MINUTES OF THE APPRAISAL COMMITTEE
for the Conversion of
Blue Cross & Blue Shield United of Wisconsin

Friday, January 14, 2000
Conference Rm. 23 of the Lake Terrace State Office Building
121 East Wilson Street
Madison, Wisconsin

Committee members present: Randy Blumer, Mark Femal, and Patricia Lipton

OCI staff members present: Guenther Ruch, Fred Nepple, and Steven Junior

Representatives of Deutsche Banc Alex. Brown: Thomas W. Johnson, Giles E. Harrison, and Kenneth M. Trujillo

Other members of the public present: Ben Adams, Stephen E. Bablitch, Sybil Better, Thomas J. Fonfara, Gary Fisher, L. Jane Hamblen, Gail L. Hanson, Michael Speller, Wade M. Williams, and Jeanne Wittig

Prior to the meeting, each Appraisal Committee member, OCI staff member, and public attendee received a packet of documents, including the following items:

1. Draft agenda for the meeting of January 14, 2000.
2. Draft minutes for the meeting of December 17, 1999.
3. A schedule of transactions between Blue Cross & Blue Shield United of Wisconsin and its publicly traded affiliates.
4. A draft report entitled, “BCBSUW Value Received from and Capital Contributions to United Wisconsin Services, Inc. (Expressed in Actual Dollars).”
5. A draft report entitled, “BCBSUW Value Received from and Capital Contributions to United Wisconsin Services, Inc. (Expressed in 12/99 Dollars).”
6. A draft report entitled, “BCBSUW and Third Party Loans to UWS and Subsidiaries (calculation of UWS stand-alone funded/drawn costs).”
7. A draft report entitled, “BCBSUW Credit Facility Commitment Fees.”
8. A draft report summarizing reinsurance and service agreement transactions in millions of dollars between Blue Cross & Blue Shield United of Wisconsin and its publicly traded affiliates.
9. A draft summary of valuations accorded to publicly traded stocks within the managed care universe.
10. A draft report entitled, “Insurance Universe Dividend Yields 1991-1995”.
11. A draft chart entitled, “Market Capitalization Weighted Relative Price Performance of Public Blue Cross Blue Shield Plans”, consisting of stock index performance comparisons.
12. A draft chart entitled, “Market Capitalization Weighted Relative Price Performance of Insurance Universe (Blues and Non-Blues)”.
13. A draft chart entitled, “Market Capitalization Weighted Relative Price Performance of Public Blue Cross Blue Shield Plans”, consisting of a comparison of certain individual stock issues with one another and the Standard & Poor’s 500 Stock Index.

The Appraisal Committee meeting commenced at 9:07 a.m.

Mr. Femal, the committee’s chairman, introduced the draft of the minutes of the appraisal committee meeting as of December 17, 1999, and inquired if any committee member had changes to discuss. Ms. Lipton moved that the minutes be approved in the form presented. The motion was seconded by Mr. Blumer, and was carried unanimously.

Mr. Femal introduced the agenda for today's meeting, and asked if anyone on the committee had any changes to suggest. Ms. Lipton moved that the agenda be approved in the form presented. The motion was seconded by Mr. Blumer, and was carried unanimously.

Mr. Femal deferred the introduction and discussion of comments that the Deutsche Banc team had concerning the minutes of previous committee meetings with respect to their presentations at those meetings.

Mr. Femal introduced correspondence that the committee members received in advance of the meeting, including a letter from Wade M. Williams dated December 21, 1999, to which was attached a May 1998 memo written by Diana Bianco of Consumers Union. The memo described various transactions among Blue Cross & Blue Shield United of Wisconsin and its publicly traded affiliates that Consumers Union believed merited review in the public interest.

Mr. Femal asked OCI staff what other correspondence of note had taken place since the committee's last meeting. Mr. Ruch provided the committee with a brief description of such correspondence, and reminded the committee of the public access through OCI's web site.

Mr. Femal suggested that it would be helpful if OCI would provide him notice of web site postings that could be useful to his work. Mr. Femal asked the other members of the committee if they felt they would benefit by such a procedure, and Ms. Lipton and Mr. Blumer agreed that this was a good idea. Mr. Ruch agreed to copy the members of the Appraisal Committee on e-mails instructing OCI's webmaster to post documents related to the Blue Cross conversion.

Mr. Femal asked OCI staff how the committee could access information that is or might be accorded confidentiality. Mr. Nepple responded that, in the event OCI were to receive information that merited confidential treatment, the commissioner would issue a protective order. The members of the Appraisal Committee would have access under the terms of such a protective order. The only documents provided to OCI for which Blue Cross has sought confidentiality are the redacted guidelines of the BlueCross BlueShield Association.

