Notification Program, Introductory Guide I, What is the Premerger Notification Program? An Overview, Revised Mar. 2009, at 10.

not to take any enforcement action during the waiting period.[17] The parties may not consummate their deal until the waiting period has passed or the government has granted early termination.[18]

While the proposed Highmark/IBC transaction was sufficient in size to trigger the federal reporting requirement, the DOJ and FTC granted early termination of the waiting period on May 29, 2007.[19] The grant expires after twelve months pursuant to federal law and, because of the lengthy state regulatory review, the companies submitted a second pre-merger notification with early termination requested. Early termination was granted for a second time on July 17, 2008.[20]

State Regulatory Analysis

State Regulatory Standard

In a typical insurance company merger in Pennsylvania, the Insurance Department reviews the proposed transaction to address matters pertaining to solvency, business plans, leadership, and the impact of the transaction on competition and the consumer. Seemingly, this transaction would have, in large part, fallen outside of the Insurance Department's jurisdiction, as the law in place at the onset of the proposed transaction would have exempted Pennsylvania's Blue plans and fraternal benefit societies from those standards of review at the holding company level. Moreover, both Highmark and IBC were supporters of healthcare initiatives of Governor Ed Rendell (D) and major employers. Highmark and IBC also understood the need to further their commitment to Rendell's healthcare programs post-closing. All of these factors suggested that the Insurance Department would not review, or would review but quickly approve the proposed merger.

However, the regulatory environment that existed prior to the proposed consolidation of IBC and Highmark changed with the introduction of a new insurance regulator for healthcare. In June 2007, two months after the filing was made with the state regulators, Rendell recruited Ario from Oregon, where he had been the top insurance regulator.

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[17] 15 U.S.C. § 18a(b).

[18] *Id*. § 18a(b)(2).

[19] *In re* Applications of Highmark Inc. and Independence Blue Cross, Second Supplemental Response to Insurance Department Information Request 4.

[20] *Id*. The parties filed notification on May 13, 2008, but these filings were withdrawn on June 13, 2008. Filings were resubmitted on June 17, 2008, and early termination was granted on July 17, 2008.

Ario had a long background as a consumer advocate. In addition to the change, Rendell called upon the Pennsylvania General Assembly to remove the regulatory loophole, asking that the legislature "swiftly enact clean legislation to give the Department of Insurance greater legal authority to more closely review proposed transactions of this type."[21] Rendell added that "[d]oing so will enhance and strengthen our ability to protect health insurance consumers across the state."[22]

The state legislature answered the call for expanded authority by passing Act 62 of 2008, which required that consolidations such as the one between IBC and Highmark be subject to state approval. The new law also provided the Senate Banking and Insurance Committee and the House Insurance Committee the authority to receive and review all filings submitted to the Insurance Department and to submit written comments and recommendations.

Because of the legislative changes at the state level, the proposed consolidation between Highmark and IBC was subject to the Pennsylvania Insurance Holding Companies Act (HCA).[23] The HCA expressly provides that no person may consolidate with a domestic insurer unless such person has filed a regulatory application with the Insurance Department and the consolidation has been approved by the Insurance Department.[24] The Insurance Department many deny an application under a variety of circumstances, including the following:

- After the proposed transaction, the domestic insurer would not be able to satisfy the requirements for the issuance of the license currently held.
- The effect of the proposed transaction would substantially lessen competition in insurance in Pennsylvania or tend to create a monopoly.
- The financial condition of any acquiring party might jeopardize the financial stability of the insurer or prejudice the interest of its policyholders.
- The acquiring party's plans for material changes in the business are unfair and unreasonable, fail to confer benefit on policyholders, and are not in the public interest.

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[21] Pennsylvania Insurance Department, Press Release, Governor Rendell Renews Call for Intensive Review of Proposed IBC-Highmark Merger (May 31, 2007).
[22] *Id*.
[23] 40 PA. STAT. § 991.1401 *et seq.*
[24] *Id*. § 991.1402(a)(1).

- The competence, experience, and integrity of the incoming controlling persons are such that it would not be in the interest of policyholders of the insurer and of the public to permit the proposed transaction.
- The proposed transaction is likely to be hazardous or prejudicial to the insurance buying public.
- The proposed transaction is not in compliance with the laws of the Commonwealth, including provisions of the "Insurance Company Mutual-to-Stock Conversion Act."

The HCA further provides a specific framework for evaluating the competitive impacts of proposed transactions involving domestic insurers. This framework includes a statistical violation determination based on whether the market shares of the consolidating companies are greater than certain minimum criteria in the relevant product and geographic markets.

Specifically, the HCA employs a "current concentration test" whereby a transaction involving two or more insurers competing in the same market is statistical evidence of violation of the competitive standards:

- If the market is highly concentrated (a market in which the share of the four largest insurers is 75% or more)[25] and the involved insurers possess the following shares of the market (note that the insurer with the largest share of the market is deemed to be insurer A):[26]

Insurer A	**Insurer B**
4%	4% or more
10%	2% or more
15%	1% or more

- If the market is not highly concentrated and the involved insurers possess the following shares of the market:

[25] *Id.* § 991.1403(d).
[26] *Id.*

Insurer A	**Insurer B**
5%	5% or more
10%	4% or more
15%	3% or more
19%	1% or more.[27]

The framework also includes an evaluation of any trend toward increasing concentration in the relevant product and geographic markets (market concentration trend test). The market concentration trend test assesses whether there is a significant trend toward increased concentration when the aggregate market share of any grouping of the largest insurers in the market, from the two largest to the eighth largest, has increased by 7% or more of the market over a period of time extending from any base year five to ten years prior to the acquisition up to the time of the acquisition.[28] Any acquisition, merger, or consolidation involving two or more insurers competing in the same market is statistical evidence of violation of the competitive standard if:

- There is a significant trend toward increased concentration in the market;
- One of the insurers involved is one of the insurers in a grouping of such larger insurers showing the requisite increase in the market share; and
- Another involved insurer's market is 2% or more.[29]

