

Report of the
Appraisal Committee
for the Conversion of
Blue Cross & Blue Shield United of Wisconsin

February 14, 2000

Table of Contents

<u>Section</u>	<u>Page</u>
Introduction	1
Committee Meetings	2
Valuation Issues	
Executive Summary	4
Issue 1- Is 100% of the Outstanding Stock 100% of the Value of Blue Cross & Blue Shield United of Wisconsin?	6
Issue 2- Impact on Value of the Divestiture Schedule	8
Issue 3- Impact on Value Resulting from Governance Provisions	10
Issue 4- The Value of the BlueCross BlueShield Association Service Mark	16
Issue 5- Impact on Value of Past and Present Inter-company Transactions	18
Issue 6- Impact of Monetization Events on Value	21
Issue 7- Market Conditions for the Health Entities Universe	23
Issue 8- Suggested Changes to the Application	23
Recommendations	24
Acknowledgement	27
<u>Exhibit</u>	
1. Conversion Resource Book	Distributed separately

Honorable Connie L. O'Connell
Commissioner of Insurance
Madison, Wisconsin

Commissioner O'Connell:

In accordance with your instructions, the Appraisal Committee (the "Committee") for the Conversion of Blue Cross & Blue Shield United of Wisconsin ("BCBSUW") respectfully submits the following report ("Report"):

INTRODUCTION

Blue Cross & Blue Shield United of Wisconsin ("BCBSUW") filed an Application for a Plan of Conversion (the "Application") with the Office of the Commissioner of Insurance ("OCI") on June 14, 1999, under s. 613.75, Wis. Stat., and the relevant portions of s. 611.76, Wis. Stat. The Application proposes to convert BCBSUW from a nonprofit service insurance corporation to a for-profit stock insurance corporation ("Conversion"). BCBSUW would become a wholly-owned subsidiary of a yet-to-be formed stock holding company to be known as United Heartland Group, Inc. ("UHG"). Initially, all of the issued and outstanding capital stock of UHG would be owned by Blue Cross & Blue Shield United of Wisconsin Public Health Foundation ("Public Health Foundation" or "Foundation"). The Application, as filed, has an intended effective date of December 31, 1999, or such later date as may be necessary for receipt of OCI's approval.

The Conversion plan provides for the Public Health Foundation to serve the health care interests of the people of the State of Wisconsin. If that aspect of the Application were approved, the Public Health Foundation would assure that funds now used to support a nonprofit, health service insurance company would continue to be applied to health care challenges and initiatives. The Public Health Foundation would be funded from the proceeds of initial and secondary public offerings and private placements of UHG common stock and/or a final sale to an acquirer of UHG over a period of five years. United Heartland Group, Inc. could also merge with United Wisconsin Services, Inc. during that five-year period.

OCI shall approve the plan of Conversion, after a hearing, unless a finding is made that the plan violates Wisconsin law or is contrary to the interests of BCBSUW policyholders or the public. In determining the interests of the policyholders and the public, OCI must consider whether the Conversion would be detrimental to the safety or soundness of BCBSUW or the contractual rights or reasonable expectations of those persons who are policyholders on or before the Conversion date.

Upon approval of the Application by OCI, the Board of Directors of Blue Cross & Blue Shield United of Wisconsin, in its capacity as the membership of that organization, must ratify the Application with whatever changes or conditions were required in the final decision, if the plan of Conversion is to take effect.

A determination of the interest of policyholders and the public is an obligation of broad scope. One component of this review relates to the proper valuation of BCBSUW; that is, the amount private investors should pay the Foundation in exchange for ownership.

Section 611.76 (3)(c), Wis. Stat., authorizes the Commissioner to appoint an appraisal committee, consisting of at least three qualified and disinterested persons with differing kinds of training, to assist her in determining whether the proposed transaction violates the law or is contrary to the interests of policyholders or the public.