Mr. Femal requested that Mr. Ruch provide a synopsis of recent meetings with Blue Cross management and others in furtherance of the work plan prepared by Deutsche Banc.

Mr. Ruch informed the committee that the Deutsche Banc team and members of OCI staff met with the senior management of Blue Cross and United Wisconsin Services for two full business days on Wednesday, January 5, 2000, and Thursday, January 6, 2000. During these meetings, Deutsche Banc interviewed Tom Hefty, Gail Hanson, and all or substantially all of the senior management of Blue Cross and United Wisconsin Services. Messrs. Ruch, Nepple, and Junior sat in by conference call on a meeting between representatives of Deutsche Banc and Donaldson, Lufkin, and Jenrette (Blue Cross's investment banker) on Friday, January 7, 2000. On Tuesday, January 11, 2000, members of the Deutsche Banc team and OCI staff visited the headquarters of the BlueCross BlueShield Association in Chicago for a half-day meeting with Mark Orloff, the association's deputy counsel. The meeting with the senior management of American Medical Security has not yet been scheduled. Mr. Ruch said that he would defer to the Deutsche Banc team with respect to the substance of the meetings.

Randy Blumer asked Mr. Ruch for his assessment of whether progress on the meetings necessitated by the work plan has been satisfactory. Mr. Ruch replied that only American Medical Security has presented a delay. Mr. Nepple mentioned that American Medical Security is seeking a confidentiality agreement for certain of the information that Deutsche Banc has requested.

Mark Femal introduced Mr. Thomas W. Johnson, a managing director with Deutsche Banc Alex. Brown, for the purpose of providing the committee with a report of Deutsche Banc's progress on the work plan.

Mr. Johnson commended the senior management of Blue Cross, the deputy counsel of the BlueCross BlueShield Association, and Blue Cross' investment bankers at Donaldson, Lufkin, & Jenrette for their cooperation and generosity with their time. Mr. Johnson continued that progress on meetings outlined in the work plan has been satisfactory. The meeting with American Medical Security is the only one that hasn't happened. There will be some follow-on discussions with Blue Cross, the BlueCross BlueShield Association, and Donaldson, Lufkin, & Jenrette. However, Deutsche Banc's review of Blue Cross' basic business is substantially complete.

Mr. Johnson said that he would refer the committee to Mr. Harrison and Mr. Trujillo concerning Deutsche Banc's progress on the review of past transactions. Before he would introduce that portion of their presentation, Mr. Johnson noted that there has been a notable increase in stock prices of health care and managed care stocks in the last week or two. One factor that may be influencing this revival would be that premium increases nationally appear to have been approved on average in the order of 11%. Increases for Wisconsin appear to be increasing at a similar pace.

Mr. Femal asked Mr. Johnson to comment on whether there had been any changes to the work plan before he proceeded to the next part of his firm's presentation. Mr. Johnson confirmed that no changes had yet been made to the work plan provided the Appraisal Committee.

Mr. Johnson proceeded to introduce his team's review of past transactions among Blue Cross & Blue Shield United of Wisconsin and its affiliates, principally United Wisconsin Services, Inc. The review could be understood as comprising three sections. First, there would be a review of transactions. Second, there would be a presentation of the flow of funds between Blue Cross and United Wisconsin Services. Third, there would be a discussion of the impact of credit facility fees and loans. In conducting its review, the Deutsche Banc team was seeking to identify and quantify the economic value of intercompany transactions, and assess the positive or negative impact on Blue Cross itself from selling portions of UWS to the public.

After his introduction, Mr. Johnson turned the presentation over to Mr. Giles Harrison. Mr. Harrison called attention to the schedule of transactions between Blue Cross & Blue Shield United of Wisconsin and its publicly traded affiliates. The schedule summarizes every major transaction since 1991. Mr. Harrison explained that Blue Cross, as other companies, has a records retention policy whereby records are not retained in perpetuity. This is not unusual. Due to the records retention policy, Blue Cross informed Deutsche Banc that it was unable to provide comprehensive documentation for transactions prior to 1991. The schedule being presented to the committee, OCI staff, and members of the public is based on an assumption that documentation provided Deutsche Banc is complete. Mr. Harrison asserted that the Deutsche Banc team has no reason to believe that the documentation provided them for 1991 and thereafter is not complete. Additionally, prior to the initial public offering in October, 1991, UWS was a wholly owned subsidiary of Blue Cross. Throughout the documents presented today, "UWS" refers to the original United Wisconsin Services taken public in 1991.

Mr. Harrison highlighted certain items on the schedule of transactions between Blue Cross & Blue Shield United of Wisconsin and its publicly traded affiliates, providing brief explanations of many, but not all of the transactions on the schedule.