If the consolidation does not pass the current concentration test or the market concentration trend test (i.e., a statistical violation exists), then the application for consolidation is denied unless:

- The acquisition would yield substantial economies of scale or economies in resource utilization that cannot be feasibly achieved in any other way; and
- The public benefits that would arise from such economies exceed the public benefits that would arise from not lessening competition; or
- The consolidation would substantially increase the availability of insurance; and

[27] *Id*. § 991.1403(d)(2)(i).
[28] *Id*. § 991.1403(d)(2)(ii).
[29] *Id.*

- The public benefits of such increase exceed the public benefits that would arise from not lessening competition.[30]

If a consolidation proposal is denied, the Insurance Department may condition approval of the consolidation on the removal of the basis of disapproval within a specified period of time.[31]

Though the FTC and the DOJ granted early termination of the waiting period, in a press release on May 31, 2007, Rendell signaled that Pennsylvania would not follow federal regulators lock step, stating, "These federal agencies did not approve the merger, they said only that they did not find any federal antitrust or competitive concerns, and granted the companies' request to terminate the 30-day waiting period."[32] He continued by stating that "[t]his is an important distinction and it is one that means Pennsylvania's review of the proposed merger will need to be very thorough."[33]

In connection with its review, the Insurance Department sought assistance from outside experts. In a press release dated December 21, 2007, the Insurance Department announced the engagement of Blackstone Advisory Services, LP (Blackstone) to provide financial expertise and Wolf Block Schorr and Solis-Cohen and Hangley Aronchik Segal & Pudlin to provide legal expertise.[34] Blackstone, a leading Wall Street firm, has advised state regulators on several high-profile Blue Cross Blue Shield transactions in recent years, including a 2005 New York sale of a converted Blue Plan to WellPoint, a transaction that was approved, and a 2003 Maryland conversion and 2004 State of Washington conversion, neither of which were approved. Wolf Block and Hangley Aronchick were Pennsylvania-based firms that have previously advised and represented various state agencies on a broad range of issues.

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30 *Id*. § 991.1403(d)(3).
31 *Id*. § 991.1402(f)(1)(ii)(C).
32 Press Release: Governor Rendell Renews Call for Intensive Review of Proposed IBC/Highmark Consolidation (May 31, 2007), www.portal.state.pa.us/portal/server.pt/document/669586/www.education.state.pa.us.
33 *Id*.
34 Press Release, Insurance Department Will Hold Public Hearings on Proposed Consolidation of Highmark, Independence Blue Cross, Hearings Will Ensure Consumers' Interests Are Considered, Protected (Dec. 21, 2007).

In addition to engaging Blackstone, the Insurance Department, pursuant to statutory authority, solicited the opinion of an economist to analyze the likely impact of the proposed transaction.[35] In this case, the Insurance Department sought the opinion of LECG Inc. (LECG).[36]

Statistical Analysis—LECG Report

Upon review of the proposed consolidation, LECG found several statistical violations. LECG examined the relevant product market by examining the direct insurance premium for a line of business as reported in the annual statement required to be filed by insurers doing business in Pennsylvania.[37] LECG conducted: (1) a statewide analysis, (2) a regional analysis, and (3) a county-by-county analysis of Medicare and Medicaid. The results of the analysis were presented in table format under the following headings:

- Summary of Statewide IBC and Highmark Market Shares of Direct Premiums Written by NAIC Line of Business;
- Summary of Market Shares of the Top Four Insurance Companies in Each Product;
- Summary of Markets with Statistical Violation Based on Concentration Test;
- Fully Insured and Self-Funded Commercial Products Summary of IBC and Highmark Market Shares by Region;
- Fully Insured Commercial (Risk Only) Products Summary of IBC and Highmark Market Shares by Region;
- Summary of County Level IBC and Highmark Market Shares of Medicare Eligibles for Lehigh Valley;
- Summary of County Level IBC and Highmark Medicaid Market Shares for Lehigh/Capitol;

[35] 40 PA. STAT. § 991.1403(c)(2).
[36] Economic Analyses of The Competitive Impacts from The Proposed Consolidation of Highmark and IBC, LECG Inc., Sept. 10, 2008.
[37] *Id*. at 19.

- Summary of County Level IBC and Highmark Medicaid Market Shares for Voluntary Managed Care;
- Summary of Market Shares of the Top 4 Insurance Companies in Each Product; and
- Summary of Markets with Statistical Violation Based on Concentration Test.

Statewide, Highmark and IBC's 2007 combined share of premiums typically exceeded 60% and their individual shares exceeded 5% each (except their dental product line).[38]

A. Summary of Statewide IBC and Highmark Market Shares of Direct Premiums Written by NAIC Line of Business[39]

Line of Business	Highmark Share	IBC Share	Combined Share
Group Comprehensive	27.8%	35.7%	63.5%
Individual Comprehensive	64.8%	18.7%	83.5%
Federal Employees Health Benefit	40.5%	24.0%	64.5%
Medicare Supplement	70.8%	13.0%	83.8%
Title XVIII Medicare	36.3%	27.2%	63.5%
Title XIX Medicaid	16.0%	30.6%	46.6%
Vision Only	30.2%	12.8%	43.0%
Dental Only	72.4%	0.0%	72.4%
Other	29.5%	11.1%	40.6%
Commercial (Risk Only)	30.6%	34.0%	64.5%

38 *Id.* at 4, 96.
39 *Id*. at 22.