In August of 1999, you appointed the Committee, which consists of the following residents of the State of Wisconsin:

Name	Principal Occupation
Mark Femal	Executive Director, Wisconsin Insurance Security Fund
Patricia Lipton	Executive Director, State of Wisconsin Investment Board
Randy Blumer	Deputy Commissioner, Office of the Commissioner of Insurance

Mr. Femal was elected chairperson of the Committee.

The work of this appraisal committee differs from that of most such committees due to the unique character of BCBSUW and the plan that its board of directors has proposed. Under a typical de-mutualization, where a mutual insurer converts to a stock insurer, the appraisal committee's valuation is used as a means to calculate the amount of stock to which each policyholder is entitled, since in a mutual insurer, the owners are the policyholders. Due to the nonprofit character of BCBSUW, the policyholders of BCBSUW are not members of BCBSUW and have no interest in, or entitlement to, any equity of BCBSUW or United Heartland Group, Inc. following the Conversion. Instead, the Application proposes that the Public Health Foundation realize the proceeds of the 10,000,000 common shares initially issued to it by UHG for BCBSUW, and thereby, by extension, realize the full market value of BCBSUW.

In view of this unique situation, the Committee concluded it is not appropriate to determine a specific value or range of values for BCBSUW/UHG at a particular date. This would serve no useful purpose to the Commissioner or any interested party reviewing the transaction since there are no liquidity events provided in the Application. Further, any liquidation event undertaken is likely to be more than 6 months from the date of this Report, at which time value can be substantially different due to market conditions at that time, the manner in which liquidity is provided, as well as other factors. Instead, the Committee determined that it is appropriate for the Committee to examine whether the Conversion, as presented in the Application, can reasonably be expected to permit the Public Health Foundation to realize the full, fair and reasonable value of Blue Cross & Blue Shield United of Wisconsin, and to provide comments and recommendations to the Commissioner as it considers necessary in furtherance of this mission. It is not the charge of the Committee, however, to deliberate on how, or to whom, the funds realized are to be distributed by the Foundation.

The Committee applied the integrity, business acumen, and life experience of each of its members to prepare this Report in response to its appointed mission.

COMMITTEE MEETINGS

In order to carry out its charge, the Committee met eight times. All meetings of the Committee were public and were noticed as such. The meeting notices and agenda, along with the

meetings' minutes are available to the public and have been posted on the website of the Office of the Commissioner of Insurance.

Based upon its review of the Application for Conversion, the Committee developed a list of valuation issues with assistance from OCI staff and the investment banking firm of Deutsche Bank Securities Inc. ("DBSI"), an indirect wholly-owned subsidiary of Deutsche Bank A.G., conducting business in the United States under the name "Deutsche Banc Alex. Brown". The Committee requested OCI staff and DBSI to analyze and comment on each of the issues. In addition, a "Conversion Resource Book" was prepared by Deutsche Bank Securities, Inc. The Conversion Resource Book is attached and incorporated into this Report as Exhibit 1. The Committee thoroughly reviewed and discussed the issues along with the comments and analyses provided by OCI staff and DBSI in formulating its conclusions and recommendations. The results of the Committee's deliberations are contained in this Report.

Following, is a list of the valuation issues concerning the proposed Conversion developed by the Committee and its comments and recommendations thereon:

VALUATION ISSUES

Executive Summary

The charge of the Appraisal Committee for the Conversion of Blue Cross & Blue Shield United of Wisconsin was to review the proposed Application for Conversion and determine whether the processes put in place in the Application allow for the realization of the full, fair and reasonable value of BCBSUW by means of the United Heartland Group, Inc. (“UHG”) common stock transferred to the Public Health Foundation. The Committee did not determine a specific value or range of values for the Foundation’s UHG stock as of a particular date. This is because the Application contemplates a liquidation event some time in the future for the Foundation’s UHG stock. With an undefined date for an undefined liquidation event contained in the Application, the Committee’s derivation of a specific value or range of values of the BCBSUW/UHG stock would serve no useful purpose. Valuation is a moving target. Instead, the Committee focused on assuring that the process of monetizing the Foundation’s UHG stock would provide the Foundation with the full, fair and reasonable value of UHG stock. After careful review of the proposed transaction, along with an in-depth review of similar transactions of recently converted Blue Plans, and with assistance of its advisers, the Committee has determined that several provisions of the proposed transaction need to either be modified or more clearly defined in order to assure that the Foundation can expect to realize the full, fair and reasonable value of BCBSUW. In addition, based upon the nature of the transaction, the Committee believes that a certain amount of regulatory oversight needs to be put in place in order to assure that the Foundation realizes the full and fair value for BCBSUW.

Those provisions of the proposed transaction that the Committee feels impact the realization of the value of BCBSUW and need to be addressed are in the following areas:

1. Corporate Governance, Voting Trust and Divestiture Requirements; and
2. Liquidity or Monetization Events (incorporating appropriate regulatory oversight)

The Committee recognizes and accepts that many, if not all, of the corporate governance issues raised by the Application are due to the requirements of the BlueCross BlueShield Association (“BCBSA”) in order for the converted BCBSUW to maintain the use of the Blue service mark. The Committee is convinced that the Blue service mark is an integral part of the wellbeing of BCBSUW/UHG’s current and future operations and thereby the value of the UHG stock to be owned by the Foundation. While the Committee believes that some of the corporate governance issues, taken as a whole, may have an adverse impact on the ability of the Foundation to realize maximum value of the UHG stock, the loss of the Blue Service mark may have a significantly greater adverse impact on the stock’s value than the BCBSA governance requirements. The body of this Report discusses, in part, the impact these restrictions and requirements may have on the value of the UHG stock. The Committee makes recommendations concerning the corporate governance issues contained in the Application with the belief that these recommendations can be implemented without adversely affecting BCBSUW/UHG’s ability to use the Blue service mark. This belief is primarily due to the fact that these recommendations, in general, are based on a thorough review of the universe of converted and converting Blues Plans, as it currently exists.

As discussed above, with respect to the monetization of the UHG stock as contained in the Application, the Committee was struck by the lack of specificity concerning how the stock would be liquidated. The Application does not provide the Foundation with a proposed monetization event. Instead it provides a limited list of possible outcomes, mostly BCBSUW preferences. This, in the Committee’s opinion, is a serious issue with the Application. The Committee has specific comment and recommendations concerning this important issue.

In conclusion, the Committee identified and discussed all the issues relative to this transaction in the context of the Committee's charge, reviewed vast amounts of information presented to it by OCI staff and representatives of Deutsche Bank Securities, Inc. ("DBSI") in response to these issues, held numerous committee meetings, reviewed the contents of the Conversion Resource Book in both its current and previous states, and had extensive discussion of key issues identified by the Committee, which issues are summarized within the body of this Report. Taken in its entirety, the Committee concludes that the Application, with the recommendations contained in this Report, will provide the Foundation with opportunities by which it can be reasonably assured to realize the full, fair and reasonable value for BCBSUW. The Committee recommends that the Commissioner adopt these recommendations as part of the approval process of the proposed transaction.

Issue # 1: Will the Public Health Foundation's ownership of 100% of the issued and outstanding common stock of United Heartland Group, Inc. constitute the full value of Blue Cross & Blue Shield United of Wisconsin?

A: While the Public Health Foundation will receive all 10,000,000 of the issued and outstanding common shares of United Heartland Group, Inc. that are issued initially, United Heartland Group, Inc. is authorized to issue up to 50,000,000 common shares.

D. The effect that the existence of blank check preferred stock may have on the valuation of common shares owned by the Public Health Foundation.