Mr. Harrison emphasized that the initial public offering of United Wisconsin Services in 1991 raised $17.5 million in new capital for that company. Blue Cross owned as many shares after the initial public offering as before it.

At this point, Mr. Johnson interjected to provide historical perspective, stating that, in the early to mid-90s, it was very common for indemnity companies to set up their health maintenance organizations and managed care businesses as separate corporations so as to fund the capital needs of these entities separately.

Mr. Harrison resumed his narrative. In 1991, UWS was a micro-cap stock. Regional underwriters did the offering. It was anticipated that most of the buying interest would be among retail investors rather than institutional investors. To attract interest among retail investors, UWS agreed to pay a large dividend (between 3% to 5%). As it happened, Deutsche Banc's understanding is that 70% of the stock was placed with retail investors. The underwriting agreement specifically stated that Blue Cross would re-contribute any dividends it would otherwise receive in cash into United Wisconsin Services until March 31, 1995. Mr. Harrison referred those assembled to a draft report entitled, "Insurance Universe Dividend Yields 1991-1995". During this period of time, most companies in the health insurance sector did not pay dividends. However, some, such as Aetna and CIGNA paid significant dividends. UWS' decision to pay quarterly dividends should be considered in light of the high proportion of retail investors that the securities underwriters sought to attract to accomplish the initial public offering. The underwriters indicated that retail investors display a preference for companies that pay significant dividends.

Mr. Johnson interjected to provide historical perspective, stating that, in the early 1990s, HMOs were expending significant capital to build their networks of health care providers and facilities. Blue Cross' decision to re-contribute what it otherwise would have received from UWS in the form of cash dividends back into UWS was a means for UWS to retain the capital it obtained from the public offering and its earnings and fund its growth, thereby generating increased value to shareholders, 81% of which was Blue Cross.

Mr. Harrison resumed his narrative, pointing out that from 1983 to 1991, UWS' earnings were such that it was able to grow its equity base by 15.9% on an annualized after-tax basis. This was a significant return on capital.

Mr. Femal asked how Blue Cross accounted for capital contributions in lieu of dividends. Gail Hanson, Blue Cross' treasurer, was in attendance at the meeting and provided the response that these transactions were simply regarded as foregone dividends. According to Ms. Hanson, there was no accounting on Blue Cross' part, there was only an increase to UWS' retained earnings.

Mr. Blumer asked for clarification as to why someone would forego a dividend. Mr. Harrison responded that UWS raised $17 million in new capital. If Blue Cross took its dividends in cash, it would have depleted capital. The capital raised by UWS was allocated to fund the growth of UWS and assure continued growth and increase in value of UWS.

Mr. Harrison proceeded to discuss the existence and consequences of a tax-sharing agreement between Blue Cross and UWS. The fact that Blue Cross maintained ownership of UWS in excess of 80% permitted the companies to consolidate their income taxes. This allowed Blue Cross to utilize net operating loss (NOL) carryforwards that otherwise may have expired before Blue Cross could have used them. In 1992 alone, Blue Cross enjoyed approximately $5 million in tax advantages from its ability to consolidate its taxes with UWS and utilize the NOLs.

Mr. Blumer requested additional clarification as to why someone would forego a dividend, and how this relates to the implications of the tax-sharing agreement.

Mr. Johnson responded that Blue Cross was not in a position to fund the growth of UWS' business at the time of the initial public offering. To allow growth to continue, and thereby enhance the value of its investment in UWS, Blue Cross permitted UWS to raise the equity capital it needed. In structuring the terms of the initial public offering, Blue Cross was careful to think of utilizing tax implications that would be in its favor. In this instance, under the tax-sharing agreement, UWS paid Blue Cross the appropriate amount of federal income tax it would have owed had it been a stand alone company. Because of its outstanding net operating loss carryforwards, Blue Cross was able to offset the positive earnings generated by UWS, and thereby avoid making cash payments to the Internal Revenue Service in 1991, 1992, 1993, and part of 1994. Even when filing a consolidated tax return, UWS' earnings were not great enough to generate a taxable income. Since UWS paid taxes to Blue Cross as if UWS was filing on a separate entity basis, UWS' cash tax payments to Blue Cross provided a real cash transfer from UWS to Blue Cross. This transfer of cash significantly exceeded the dividends that Blue Cross would have received had it not reinvested them.

Mr. Johnson explained that, in most initial public offerings, institutional investors comprise the majority of the buyers. In the instance of UWS in 1991, the interest was clearly among the retail investors, who show a marked preference for receipt of dividends. If Blue Cross had taken what would normally have been its share of cash dividends, Blue Cross would have decapitalized UWS, and thereby counteracted its purpose in raising money in the first place.