LECG then reviewed the total share of the top four insurance companies both overall and for each line of business to determine whether they exceeded the 75% threshold. LECG answers this affirmatively in all areas except Medicaid, as demonstrated by the chart below.[40]

B. Summary of Market Shares of the Top Four Insurance Companies in Each Product[41]

Product	Shares by Premiums Written	Shares by End-of-Year Members
Commercial (Risk Only)	80.9%	80.3%
Group Comprehensive	80.4%	79.1%
Individual Comprehensive	93.6%	90.9%
Federal Employees Health Benefit	84.5%	84.5%
Medicare Supplement	99.9%	99.9%
Title XVIII Medicare	77.8%	78.0%
Title XIX Medicaid	74.9%	65.3%
Vision Only	100.0%	100.0%
Dental Only	97.5%	98.6%
Other	88.4%	85.3%

40 *Id*. at 23.
41 *Id*. at 24.

Next, based upon these findings, LECG applied the current concentration test to each of the NAIC lines of business and concluded that all but the dental line resulted in a statistical violation of the statute. This finding is supported by the conclusions drawn below.

C. Summary of Markets with Statistical Violation
Based on Concentration Test[42]

Geographic Area/Product	Statistical Violation
Commercial (Risk Only)	Exceeds 4/4
Group Comprehensive	Exceeds 4/4
Individual Comprehensive	Exceeds 4/4
Federal Employees Health Benefit	Exceeds 4/4
Medicare Supplement	Exceeds 4/4
Title XVIII Medicare	Exceeds 4/4
Title XIX Medicaid	Exceeds 5/5
Vision Only	Exceeds 4/4
Dental Only	
Other	Exceeds 5/5

LECG also supplemented the statewide analysis by conducting a regional analysis. The following two charts summarize each party's share of commercial insurance for each service area using a residence-based and employer-based approach:

42 *Id*. Figures are on a percentage basis.

D. Fully Insured and Self Funded Commercial Products
Summary of IBC and Highmark Market Shares by Region[43]

Region	Highmark Share		IBC Share		Combined Share	
	Residence Based	Employer Based	Residence Based	Employer Based	Residence Based	Employer Based
Southeast PA	3.5%	0.0%	58.1%	59.3%	61.6%	59.3%
Western PA	57.5%	62.4%	1.2%	0.2%	58.6%	62.7%
Central PA	29.8%	23.4%	12.1%	0.6%	41.8%	24.0%
Northeast PA	16.4%	6.7%	6.8%	0.2%	23.2%	6.9%

E. Fully Insured Commercial (Risk Only) Products
Summary of IBC and Highmark Market Shares by Region[44]

Region	Highmark Share		IBC Share		Combined Share	
	Residence Based	Employer Based	Residence Based	Employer Based	Residence Based	Employer Based
Southeast PA	3.3%	0.0%	61.9%	62.0%	65.2%	62.0%
Western PA	55.4%	56.1%	0.6%	0.0%	56.0%	56.1%
Central PA	24.6%	21.8%	9.5%	0.0%	34.1%	21.8%
Northeast PA	13.7%	7.3%	4.0%	0.0%	17.8%	7.3%

The county-eligible combined shares for Medicare eligibles for Lehigh Valley fell below 7%, as reflected in the table below.

F. Summary of County Level IBC and Highmark Market Shares of
Medicare Eligibles for Lehigh Valley[45]

County	Highmark Share	IBC Share	Combined Share
Berks	4.6%	2.0%	6.6%
Lancaster	4.7%	0.9%	5.6%
Lehigh	4.6%	2.5%	7.2%
Northampton	5.5%	2.0%	7.5%
York	6.1%	0.3%	6.4%
Total	5.1%	1.4%	6.5%

[43] *Id*. at 50.
[44] *Id*. at 51.
[45] *Id*. at 55.

The low percentage was because of the inclusion of total Medicare eligibles (which includes those enrolled in a Medicare Advantage (MA) Plan). However, separating MA enrollment from traditional government Medicare plans causes the market shares to increase dramatically, resulting in a statistical violation of the statute.

LECG also reviewed shares of enrollment in Medicaid HealthChoice, a government-regulated program. The April 2008 shares of enrollment in the Lehigh/Capital region, by county and overall, were high enough to show that the proposed consolidation would have an anticompetitive effect.

G. Summary of County Level IBC and Highmark Medicaid Market Shares for Lehigh/Capitol[46]

County	Highmark Share	IBC Share	Combined Share
Adams	38.1%	10.2%	48.3%
Berks	19.9%	63.8%	83.6%
Cumberland	71.8%	12.8%	84.6%
Dauphin	78.8%	8.9%	87.7%
Lancaster	36.7%	46.1%	82.8%
Lebanon	87.2%	7.4%	94.7%
Lehigh	35.1%	57.7%	92.8%
Northampton	41.1%	51.9%	93.0%
Perry	79.9%	10.9%	90.8%
York	33.2%	22.1%	55.2%
Total	**42.7%**	**39.4%**	**82.1%**

The next table summarizes the April 2008 shares of Medicaid enrollment in Voluntary Managed Care in five counties where both Highmark and IBC offer Medicaid products.[47] In these counties, only three private payors offered plans, and Medicaid fee-for-service coverage was available through a government program entitled “Access Plus.” Combined, IBC and Highmark’s shares totaled 3.5%. However, if the private plans were a separate market from Access Plus, the percentage would increase significantly, resulting in a statistical violation.

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[46] *Id*. at 56.
[47] *Id*.

H. Summary of County Level IBC and Highmark Medicaid Market Shares for Voluntary Managed Care[48]

County	Highmark Share	IBC Share	Combined Share
Carbon	8.6%	4.6%	13.2%
Lackawanna	0.9%	1.6%	2.5%
Luzerne	0.3%	0.9%	1.1%
Monroe	2.0%	4.9%	7.0%
Pike	0.3%	1.9%	2.2%
Total	**1.3%**	**2.2%**	**3.5%**

LECG then summarized the results of the market concentration tests for each geographic and product market highlighted above. The table below demonstrates that all markets except for Medicare in Lehigh Valley and commercial products in central Pennsylvania were highly concentrated.

48 *Id*. at 57.