The Committee reviewed the proposed capital structure of UHG in light of other publicly-traded healthcare and managed care companies. The Committee determined that UHG's capital structure (namely, 50 million shares of common stock authorized with 10 million initially outstanding and 1 million preferred shares authorized) is consistent with that of other publicly traded managed healthcare companies. A summary of capital stock authorized and issued is contained in Section 5 of the Conversion Resource Book, attached as Exhibit 1, which supports the UHG ratio of 5:1 authorized:issued shares of common stock. The Committee noted that all companies in this comparable universe have the ability to issue "blank check preferred" stock (i.e. preferred stock that has repayment terms, coupon and conversion features, if any, that are determined at the Board of Directors' discretion), but that, to date, only one company (a non-Blue entity) has actually issued such preferred stock. The Committee did not identify any instances where such blank check preferred stock has been issued in an inappropriate manner in the healthcare and managed care universe. The summary of capital structures reviewed by the Committee is contained in Section 5 of Exhibit 1.

B. The effect that the issuance of additional shares by United Heartland Group, Inc. may have on values realized by the Public Health Foundation on the sale of its shares.

C. The effect that the purpose for the issuance of additional shares by United Heartland Group, Inc. may have on the valuation of common shares owned by the Public Health Foundation.

The Committee reviewed data on stock price performance of follow-on offerings in the managed care universe and determined that there are many variables that impact stock price performance; the issuance of stock via a follow-on offering is only one such variable (see Section 8 of Exhibit 1). A follow-on offering is a public offering of either newly-issued or currently outstanding registered stock subsequent to an initial public offering. Many companies have successfully utilized equity follow-on offerings as mechanisms to (a) raise additional capital and/or (b) provide liquidity for selling shareholders without adversely impacting share value.

However, the Committee noted that the Foundation's realization of value could be adversely affected by at least two factors relating to the issuance of UHG stock. First, the Foundation's stock value could be diluted by the issuance of options on UHG stock. Although the use of stock options is often an effective incentive device, excessive or inappropriate granting of options can dilute shareholder value. Second, the Foundation's stock value may be diluted by the issuance of stock for the purposes of raising capital or funding an acquisition. Dilution from capital raising activities will occur if stock is sold at a price below fair value, while dilution from acquisitions will occur if an inappropriate exchange ratio results in UHG issuing too many shares in relation to the combined entity's value. Dilution is usually measured by its impact on pro forma earnings per share.

Companies that are publicly traded are subject to various oversight measures designed to protect shareholders. For example, if an acquisition is of a material size, public companies typically appoint special board committees who typically retain the services of a financial advisor to provide an opinion that the proposed acquisition is fair, from a financial point of view, to the company's shareholders. Separately, if an acquisition involves the issuance of more than 19.9%

of the pre-transaction number of shares outstanding, then the issuance must be approved by a shareholder vote. As proposed in the Application, UHG will be a private company for an indefinite period of time and, therefore, no mechanism exists to provide for the liquidity of UHG shares and to protect the value of existing shareholders during that period.

The Committee has reviewed the costs of various liquidation alternatives including fees related to initial public offerings ("IPOs"), follow-on offerings, block trades of publicly traded stock, and merger and acquisitions. A detailed summary of these costs, as well as a summary of IPO and follow-on offering considerations, is contained in Sections 6 and 7 of Exhibit 1.

The Committee determined that the Foundation's ownership of 10 million issued and outstanding common shares of UHG does constitute the full value of BCBSUW. The Committee also determined that the capital structure proposed by the Applicant to be appropriate. However, the Committee has concerns about the lack of immediate liquidity for the Foundation's UHG shares, without which the shares have an unrealizable value. Further comment on this concern may be found in the sections of the Report pertaining to the Foundation's divestiture requirements and the monetization options.