Mr. Femal remarked that, on the basis of what Mr. Johnson had said, one could posit that the enhanced valuation in United Wisconsin Services and tax advantages that Blue Cross captured were overwhelmingly in excess of the cost of the 19% of the re-contributed dividends that Blue Cross was giving away, on a notional basis, to the minority shareholders. In other words, Blue Cross more than made up for the foregone dividends with the increased value it realized by maintaining UWS' capital.

Mr. Ruch interjected that, for Blue Cross to gain the advantages of the tax-sharing agreement with UWS, it was not essential for Blue Cross to re-contribute the dividends. Mr. Ruch looked to Mr. Johnson and Mr. Harrison for either one to confirm or deny this point. Mr. Harrison responded by saying that while the tax-sharing agreement and temporary re-contribution of dividends were components of a coordinated strategy, neither measure was a mandatory precursor to the other.

Mr. Harrison continued a summation of his review of historical transactions between Blue Cross and UWS. Mr. Harrison highlighted the fact that UWS has been able to piggyback on the creditworthiness of Blue Cross from time to time, and has thereby enjoyed more favorable access to credit facilities than it would on its own. According to Mr. Harrison, as the Deutsche Banc team went through the documentation, it was evident that the common management of Blue Cross and UWS gave much attention to how potential conflicts of interest should be addressed. Mr. Harrison noted that great effort had been made over the years to codify every arrangement and document every material, and some not so material, transactions. Mr. Harrison then reiterated the existence of detailed cost allocation arrangements among Blue Cross and its affiliates.

Ms. Lipton asked whether the Deutsche Banc team noted the existence of any arrangements that were not proper, or any situations for which an agreement should have existed, but was not in place.

Mr. Harrison said that Deutsche Banc could not affirm each individual and distinct agreement's propriety or affirmatively assert that there was not in existence some portion of the operations that should be covered by a written agreement, but is not. Mr. Harrison indicated that none of the arrangements reviewed appeared out of the ordinary. He described the three general types of contracts that he noted among Blue Cross and its affiliates, namely, fixed-price contracts, percentage of funds subject to the arrangement, and cost allocation arrangements. It should be noted that the participants in the shared service agreements are free to terminate their participation and seek services from nonaffiliated entities. Mr. Harrison reiterated his position that what is clear is that the companies took great care to document their agreements and transactions as they entered into agreements or conducted transactions among themselves.

Mark Femal asked if the Deutsche Banc team had gotten a sense that the allocation methodology selected for the contracts that they reviewed was appropriate for the services subject to those agreements.

Mr. Johnson responded that, without opining as to each individual and distinct agreement, his team had a general sense of propriety with respect to the arrangements. On a limited basis, his team had checked that market-based consideration was being used.

Ms. Lipton asked whether there were any specific instances in which a party to an affiliated service agreement had terminated participation in favor of outsourcing. Mr. Harrison responded that he had not, but that he could recount one instance off the top of his head for which the entire group had elected to outsource certain services to EDS.

Randy Blumer noted that the Office of the Commissioner of Insurance regulates holding company transactions, including entry into agreements among affiliates, and that review of such transactions are part of the financial examination process.

Mr. Harrison directed the attention of those present to a draft report summarizing reinsurance and service agreement transactions in millions of dollars between Blue Cross & Blue Shield United of Wisconsin and its publicly traded affiliates. He indicated that this draft report represents a roll-up of the 600 to 800 cost centers that track revenue and expenditures within and among Blue Cross and its affiliates.

Mark Femal asked why the volume of intercompany service transactions jumped in 1996, although the net amount was fairly consistent. Mr. Johnson responded that it would be necessary for his team to check with Blue Cross' management to obtain a definite answer, but that it was his recollection that there may have been a transfer of employees among the companies. Mr. Johnson added that this could be expected to result in higher figures in the gross value of transactions, while leaving the net value fairly consistent. Gail Hanson, Blue Cross' treasurer, when asked for input, replied that these numbers are a function of where the employees are.

After this exchange, Mr. Harrison resumed his summation of his review of historical transactions between Blue Cross and UWS.

Mr. Harrison noted that the tax-sharing agreement was cancelled on June 30, 1994. Blue Cross had exhausted its supply of net operating loss carryforwards earlier than it had expected. There was no longer any tax reason to maintain an ownership stake of over 80% in UWS. On July 1, 1994, Blue Cross held a secondary offering that brought its ownership percentage down to 59.7%. This reduction in the level of ownership in the issued and outstanding shares was the result of Blue Cross selling shares it had owned, as opposed to the 1991 offering in which UWS raised new capital. Mr. Harrison noted that, despite the fact that Blue Cross had exhausted the advantages of the tax-sharing agreement and was, therefore, no longer receiving cash tax payments from UWS, Blue Cross was contractually obligated to continue re-contribution of cash dividends until March 31, 1995.