I. Summary of Market Shares of the Top 4 Insurance Companies in Each Product[49]

Geographic Area	Commercial (Risk and Non-Risk)	Commercial (Risk Only)	Medicare	Medicaid
Western PA	95%	98%		
Southeast PA	85%	84%		
Central PA	67%	59%		
Northeast PA	88%	93%		
Total Medicare "Lehigh Valley"			16%	
Berks			24%	
Lancaster			16%	
Lehigh			17%	
Northampton			15%	
York			16%	
Total Medicaid HealthChoices "Lehigh/Capital"				100%
Adams				100%
Berks				100%
Cumberland				100%
Dauphin				100%
Lancaster				100%
Lebanon				100%
Lehigh				100%
Northampton				100%
Perry				100%
York				100%
Total Medicaid Voluntary Managed Care				100%
Carbon				100%
Lackawanna				100%
Luzerne				100%
Monroe				100%
Pike				100%

The statistical test was then applied to each market depending on the concentration finding. The table below indicates that IBC and Highmark shares were above the levels that result in a statistical violation of the statute at the regional level (based upon the residence of their members and allocating joint venture membership).[50]

49 *Id*. at 58.
50 *Id*. at 59.

J. Summary of Markets with Statistical Violation Based on Concentration Test[51]

Geographic Area/Product	Commercial (Risk and Non-Risk)	Commercial (Risk Only)	Medicare	Medicaid
Western PA	Exceeds 15/1	Exceeds Interpolation		
Southeast PA	Exceeds 10/2	Exceeds 10/2		
Central PA	Exceeds 5/5	Exceeds 5/5		
Northeast PA	Exceeds 4/4	Exceeds 4/4		
Total Medicare "Lehigh Valley"			-	
Berks			-	
Lancaster			-	
Lehigh			-	
Northampton			-	
York			-	
Total Medicaid HealthChoices "Lehigh/Capital"				Exceeds 4/4
Adams				Exceeds 4/4
Berks				Exceeds 4/4
Cumberland				Exceeds 4/4
Dauphin				Exceeds 4/4
Lancaster				Exceeds 4/4
Lebanon				Exceeds 4/4
Lehigh				Exceeds 4/4
Northampton				Exceeds 4/4
Perry				Exceeds 4/4
York				Exceeds 4/4
Total Voluntary Managed Care				Exceeds 4/4
Carbon				Exceeds 4/4
Lackawanna				-
Luzerne				-
Monroe				Exceeds 4/4
Pike				-

Competitive Effects Analysis

After performing the statistical violation evaluation, LECG performed "post-prima facie" economic analyses of: (1) the likely effects on current competition; (2) the likely effects of the consolidation on the potential for competition between the companies; and (3) the likelihood of substantially increased market power for Newco.[52] With reference to current competition, LECG found that immediate direct competition was not great.[53] However, concerning the potential for competition, LECG found that the consolidation

[51] *Id*. Figures are on a percentage basis.
[52] *Id.* at 97.
[53] *Id.*

would eliminate Highmark as a potential independent entrant into southeastern Pennsylvania, where it held the right to use the Blue Shield mark and already had a physician provider network in place (two competitive advantages that other competitors lack), but where IBC dominates the five-county area with a 62% commercial insurance market share.[54] LECG also noted arguments that but for the proposed consolidation, Highmark would likely enter the region and compete with IBC, resulting in a benefit for both health insurance customers and healthcare providers.[55]

With reference to Newco's increased market power, LECG did not draw any conclusions but did not rule out the possibility that Newco could significantly strengthen the companies' concentration in the west and southeastern regions, which could potentially lead to the use of "most favored nation" or "all products" clauses for customers or providers, or lead to the increased usage of insurance broker incentives for rewarding larger volume of Newco or of employer minimum share requirements—all ultimately adversely impacting competition.[56]

Finally, LECG compared the loss of consumer benefit that would result if Highmark entered the five-county Philadelphia region (discounted by the probability that it may not enter) with the claimed benefits of Newco to assess the tradeoff.[57] LECG calculated the minimum probabilities of Highmark's entry that would result in estimated consumer losses (as a result of lessened competition) exceeding the estimated potential maximum total public benefits of Newco.[58] LECG found that the estimated probabilities suggest that for the public benefits from the potential increase in competition to outweigh the potential public benefits from Newco over the next six years, Highmark's entry into Philadelphia would have to be fairly likely.[59] However, if the benefits of competition were likely to last more than six years, then Highmark's entry would not be relevant for the expected benefits of entry to outweigh the maximum benefits of Newco.[60]

[54] *Id.*
[55] *Id.*
[56] *Id.*
[57] *Id.* at 98.
[58] *Id.*
[59] *Id.*
[60] *Id.*

Financial Analysis—Blackstone Reports

The Insurance Department also retained Blackstone to complete a financial analysis of the proposed transaction. Blackstone filed an initial report dated September 2, 2008, prior to the public comment period's closing.[61]

As part of its work on behalf of the Insurance Department, Blackstone represented completion of the following tasks:

- Reviewed the Form A filings submitted by the parties;
- Reviewed Highmark's and IBC's audited Generally Accepted Accounting Principles (GAAP) financial statements for the years ended December 31, 2005-2007;
- Reviewed Highmark's and IBC's available projected financial statements;
- Reviewed responses submitted by Highmark and IBC to the Insurance Department's requests for additional materials;
- Reviewed public comments submitted to the Insurance Department by all concerned parties;
- Reviewed the Opportunity Assessment, dated July 12, 2006, and the Opportunity Identification, dated February 9, 2007, prepared by Booz Allen Hamilton on behalf of Highmark and IBC;
- Reviewed the Applicants' response to item six of the Insurance Department's August 4, 2008, letter prepared by Booz & Co. on behalf of Highmark and IBC;
- Reviewed a draft of the Newco Integration Plan;
- Attended public hearings in Pittsburgh (July 8, 2008), Harrisburg (July 10, 2008), and Philadelphia (July 15-16, 2008);
- Held discussions with the members of both Highmark and IBC's management to discuss their respective businesses, operating environments, financial condition, and strategic objectives;

[61] Report on the Proposed Consolidation of Highmark Inc. and Independence Blue Cross, Sept. 2, 2008.