The Committee also has concerns about the impact that corporate actions taken unilaterally by UHG post-Conversion could have on the as-yet-unrealized value of the Foundation's UHG stock, particularly given the lack of immediate liquidity. For example, if BCBSUW is allowed to convert today, but an IPO or merger with United Wisconsin Services Inc. ("UWS") does not follow for many months (or years), there is essentially no scrutiny, public or otherwise, of UHG's actions, yet those actions could significantly impact the value of the Foundation's UHG shares when ultimately liquidated. While it is not possible for the Committee to anticipate the full range of potential corporate actions, the Committee was especially concerned about the unrestricted ability of UHG to (i) provide management with various equity-related incentive packages, (ii) issue UHG stock in various private merger transactions, and (iii) be the sole party to determine what constitutes an acceptable takeover proposal to present to the Foundation for approval, in all cases without any external or shareholder oversight. The Committee does not believe that an appropriate plan of action has been presented for its and the Commissioner's consideration that properly contemplates the corporate governance of UHG during such an interim period when UHG is private, and as a result the Committee makes certain recommendations to address this concern.

Issue # 2: The plan of Conversion filed with OCI requires the Public Health Foundation to reduce its holdings in United Heartland Group, Inc. on a divestiture schedule. The foundation's ownership percentage must decline to less than 80% by September 30, 2001; less than 50% within 3 years of closing; and less than 20% within 5 years of closing. What impact can the divestiture schedule be expected to have on the Public Health Foundation's efforts to realize a fair and reasonable amount in exchange for its UHG common stock? How do the divestiture requirements compare with those of other Blue Plan conversions?

The Foundation is required to reduce its beneficial ownership to less than 80% of the issued and outstanding stock of each class of capital by September 30, 2001, to less than 50% within three years of the closing date, and to less than 20% within 5 years of the closing date of the Conversion. This schedule is essentially identical to that of the RightChoice ("RIT"), the Blue Plan conversion in Missouri, except that RIT did not have a one year/80% target, as its foundation already owned less than 80% at inception. However, the Committee noted that in certain instances, the RIT third year requirement may be extended for up to one year, and the fifth year requirement may be extended for up to 2 years if (i) the BlueCross BlueShield Association ("BCBSA") opines that it will not terminate the Blue's license and (ii) the foundation is unable to meet the target because certain actions by RIT have frustrated the foundation's efforts. RIT's foundation is still in the process of being vested with the stock, so no divestiture actions or deadlines have yet occurred.

WellPoint Health Networks ("WLP"), the California Blue Cross Plan conversion, does not have an explicit divestiture requirement; rather, its foundation must either reduce its ownership to certain levels by certain dates or place the equivalent number of shares into a voting trust (ceding voting control to a trustee) and vote the remaining shares (in excess of 5%) according to a voting agreement¹. The Committee noted that the WLP foundation has successfully reduced its exposure ahead of schedule through follow-on offerings of equity in the public market and a sale of shares back to the company.

A comparison of the various Blue Plan divestiture requirements is found in Section 3 of Exhibit 1.

In reviewing the Foundation's divestiture requirement as contained in the Application, the Committee believes that the "Voting Trust and Divestiture Agreement" could have an adverse impact on the Foundation's UHG common stock as follows:

- First, if UHG becomes publicly-listed, and market participants are aware that large blocks of stock must be liquidated by certain liquidation dates, investors will tend to drive the stock price down ahead of any offering (sometimes referred to as "overhang");
- Second, in the event that the Foundation fails to meet any of the divestiture deadlines, shares held in excess of the ownership limit are deemed to be delinquent shares; if an extension or waiver is not granted by BCBSA, UHG has the right to dispose of the delinquent shares at its own discretion without any liability whatsoever to the Foundation (except as to proceeds of the sale); and
- Third, any strategic acquirer of UHG will be aware of the deadlines and could use this knowledge to extract more advantageous economic terms in a merger than might otherwise be available

The Committee does note, however, that UHG may, at the Foundation's request, petition the BCBSA to extend the divestiture deadlines if the Foundation believes that compliance would have

¹ The Committee noted that the WLP conversion was the first of its kind, and occurred before the BCBSA had formalized its guidelines for converting Blues Plans.

a material adverse effect on it. UHG must receive written confirmation from BCBSA that extension would not cause a violation of the license agreement.