In touching upon some loan transactions, Mr. Harrison noted that those assembled should understand that there are two costs to using a credit facility. There are fees simply to maintain the existence of a credit facility, whether it is used or not, and, if it is used, there are interest costs that must be paid. Mr. Harrison said that it was useful to keep these facts in mind, because he would return to them later in the presentation.

As Mr. Harrison continued through an abbreviated reference to transactions, he arrived at a transaction in which United Wisconsin Services wanted to transfer certain books of business from United Wisconsin Insurance Company to United Wisconsin Life Insurance Company. In order for United Wisconsin Insurance Company to meet its regulatory capital requirements during a period of transition, Blue Cross issued a surplus note to United Wisconsin Insurance Company. During the discussion, it was noted that the schedule of transactions incorrectly specified United Wisconsin Life Insurance Company as the issuer of the surplus note. This error and its correction at the meeting were noted as a matter of record.

On a more substantive note, Mr. Harrison commented that the 7.25% coupon on this surplus note was equivalent to Blue Cross' own cost of borrowing under its credit facility. UWS was, he continued, in some sense subsidized in this transaction through a preferential cost of credit. It is possible that Blue Cross was the only willing lender at that time. Mr. Harrison indicated that management had given careful thought to the structure and documentation of this transaction and that the surplus note was timely repaid.

Mr. Harrison noted that Blue Cross sold more of its stock in UWS, with the proceeds going to Blue Cross. Mr. Johnson added that, in the 1995 offering, Blue Cross was receiving a significant return on its investment in UWS.

In 1996, Mr. Harrison noted that Blue Cross had sold investments in its own portfolio to enable it to make a loan to United Wisconsin Services. The loan was made at the borrowing rate that Blue Cross had under its credit facility at that time. UWS used the proceeds of the loan in conjunction with the issuance to the seller of new UWS stock to buy the portion of the American Medical Security joint venture that it did not yet own. He continued that American Medical Security was subsequently spun-off to United Wisconsin Services shareholders in 1998, including Blue Cross, in proportion to their ownership of United Wisconsin Services. American Medical Security has not paid a dividend since the spin-off.

In 1999, Mr. Harrison noted that Blue Cross decided that it wanted to brand the products of Compcare Health Services Insurance Corporation (Compcare), a wholly-owned subsidiary of UWS, under the Blue Cross and Blue Shield service marks. In August 1999, Blue Cross made open market purchases of UWS stock to achieve the level of control required by the BlueCross BlueShield Association to qualify Compcare for use of the brands.

Ms. Lipton asked if there was any consideration of the value of the Blue Cross and Blue Shield service marks extended to Compcare. Mr. Johnson replied that Blue Cross could derive value, among other possibilities, through its ownership stake in Compcare if Compcare gains access to business through the BlueCross BlueShield Association's national accounts program. Mr. Johnson said that his team was not ready to get to the issue that Ms. Lipton raised, but would follow up on the question.

Mr. Harrison directed the committee members and other attendees to a draft report entitled, "BCBSUW Value Received from and Capital Contributions to United Wisconsin Services, Inc.

(Expressed in Actual Dollars)". As a preface to this section of Deutsche Banc's presentation, Mr. Harrison explained that in order for 100% of the stock of United Heartland Group, Inc. not to constitute 100% of the value of Blue Cross & Blue Shield United of Wisconsin, there would have to have been a diversion of value from Blue Cross to United Wisconsin Services outside of Blue Cross' ownership interest. Mr. Harrison described the draft report under discussion as a study of the economic value of transactions between Blue Cross and United Wisconsin Services from 1983 to January 12, 2000.

He reminded the committee of his earlier comments regarding the care that the common management of Blue Cross and UWS took with respect to intercompany agreements and transactions. Nonetheless, there were two general categories of transactions that the Deutsche Banc team identified as transferring value from Blue Cross to UWS without compensation. First, Blue Cross' decision to re-contribute dividends back to UWS without consideration in the form of additional shares until March 31, 1995, transferred value to UWS' other shareholders in the form of an increase to UWS' retained earnings. The increase in retained earnings of UWS as a result of the re-contribution of dividends benefited Blue Cross in proportion to its ownership stake in UWS and the other shareholders to the extent of their respective ownership stakes. Second, Blue Cross extended benefits to UWS without full consideration in the form of loans and participation in its credit facility. UWS was able to borrow from Blue Cross and through Blue Cross' credit facility at rates more favorable than it could otherwise have obtained independently. In addition, UWS did not reimburse Blue Cross for its allocable portion of the credit facility fees charged by the bank providing the credit facility.

Mr. Harrison introduced his colleague, Ken Trujillo, who proceeded to discuss the specifics of the draft report entitled, "BCBSUW Value Received from and Capital Contributions to United Wisconsin Services, Inc. (Expressed in Actual Dollars)".