- Held discussions with several third parties that provided their unique perspective on the proposed consolidation and its potential impact on the health insurance market in Pennsylvania;
- Reviewed the report of Barry C. Harris, principal and chairman of Economists Incorporated, dated January 25, 2008;
- Reviewed the supplemental report of Barry C. Harris, principal and chairman of Economists Incorporated, dated August 2008;
- Reviewed a draft of LECG's report to the Insurance Department, dated August 26, 2008, regarding the proposed consolidation;
- Reviewed the executive compensation information prepared by Highmark and IBC that was received by the Insurance Department on August 13, 2008;
- Reviewed transcripts from the public hearings held on July 8, 10, 15, and 16, 2008;
- Reviewed the financial terms of selected recently completed mergers and acquisitions in the managed care industry;
- Reviewed the operating and trading statistics of selected publicly traded managed care companies; and
- Reviewed such other information, performed such other studies and analyses, and took into account such other matters as Blackstone deemed appropriate.

Blackstone provided the conclusions set forth below as of September 2, 2008.

Standard 1: Satisfy License Requirements

Blackstone analyzed the relevant capital, surplus, and net-worth requirements for each of the domestic insurers for issuance of a license.[62] Blackstone compared the capital, surplus, or net-worth requirements, as appropriate, based upon the type of company to the actual capital, surplus, and net worth of each of the domestic insurer.[63] Blackstone

[62] *Id*. at 9.
[63] *Id*.

concluded Newco would likely satisfy the requirements for issuance of a license to write the lines of insurance in effect at the time of the proposed consolidation.[64]

Standard 2: Not Substantially Lessen Competition or Tend to Create a Monopoly

Blackstone indicated that LECG was engaged to perform statistical tests of market share and market concentration for this standard. Accordingly, Blackstone deferred to the conclusions in the LECG report for the primary analysis of whether the proposed consolidation violated Standard 2.[65]

Blackstone assessed the reasonableness of expected synergies and whether synergies outlined could “feasibly be achieved in any other way.”[66] Blackstone also analyzed and placed a value on the expected synergies and the potential public benefits.[67] Blackstone’s review of this standard was not complete as of the date of the September 2, 2008 report, but included a preliminary analysis of these issues.[68]

As a preliminary matter, Blackstone noted that there is not an exact correlation between the expected synergies that may be realized by the proposed transaction and the resulting public benefits.[69] Some synergies would not result in a specific public benefit, and there may be public benefits that would arise from the proposed consolidation that do not result from a specific expected synergy.[70]

Blackstone concluded that the applicants’ estimate that the synergies would yield more than $1 billion in scale-based economies and new growth opportunities in the first six years following the closing of the transaction was reasonable (the net present value of the sources totaled $892 million).[71] Scale-based economies include the following: (1) information technology; (2) pharmaceutical; (3) back office; (4) corporate functions; (5) procurement and facilities; (6) middle office; (7) front office; (8) unbranded subsidiaries;

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[64] *Id*. at 76.
[65] *Id*. at 77.
[66] *Id*.
[67] *Id*.
[68] *Id*.
[69] *Id*. at 78.
[70] *Id*.
[71] *Id*. at 79.

and (9) seniors business.[72] New growth opportunities include the pharmacy benefit management expansion, unbranded subsidiaries, national accounts, and ancillary products.[73]

Nearly 50% of the synergies would result in cost savings in information technology (driven primarily by the elimination of redundant applications, infrastructure, and management, and increased leverage in information technology procurement)[74] and from pharmaceuticals (primarily due to Highmark's ability to use IBC's pharmacy benefit manager and through the negotiation of higher rebates due to the increased scale).[75] The net present value of merger-specific synergies in years seven through twenty could range from $1.4 billion – $2.2 billion.[76] Though some criticized the data submitted by the applicants as being overly optimistic, Blackstone concluded that the expected gross synergies were in line with the range of precedent transactions.[77] In similar transactions, the acquirer realized all expected synergies (though the report questioned the comprehensiveness of publicly available information, stating that companies may be disinclined to report information when they have failed to realize the expected synergies).[78]

Newco announced its expectation that it would return more than $1 billion to policyholders and the Commonwealth of Pennsylvania.[79] The net present value of the uses exceeded the net present value of the sources of the synergies, indicating that the return to the public would be greater than the benefits realized by the synergies. The proposed benefits would include the following: (1) holding per-member, per-month administrative fees flat; (2) passing on pharmacy cost savings from insourcing the pharmacy benefit management function (Highmark would no longer be paying margins to Medco); (3) eliminating the Blue Card fees paid between Highmark and IBC; (4) supporting programs for the uninsured; (5) investing in quality-improvement programs;

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[72] *Id*.
[73] *Id*.
[74] *Id*. at 82.
[75] *Id*. at 81, 83.
[76] *Id*. at 97.
[77] *Id*. at 100.
[78] *Id*.
[79] *Id*. at 105.

and (6) expanding the commitment to the Community Health Reinvestment entered into in 2005 between four non-profit Blue Cross Blue Shield plans to provide health insurance for low-income people through state-approved programs and publicly sanctioned health coverage programs or community benefit initiatives.[80]

Standard 3: Not Jeopardize Financial Stability or Prejudice the Interest of Policyholders

Blackstone analyzed the expected financial condition of Newco as well as how the current policy holders of Highmark and IBC would be affected by the consolidation.[81] This analysis considered the impact on products offered and breadth of the provider network and included an analysis of the specific benefits to be received by policyholders in the proposed consolidation.[82]

Blackstone concluded that the proposed consolidation would not violate this standard. Blackstone indicated that the financial condition of Highmark or IBC would not jeopardize the financial stability of the other party or Newco or prejudice the interest of its policyholders based on the following:

- IBC policyholders would be insured by a company with a higher Risk Based Capital (RBC) ratio, more reserves, and stronger financial rating;
- Highmark policyholders would be insured by a company with more reserves, but would have a lower RBC ratio and somewhat weaker financial strength rating; and
- Newco's RBC ratio would still be in the "sufficient" category.[83]

Standard 4: Not Unfair and Unreasonable and Confers Benefit to Policyholders

Blackstone analyzed the expected financial condition of Newco and how the current policyholders of Highmark and IBC would be affected by the consolidation.[84] Blackstone

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80 *Id*. at 105-08. The report also detailed several reasons why these amounts may need to be discounted. *Id*. at 109. For example, even though the Insurance Department could monitor the public benefit during the first six years, Newco may decrease the value of these benefits after the Insurance Department's monitoring phases out. *Id*.
81 *Id*. at 111.
82 *Id*.
83 *Id*.
84 *Id*. at 113.

analyzed the impact on products offered and breadth of the provider network and analyzing the specific benefits to be received by policyholders in the proposed consolidation.[85]

Based on its review as of the September 2, 2008 report, Blackstone had not identified any significant evidence of a violation of this standard.[86] Blackstone did not believe that the plans or proposals of Highmark and IBC were unfair and unreasonable or failed to confer benefit on policyholders of the insurer for the following reasons:

- Policyholders would still have had access to the same or substantially similar products that were offered prior to the proposed consolidation;[87]
- Policyholders would still have had access to substantially all providers to which they currently have access;[88]
- Policyholders would still receive specific benefits from the consolidation if the public benefits outlined by Highmark and IBC are accepted by the Insurance Department;[89] and
- Policyholders would likely not incur a decline in the quality of customer service from Newco relative to Highmark and IBC currently.[90]

Standard 5: Integrity of Persons Who Would Control Operation of Insurer

Blackstone did not analyze Standard 5 and instead deferred to the Insurance Department for this determination.

Standard 6: Not Hazardous or Prejudicial to the Insurance-Buying Public

Blackstone analyzed how the consolidation would affect the insurance-buying public[91] and the impact of the consolidation on the insurance market broadly in Pennsylvania.[92]

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85 *Id*.
86 *Id*. at 118.
87 *Id*. at 114.
88 *Id*. at 115.
89 *Id*. at 116.
90 *Id*. at 117.
91 *Id*. at 120.

Blackstone synthesized input from written public comments and the public hearings and utilized objective, third-party data, determining the validity and potential impact of concerns raised by the insurance-buying public.

As part of its review of Standard 6, Blackstone focused on the ten primary concerns outlined below and assessed the validity of these concerns.

- ***The proposed consolidation would substantially lessen competition. This would lead to increased premiums and excess leverage in the marketplace.*** Blackstone responded that the LECG Report is the primary analysis on this topic.[93] Blackstone noted that Newco would become the seventh largest national insurer in terms of medical enrollment and, compared with the largest fifteen insurers, would maintain the highest market share in its top state.[94]
- ***Newco's market power would be used to reduce reimbursements to hospitals, doctors, and other providers.[95] This would lead to increased physician flight from Pennsylvania and a decreased ability to recruit new physicians.[96] This would, in turn, lead to lower provider quality and availability.[97]*** Blackstone noted that, over the past five years, the medical-loss ratios at Highmark and IBC were above those of national publicly traded competitors and in line with the mean and median of other Pennsylvania competitors, indicating that the two companies would not have a disproportionate percentage of their premium revenue available to cover administrative expenses.[98]
- ***The proposed consolidation would create a higher barrier to entry for other insurers to enter the market.[99] This would lead to a reduction in competition.[100]*** Blackstone concluded that, historically, new competitors have had difficulty in

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92 *Id*.
93 *Id*.
94 *Id*. at 123.
95 *Id*. at 120.
96 *Id*.
97 *Id*.
98 *Id*. at 124.
99 *Id*. at 120
100 *Id*.

successfully entering the Pennsylvania market and indicated that the proposed transaction may exacerbate this problem.[101]

- ***The proposed consolidation would lead to increased compensation to Newco's executives.[102]*** Blackstone did not analyze this concern.[103]
- ***The proposed consolidation would provide even more reserves that would be used to finance predatory pricing.[104]*** Blackstone concluded that Newco's consolidated GAAP assets and equity would be larger than most other national and regional competitors, but that several competitors have comparable reserves.[105] On a per-member basis, Newco would have about the same amount of assets but more equity than competitors, consistent with nonprofit insurers maintaining higher capital ratios than their publicly traded counterparts.[106]
- ***The transaction would eliminate the prospect of head-to-head competition.[107]*** Blackstone deferred to the LECG analysis on this topic.[108]
- ***The transaction would give Newco undue influence regarding state public policy.[109]*** Blackstone stated that there may be merit to the argument that Newco could exercise significant, incremental political clout within Pennsylvania as a result of the consolidation.[110]
- ***The transaction would negatively affect non-physician reimbursement policies.[111]*** Blackstone stated that there was a risk that Newco might adopt Highmark's more-stringent credential requirements.[112]

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[101] *Id*. at 127, 130.
[102] *Id*. at 121.
[103] *Id*. at 133.
[104] *Id*. at 121.
[105] *Id*. at 134.
[106] *Id*.
[107] *Id*. at 121.
[108] *Id*. at 135.
[109] *Id*. at 121.
[110] *Id*. at 136.
[111] *Id*. at 122.
[112] *Id*. at 137.

- ***The transaction would cause Newco to bundle more of its products together, hindering potential competitors that offer only certain products.[113]*** Blackstone indicated that it is reasonable to conclude that Newco may adopt bundling policies.[114]
- ***The transaction would negatively impact the ability of specialists to sell new treatment technology.[115]*** Blackstone stated there may be merit to the argument that the proposed consolidation would lead to a loss of alternatives for developers of treatment technologies in Pennsylvania.[116]

At the time of the September 2, 2008 report, Blackstone had not completed its review of Standard 6. Blackstone had yet to determine whether the proposed consolidation violated this standard.