The Committee noted further that the relatively small size of UHG will likely result initially in a smaller float of shares (both in number and in dollar value), less equity research coverage, and the Foundation's need to sell UHG shares may reduce institutional investor interest in UHG. A reduction in the Foundation's ownership through follow-on equity offerings will (a) increase the publicly-traded float and (b) reduce the "overhang" issue.

The Committee concludes that the proposed divestiture schedule may act to reduce materially the actual value realized by the Foundation from its liquidation of its UHG shares. The BCBSA has essentially imposed an inflexible divestiture schedule that as a result places a significant premium and emphasis on the Foundation achieving immediate, short-term liquidity for a portion (20%) of its shares. Any time an owner of a significant portion of the equity of a company is faced with a forced liquidation schedule (in particular one that is known publicly), it is extremely likely that value realized will suffer. This is commonly referred to as an overhang. It is thus all the more important to (i) anticipate this liquidity requirement at the time of Conversion so as to reduce the likelihood that the Foundation will find itself facing a near-term divestiture schedule with no practical alternatives and (ii) establish appropriate information-sharing mechanisms between UHG and the Foundation during its ownership period to enable the Foundation to make well-informed decisions with regard to stock divestiture.

The Committee further determined that, to the best of its knowledge, the BCBSA has not made any significant concessions to other converting Blues Plans with regard to the divestiture schedule². While the Committee has various recommendations on this subject, the Committee accepts that there are certain limitations that come with the right to operate a BCBSA license, and finds that these limitations do have the ability to impair the realization of full value by the Foundation in comparison to shareholders that might not have these restrictions. However, as these limitations are an integral component of the license agreement, and the license agreement provides a significant portion of the value in UHG stock, the Committee accepts that value reduction may occur as a result of the divestiture schedules. While the Committee has not determined the exact amount of such value diminution, it is the Committee's conclusion that such value diminution is less than the reduction in BCBSUW/UHG value should the BCBSA license be terminated (see Issue # 4). As a result, its recommendations focus on constructive mechanisms that could minimize potential value reduction.

² The Committee noted that the current Empire Blue Cross and Blue Shield of New York proposal contains a 10-year divestiture schedule; however, as this plan has yet to be submitted for final BCBSA approval, it is not possible for the Committee to rely on this information. The Committee noted further that the WLP divestiture structure was developed before the BCBSA formally adopted its current "Statement of Principles" in 1997, the contents of which are summarized in Section 2 of Exhibit 1.

Issue # 3: What effect do the provisions contained in the Application, including the requirements of the BlueCross BlueShield Association, pertaining to control or change in control have on the value of the common stock donated to the Public Health Foundation and to the public interest?

Factors considered include, amongst others:

- A. *Under the United Heartland Group's articles of incorporation, shareholders have no right to remove any director or the whole board unless the director or the entire board is convicted of a felony or found liable for gross negligence or willful misconduct in a matter of substantial importance to the corporation, where such adjudication is no longer subject to direct appeal. Even then, the holders of 75% of the issued and outstanding common shares must vote in the affirmative to remove the director or offending board. Consideration should be given to how such governance provisions compare to other health insurance companies in general, and to other converted Blue Plans in particular.*

The Committee determined that this provision, concerning director removal, is identical to RIT but more strict than WLP and Trigon ("TGH"), a Virginia Blue Plan which converted from a mutual insurer to a stock insurer. WLP and TGH require an affirmative vote of only 50% of the shareholders rather than 75%. The Committee believes that any provisions in a company's corporate governance structure that decrease the ability of a shareholder to exercise the full range of commonplace ownership rights has a negative effect on valuation. This provision, along with other such provisions including classified boards of directors (present in the Application and in all other converted Blues Plans and the vast majority of the publicly traded comparable managed care/health insurance companies), significantly hinders a shareholder's ability to influence board decision-making via a proxy fight.