Mr. Trujillo described the transactions between Blue Cross and UWS from March 1983 through UWS' initial public offering on October 24, 1991.

After this portion of the discussion, Mr. Femal stated that he was comfortable that the transactions between Blue Cross and United Wisconsin Services from 1983 to the initial public offering in 1991 could not have caused a loss of value to Blue Cross because UWS was a wholly-owned subsidiary of Blue Cross during this period. Mr. Blumer and Ms. Lipton did not disagree with Mr. Femal's assessment.

Mr. Trujillo continued with his description of the draft report.

Mr. Blumer and Ms. Lipton asked for an explanation of what the $49,043,000 contribution on October 24, 1991, from Blue Cross to UWS represented, and why the $49,043,000 differed from the $25,015,829 in contributions that UWS had received from Blue Cross up to that time.

Both Mr. Johnson and Mr. Trujillo responded to these questions. The $25,015,829 in contributions from 1983 to 1991 represented the book value of the common stock of wholly-owned subsidiaries, and also cash and securities, that Blue Cross provided to build United Wisconsin Services. The difference between the $49 million and the $25 million represented the earnings that United Wisconsin Services had retained during the time that it was a wholly-owned subsidiary. This level of retained earnings was the product of a 15.9% annualized rate of return, net of taxes, a very impressive rate of growth. The purpose of the draft report is to express the total investment of Blue Cross in UWS relative to the total returns derived by Blue Cross on this investment. In order to express fairly the investment of Blue Cross in UWS, one must include the stated value of retained earnings at the time of the initial public offering.

Continuing with the presentation, Mr. Trujillo and Mr. Johnson described how the decision of Blue Cross to re-contribute the cash dividends to which it would otherwise be entitled back into the retained earnings of UWS could be regarded as having provided a benefit to UWS' minority shareholders. This decision was very clearly expressed in the underwriting agreement and represented a contractual commitment to the minority shareholders. The increase in retained earnings of UWS as a result of the re-contribution of dividends benefited Blue Cross in proportion to its ownership stake in UWS and the other shareholders to the extent of their respective ownership stakes. For example, on March 25, 1992, Blue Cross forwent a dividend of $1,080,000, thereby contributing this amount to retained earnings. Blue Cross owned approximately 81.3% of UWS at the time, so Blue Cross was advantaged by the increase in retained earnings. However, Blue Cross was not UWS' sole shareholder, so approximately 18.7% of the $1,080,000 addition to retained earnings could be said to have advantaged the minority shareholders. These minority shareholders, which were by and large retail investors, did not receive this part of the increase in retained earnings in cash. The increases in retained earnings were retained in UWS to fund the growth of its business.

Mr. Trujillo noted the fluctuations in Blue Cross' ownership over the years. Blue Cross reduced its ownership stake through sizable and profitable public offerings in June 1994 and again in February 1995. In 1997 and 1998, Blue Cross chose to reinvest a portion of the cash dividends it received. No longer bound by the contractual obligations of the 1991 underwriting agreement, Blue Cross received additional, newly issued common shares just as might any other participant in a dividend reinvestment program. In August 1999, after its decision to pursue branding Compcare with the Blue Cross and Blue Shield service marks, Blue Cross purchased just under $12 million worth of UWS stock in order to achieve the level of control required by the BlueCross BlueShield Association for use of its service marks.

Discussion turned back to the structure of the 1991 initial public offering. Mr. Nepple noted that Blue Cross received $14.2 million in benefits under the tax-sharing agreement, as contrasted with the $3.05 million in value implicitly received by the public shareholders through Blue Cross forgoing dividends.

Mr. Femal questioned whether such a comparison was a valid one to make. If Blue Cross had not been able to use its net operating loss carryforwards when it did as a function of the tax-sharing agreement with United Wisconsin Services, he reasoned, it could have retained them for future years. Mr. Johnson replied that the time value of money is no small matter and net operating loss carryforwards have expiration dates.

Ms. Lipton proposed that Deutsche Banc prepare an analysis of how valuable the net operating loss carryforwards would have been if the tax-sharing agreement would not have accelerated their use. Mr. Blumer and Mr. Femal agreed, and the committee resolved that Deutsche Banc prepare a report responsive to their concern.

Mr. Johnson agreed to contact Blue Cross for the additional documentation needed. He advised the committee that, absent the accelerated use of the net operating loss carryforwards, it is probable that some of these carryforwards would have expired worthless. Mr. Ruch promised to distribute Deutsche Banc's analysis to the committee members in advance of the next meeting.