January 20, 2008, Supplemental Report

Blackstone issued a supplemental report dated September 2, 2008, to be read in conjunction with Blackstone's first report on the proposed consolidation.[117] Blackstone concluded based on its review of Standard 6 that the proposed consolidation *may substantially lessen competition, result in the reduction of reimbursements to providers, and raise competitor's costs through the use of the "Blue Card" access fees*.

Public Hearings and Public Comment

In addition to the special analytic work completed by Pennsylvania's retained experts, the state held public hearings to obtain input from the public. For this transaction, the state extended the public hearing and comment periods.

Media coverage suggested strong opposition to the proposed consolidation. Among comments from other parties, Donald White, the Republican Chairman of the Pennsylvania Senate Banking and Insurance Committee, strongly opposed the transaction. Medical trade groups and the Insurance Federation of Pennsylvania,

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[113] *Id*. at 122.
[114] *Id*. at 138.
[115] *Id*. at 122.
[116] *Id*. at 139.
[117] Supplemental Report on the Proposed Consolidation of Highmark Inc. and Independence Blue Cross, Jan. 20, 2008.

representing rivals, engaged in intense lobbying. Providers and consumers alike were vocal in their concerns.

White said his panel's review of "testimony and facts presented over the last two years showed the consolidation would have substantial and serious negative consequences on both the availability and affordability of health care insurance for consumers across Pennsylvania."[118] Sam Marshall of the Insurance Federation of Pennsylvania expressed his concern that no other type of insurance is so completely dominated by a handful of companies in Pennsylvania that would not be tolerated in auto or life insurance and asked why such domination would be allowed for health insurance.[119]

The proposed consolidation met with opposition from both the left and right of the political spectrum. Consumer groups on the left were opposed because combining the two health insurance giants would have given the new entity a considerable portion of Pennsylvania's market, possibly leading to higher premiums. On the right, some Republicans expressed concern that the newly consolidated entity would pose difficulties for doctors and hospitals—concerns that drove the Senate Banking and Insurance Committee to call for rejection.

Specific to this proposed transaction, the regulators heard a choir of dissenting opinions regarding the public benefit. Although Highmark and IBC argued the benefit to the public would be greater competition, this argument was not persuasive in winning public support or regulatory approval.

Approval Conditions and Withdrawal of Applications

Both companies were confident that the proposed consolidation would gain approval from regulators up until mid December 2008, when Pennsylvania advised of specific terms that the parties would have to meet in order to gain approval of the consolidation. These three conditions were as follows: (1) the new company would be required to give up one of its highly valued and popular "Blue" trademarks (Highmark uses Blue Cross

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118 Senator Don White's Statement on Highmark-IBC's Withdrawal of the Merger Proposal, Pennsylvania Senate Republican News (Jan. 21, 2009), *available at* http://senaterepublicannews.com/news/archived/2009/0109/dwhite-012109.htm.

119 *No Blue Cross Mega Merger Simply Preserves Status Quo*, Philly.com (Jan. 23, 2009), *available at* www.philly.com/philly/blogs/phillyinc/No_Blue_Cross_mega-merger_simply_preserves_Pa_status_quo.html.

and Blue Shield; IBC is Blue Cross) so another company could use it to compete against Newco in Pennsylvania; (2) the parties would need to expand their charitable work; and (3) the parties would have to agree to some “fair-trade” measures, such as more scrutiny of their reimbursement practices.[120]

In a joint announcement on January 21, 2008, the two insurers said that they could not accept an Insurance Department requirement to relinquish either the Blue Cross or Blue Shield brand as a condition of the consolidation, according to a statement by Highmark President and Chief Executive Officer (CEO) Ken Melani and Joseph Frick, IBC president and CEO. The Insurance Department notified the insurers that approval would hinge on that condition, so they decided to withdraw their application to form a single company, which would have been one of the biggest health insurers in the country.

After withdrawal of the consolidation application by Highmark and IBC, Ario said that the megamerger would have created a health insurance company with too much market share. “Bigger is not always better—and in this case, bigger would have been bad for consumers,” Ario said.[121]

Ario said his staff and outside consultants determined that a combined Highmark-IBC would control 51% of Pennsylvania’s healthcare insurance market.[122] The consolidation also would have ranked second in the country in revenue from premiums, with about $17.4 billion—second only to California insurer Kaiser Permanente’s $35.1 billion.[123] The proposed $1 billion dollar savings and efficiencies resulting from the consolidation were not enough to offset the more than $17 billion in annual premium revenues of the consolidated entity.[124]

120 Pennsylvania Insurance Department, Press Release, Insurance Commissioner Welcomes Withdrawal of Proposed IBC / Highmark Consolidation (Jan. 22, 2009), *available at* www.portal.state.pa.us/portal/server.pt?open=514&objID=585572&mode=2.
121 *Id*.
122 Rick Stouffer, *Failed Health Insurance Merger Hailed Across the State*, TribLive Bus. (Jan. 23, 2009), www.pittsburghlive.com/x/pittsburghtrib/business/headlines/s_608432.html.
123 *Id*.
124 *Id*.

Transaction Themes

The proposed consolidation of the two largest nonprofit insurance organizations in Pennsylvania produced broad media coverage of the issues, concerns from the public, and regulatory actions. Multiple transaction themes provide both insight into the political ambiguity of the regulatory process and changes in the political and regulatory environment that occur during short time periods, producing unexpected outcomes for all parties.

According to media coverage, the proposed consolidation was expected to gain regulatory approval. Instead, during the regulatory review period both the chief regulator changed and the legislature passed a new law enhancing the existing regulatory oversight of the Insurance Department over certain consolidations. This change in regulatory environment was a critical factor that the parties could not have predicted or foreseen.