With regard to UHG, the existence of the Voting Trust further restricts the Foundation, as a 100% or significant equity owner of UHG, from exercising any of the usual and customary influences over UHG. For example, on most governance issues, the Foundation's shares will be voted by an independent trustee as directed by UHG's board, which may well vote against the removal of a director. In such an event, the earliest that a UHG director could be removed would be after the Foundation has sold 75% of its stock and 100% of the new owners of the stock support the removal of the director and, at that, only after a lengthy court process first results in conviction of the director and all appeals have been exhausted. Given the dispersed ownership that is mandated by the 5/10/20 BCBSA rule³, removal of directors is effectively impossible.

The Committee noted that the BCBSA governance requirements prohibit the Foundation from nominating UHG directors, or for voting UHG shares for or against a nominee in any fashion except as directed by the UHG board. The Committee also noted that the Application proposes that at all times at least 80% of the UHG board consist of "Independent" directors⁴. For UHG, this means that, if elected by the shareholders (other than the Foundation), only 1 out of 9 directors can be non-Independent. Should this occur, subsequent "non-Independent" nominees become ineligible for election. The Committee noted that the BCBSA license agreement only requires that at least 50% of the board consist of independent directors, which is the approach taken by Empire Blue Cross and Blue Shield of New York ("Empire"). The 80% rule proposed in the Application is consistent with conditions the BCBSA required of RIT. The BCBSA takes the position that a more rigorous standard must be applied when parties, in this case the Foundation,

³ The so-called BCBSA 5/10/20 limits prohibit any one person owning 5% or more of the voting rights, any institutional investor owning 10% or more of the voting rights, or any person or persons acting in concert owning 20% or more of the equity of a converted Blue Plan such as UHG.

⁴ The UHG definition of "Independent" means (a) current BCBSUW directors and (b) directors not affiliated or sponsored by the Foundation or an investor who owns more than the BCBSA 5/10/20 limits

own a controlling interest in common stock even though the shares will be held in a voting trust. WLP and TGH have no equivalent rule, although WLP has a nominating committee.

The Committee noted further that the Application contains many corporate actions (i.e. changes to by-laws and articles of incorporation) that require only the vote of a majority of the Independent board (i.e. as little as 41% of the total board), allowing the Independent directors significant control.

Based upon its analysis of the above issues and the impact the governance provisions may have on the value of the Foundation's UHG common stock, the Committee makes certain recommendations to possibly mitigate the impact these requirements may have on the UHG stock's value.

B. Under the Voting Trust and Divestiture Agreement, the Public Health Foundation is not permitted to solicit or encourage any inquiries or proposals relating to the sale of any of the stock holding company's common shares until any such proposal is approved by UHG's board of directors.

The Committee noted that one of the fundamental rights afforded owners of equity (particularly majority owners) is the ability to sell. The Committee noted further that another fundamental right typically afforded majority owners of a corporation is the right to influence merger and acquisition processes and outcomes. In the Application, the Foundation is prohibited from actively seeking strategic buyers of its equity stake, or from directing the UHG board to seek strategic buyers of the Foundation's equity. Further, unlike RIT, the Foundation is prohibited from joining litigation against UHG for its actions or inactions regarding changes of control (the RIT foundation has the right to join (but not initiate) litigation against RIT that alleges that the RIT Board should solicit acquisition proposals, change of control proposals or initiate a bidding process/auction). In fact, the Foundation's scope of decision-making ability, as proposed in the Conversion plan, extends only to deciding the timing of a Demand registration right to sell shares and deciding whether to accept or reject a UHG board-recommended sale of the entire company to a strategic acquirer (excluding a merger with UWS).