Mr. Trujillo then referred to a draft report entitled, "BCBSUW Value Received from and Capital Contributions to United Wisconsin Services, Inc. (Expressed in 12/99 Dollars)". This draft report recognizes that, to understand the economic impact of transactions in the past, one must consider opportunity costs. The Deutsche Banc team calculated the actual rate of return Blue Cross experienced on its investment portfolio, excluding returns on its investment in UWS, for each calendar year since 1991. In terms of opportunity cost, Blue Cross' contribution of $49 million, essentially their initial investment in United Wisconsin Services, was worth $101.1 million in December 1999 dollars. The first dividend that Blue Cross re-contributed to UWS' retained earnings on March 25, 1992 was worth $2,123,638 in opportunity cost, as compared to $1,080,000. Conversely, the $38.8 million that Blue Cross obtained from its June 1994 public offering was worth more on the order of $66.5 million in today's dollars given the rate of investment return that Blue Cross actually achieved since that time. Mr. Trujillo emphasized that time magnifies the impact of every choice.

Mr. Harrison noted that, in terms of opportunity cost, the implicit value transferred to shareholders other than Blue Cross as a result of Blue Cross' contractual commitment to forego cash dividends until March 31, 1995 was not worth $3,056,088, but rather $5,421,924. Mr. Harrison indicated that this transfer of value is more academic than real from the perspective of any individual shareholder. These minority shareholders, which were by and large retail investors, did not receive this part of the increase in retained earnings in cash. The increases in retained earnings were retained in UWS to fund the growth of its business and thereby enhance its value to all shareholders.

Mr. Johnson wrapped up the presentation by drawing attention to the totals on the two reports just presented. The draft report based on a recognition of opportunity costs indicates that Blue Cross has received, or retained in the form of its present stockholdings, $266,796,071 in economic value stated in December 1999 dollars, as compared to a total investment of $148,152,867. That represents a gain of $118 million over and above the opportunity costs of the investment, a very appreciable return. The draft report based on nominal dollars indicates that Blue Cross has received, or retained in the form of its present stockholdings, $185,835,536 in economic value, as compared to a total investment of $81,455,093. That represents a gain of $104 million over and above the costs of the investment, once again, a very appreciable return. Mr. Johnson acknowledged that one could fine-tune the numbers on the basis of any number of assumptions, but the order of magnitude will not be materially affected. Mr. Johnson stated that there has been overwhelming value received by Blue Cross through its investment in, and ongoing relationship with, United Wisconsin Services.

Ms. Lipton inquired whether the Appraisal Committee ought not to be concerned with the $5.4 million in leakage. Mr. Harrison agreed that the question was an important one for the committee, and one to which he would be responsive, but he asked that the question be deferred until later in the meeting so that he could convey additional information of interest on that subject.

The committee recessed at 11:08 a.m.

Mr. Femal called the meeting to order at 11:22 a.m.

Mr. Harrison continued his presentation and referred to a draft report entitled, "BCBSUW and Third Party Loans to UWS and Subsidiaries (calculation of UWS stand-alone funded/drawn costs)". He stated that it is simply not possible to know what United Wisconsin Services would, in fact, have paid for borrowing cash on a stand-alone basis. Over the time period considered, there have been dramatic variations in credit spreads over the years. The Deutsche Banc team looked at interest rates and interest rate spreads at applicable dates in time. Mr. Harrison acknowledged that one could argue perhaps 25 basis points either way from his firm's estimates, but that the figures would not be off much further than that. It is the Deutsche Banc team's view that United Wisconsin Services borrowed at a lower rate than it would have obtained absent loans from Blue Cross or through use of Blue Cross' credit facility. Just as in the case of re-contributed dividends, the incremental advantage to the retained earnings of UWS as a result of lower borrowing costs implicitly benefited Blue Cross in proportion to its ownership stake in UWS and the other shareholders to the extent of their respective ownership stakes. The implicit benefit to UWS shareholders other than Blue Cross is estimated at $1,091,674 in nominal dollars and $1,358,058 with due consideration of opportunity costs.

Mr. Harrison proceeded to call attention to a draft report entitled, “BCBSUW Credit Facility Commitment Fees”. United Wisconsin Services does not pay anything to reimburse Blue Cross for a portion of credit facility fees, despite the fact that it shares access and use of this credit facility. The implicit benefit to UWS shareholders other than Blue Cross is estimated at $146,847 in nominal dollars and $187,962 with due consideration of opportunity costs.

Mr. Harrison once again acknowledged that one could play with certain assumptions and argue on basis points one way or the other. These estimates do not possess precision to their last dollar. However, Mr. Harrison continued, he could not believe that the implicit benefit to UWS shareholders other than Blue Cross on favorable lending rates and the lack of credit facility fees combined to be much below $1.1 million or much above $1.5 million.