In the case of this proposed transaction, the media coverage was focused on the negative aspects on consumers, such as lack of or reduced competition and payor control over the delivery of healthcare. Jay Zdunek, head of the Tri-State Medical Group in Midland, Beaver County, said, "The bigger the company, the more impersonal the company."[125] He further stated that "managed-care companies (like Highmark and Independence Blue Cross) have gotten between the physician and the patient, and taken the challenge of treatment out of the doctor's hands and tried to substitute a mechanical process."[126]

Moreover, the efficiency boost that the insurers were predicting from consolidation would have cost an estimated 1,200 jobs—an ill-timed "savings," given the dire state of the economy. Besides, there was no guarantee that health insurance would have been made more accessible or more affordable for Pennsylvanians. Absent that, it was hard to see any public benefit. Though the consolidated entity may have been better positioned to compete nationally, critics argued that the consolidation would have come at the expense of competition in Pennsylvania.

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[125] *Id.*
[126] *Id.*

Indeed, the outcome of the transaction may signal a change in the regulatory landscape for health plans desiring consolidation in both Pennsylvania and also nationally. Parties to such transactions should heed these warnings and engage in advance planning to define clearly to regulators and the public the community value of a proposed transaction. In Pennsylvania in particular, the policy shift is further reflected by the Insurance Department's recent announcement indicating its intent to examine the conduct of the state's four Blue Cross and Blue Shield companies, including both Highmark and IBC, to determine if they are engaging in anticompetitive conduct or unfair trade practices.[127]

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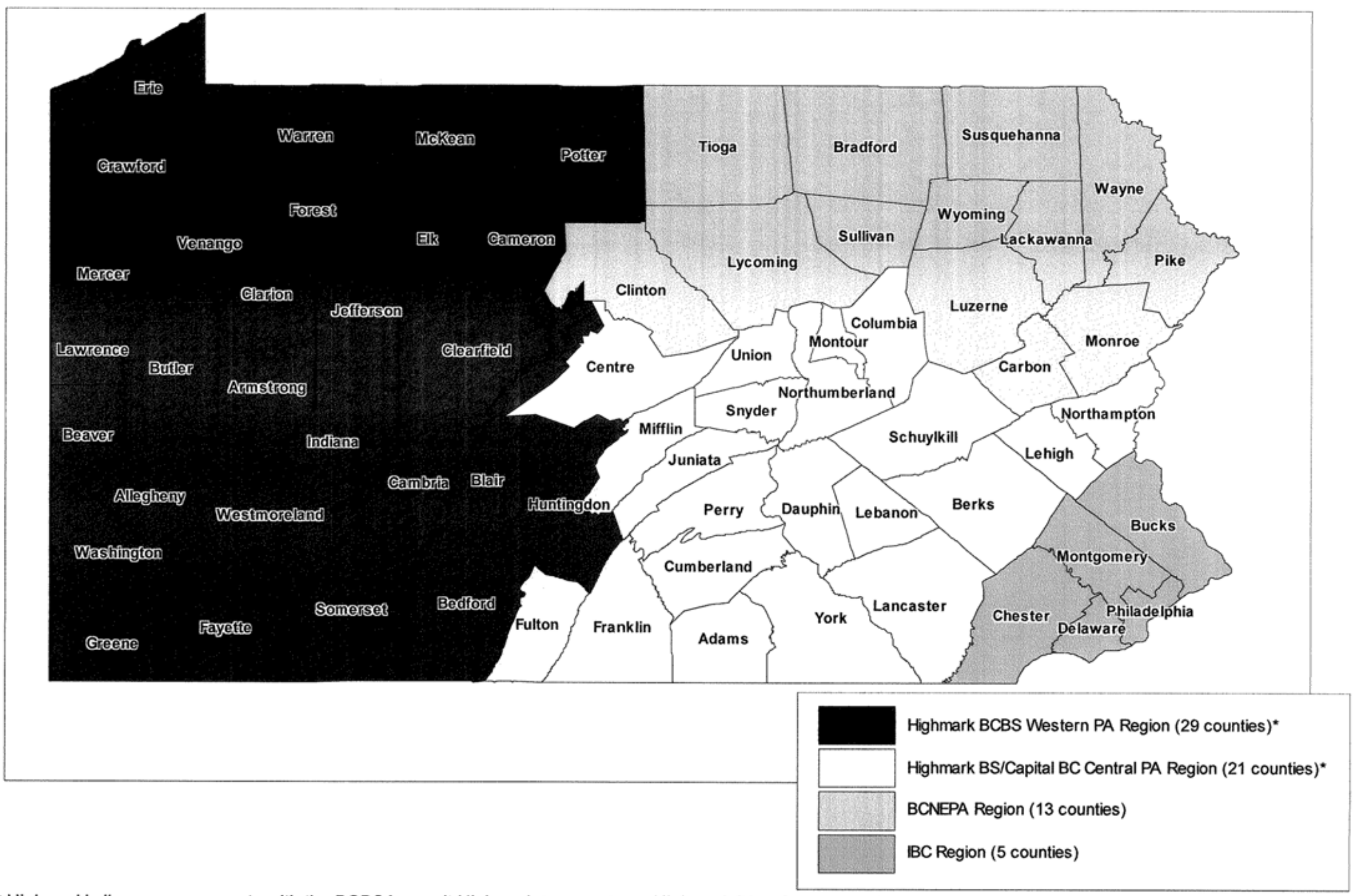
[127] Pennsylvania Insurance Department, Press Release, Insurance Department Examinations to Focus on Health Insurance Competition (July 17, 2009).

Service Areas in Pennsylvania Under BCBSA License Agreements



* Highmark's license agreements with the BCBSA permit Highmark to operate as Highmark Blue Cross Blue Shield in the western-most portion of Centre County and as Highmark Blue Shield in the eastern portion of Centre County. Capital Blue Cross' license agreement with the BCBSA permits it to operate as Capital Blue Cross in the eastern portion of Centre County.