Mr. Johnson concluded Deutsche Banc’s presentation on past transactions among Blue Cross and United Wisconsin Services, by noting that there has been roughly $7 million in value implicitly transferred from Blue Cross to shareholders of UWS other than Blue Cross over the course of nine years. The practical advantages enjoyed by these shareholders in consequence of these transactions are arguable for reasons already discussed. Mr. Johnson said that one should note the difference in magnitude between the $118 million Blue Cross has gained over the opportunity cost of its investment in UWS and $7 million in the implicit value transferred to the other shareholders.

Mr. Femal reopened the subject of net operating loss carryforwards.

During this discussion, Mr. Harrison explained that the Blue Cross is in a series of disputes with the federal Internal Revenue Service. Blue Cross has not closed a tax year since 1987. In order to limit its exposure to interest and penalties, Blue Cross has thus far paid the amounts assessed by the Internal Revenue Service with interest to the date of the demand. If Blue Cross wins all or part of the refunds it is seeking, Blue Cross and United Wisconsin Services would have to recompute their tax settlements.

Mr. Johnson stated that it could be a long time, though he would not speculate as to the probable duration, before the tax cases settle. While one can alter the charts of economic transactions to reflect different assumptions, one will not materially change the order of magnitude in their totals. The amount Blue Cross has gained over the opportunity costs of its investment in United Wisconsin Services would remain impressive, and the amount of implicit value transferred to UWS shareholders other than Blue Cross would remain on their existing scale in relative terms.

Ms. Lipton asked if Deutsche Banc could place a reasonableness boundary, perhaps of 1%, around their estimates for totals within the draft report entitled, “BCBSUW Value Received from and Capital Contributions to United Wisconsin Services, Inc. (Expressed in 12/99 Dollars).” Mr. Johnson replied that his team would be unable to get to a 1% boundary, but could provide some assurance of that sort.

Mr. Femal told the other members of the committee that he was reconsidering the need for Deutsche Banc to prepare an analysis of how valuable the net operating loss carryforwards would have been if the tax-sharing agreement would not have accelerated their use. Mr. Femal suggested that if the order of magnitude among the estimates was unlikely to change and if there were inherent uncertainties with respect to the federal income taxes, it did not seem that this study was needed. The members of the committee unanimously agreed to withdraw their request for a study of this kind.

Mr. Johnson then discussed recent developments in other Blue Plan conversions. Mr. Harrison promised to have a detailed chart comparing the corporate governance provisions in other pending and completed Blue Plan conversions to the Wisconsin conversion plan.

Mr. Blumer thanked the representatives of Deutsche Banc for their presentation on past intercompany transactions. Mr. Blumer expressed the view that Blue Cross' actions to create a downstream holding company and raise equity capital from investors to develop these for-profit businesses had an important and positive influence on Blue Cross' financial position today.

Mr. Johnson said that if one were to consider the situation of Blue Cross and that of the HMO and managed care sector in 1991, it would be reasonable to say that UWS would not have grown as it had without the capital infusions provided by the sale of equity.

The committee decided that all items on its working list of issues would be on the agenda for discussion at the next meeting.

Discussion then turned to the next available meeting dates. The committee agreed to hold its next meeting on Thursday, January 27, 2000, starting at 9:00 a.m., with the possibility of continuing as long as 2:00 p.m., if necessary.

Mr. Johnson reported that Deutsche Banc was well on the way to getting the documentation necessary to be responsive to all of the items on the Appraisal Committee's working list of issues. He related that the Deutsche Banc team expects to be nearing completion by the time of the next meeting. The reason for the thorough emphasis on one item to the exclusion of the rest was to achieve substantial completion on some items for the committee rather that moving slightly ahead on everything. The most important deliverable that Deutsche Banc would provide at the next meeting is a study of how the structure of the proposed Wisconsin conversion compares with other completed and pending Blue Plan conversions.

Mr. Ruch requested the committee's consent to proceed with preparation of a draft of the Appraisal Committee's report to the Commissioner of Insurance. The committee approved this request by unanimous consent.

Mr. Femal asked Mr. Johnson for any comments that the Deutsche Banc team had concerning the minutes of previous committee meetings with respect to their presentations at those meetings. Mr. Johnson affirmed that he wanted to clarify some items to prevent any misunderstandings, but he had mislaid his list for the moment. After a brief discussion, the committee asked Mr. Johnson to forward a memo with these clarifications to Mr. Ruch, who would distribute them promptly to the committee.

Mr. Junior would coordinate scheduling one or possibly two additional meeting dates after the one scheduled for January 27.

Mr. Femal inquired whether there was any further business or if anyone cared to make a motion to adjourn. Mr. Blumer moved to adjourn. The motion was seconded by Ms. Lipton, and carried unanimously. The committee adjourned shortly before noon.