The Committee noted that it is highly unlikely that a change of control proposal that is unfavorable to UHG management will ever be presented to the Foundation, regardless of its relative merits from the Foundation's point of view. The Committee further notes that it is also possible for UHG management to present to the Foundation only change of control proposals that satisfy the personal objectives of UHG management, which proposals may not represent the best economic value to the Foundation. Should the Foundation receive inquiries from third parties, it is required to forward them to the UHG board and take no further action.

The Committee noted, however, that in reality it is highly unlikely that a significant owner of UHG, such as the Foundation in its early years, would or could be successful at arranging and concluding a sale of all or a large portion of its stock to a strategic acquirer without the assistance and support of the UHG management team and board. Hostile takeovers are rare in this and other regulated service businesses. As a result, the most preferable scenario would be one where the Foundation works in conjunction with the management team and the board of UHG to determine the appropriate time for a sale and the appropriate parties to approach.

While the Committee did not quantitatively substantiate this finding, it is the assertion of the Committee that, all other things being equal, a limited potential buyer universe will act to reduce the competition for an acquisition of UHG. Reduced competition, by itself, can act to reduce the value that could be realized by the Foundation from the sale of its equity, either to the public or private markets in lot sizes below the BCBSA 5/10/20 limits or in its entirety to a strategic (i.e., same industry) acquirer.

The Committee believes that the Foundation's inability to have any rights of involvement in regard to the timing of a potential sale or the parties approached has an additional negative impact on valuation. By leaving all of the decision-making to UHG, with the BCBSA limitations in place, it is highly likely that the only change of control proposals that are recommended to the Foundation by the UHG board will be those proposals that (a) involve another Blue acquirer (i.e. representing only a portion of the potential healthcare/managed care acquiring universe) and (b) those proposals that offer the best "package" for the management team. For example, it would not be unusual for "social" issues (such as management titles post-merger) and personal compensation packages to be decisive factors in the merger and acquisition process, rather than simply the maximization of value for the Foundation's equity. This could result in material transfers of value away from the Foundation and future shareholders and into the hands of the management team in the form of lucrative employment contracts.

The Committee further concluded that the Application contains no mechanism for the transfer to the Foundation of any information regarding the financial and strategic situation and prospects of UHG. In essence, the Foundation could be forced to make its decisions, which are restricted in scope, in the complete absence of information about its sole asset. Other converted Blues Plans such as RIT have provided for mandatory consultation between the company's Board and the foundation (for as long as the foundation owns at least 20% of RIT) before beginning any change of control process or after receiving any change of control proposal. While RIT is only obligated to consult (presumably anything further would violate the BCBSA's "influence or control" guidelines), the foundation is assured that it will be adequately appraised of the board of RIT's strategic intent. With knowledge of planned action (or inaction), the foundation is free to pursue legal recourse if it so chooses in order to effect a liquidity event and protect its interests.

The Committee concluded that the UHG governance structure, with regard to change of control issues, is usually contrary to the stockholders interests when compared to both non-Blue healthcare and managed care company governance provisions as well as other comparable converted Blues Plans. In particular, the proposed governance mechanisms that deal with stockholder participation and knowledge concerning the timing of change of control transactions and the selection of competing bids are particularly onerous to stockholders and could have an adverse effect on the Foundation's ability to achieve a reasonable value for its UHG stock. This deficiency is particularly noteworthy given that a properly conducted auction of the entire company is often the best way to maximize value. The Committee noted that between 1993 and 1999 the average premium paid in a merger or acquisition transaction involving healthcare and managed care companies over the market trading price one-month prior to a transaction announcement was 44%. The Committee believes that a mechanism to allow for the flow of information between UHG and the Foundation is essential and will be reflected within the Recommendation section of this Report.

- C. Section 11 of the Registration Rights Agreement allows the stock holding company to negotiate for the sale of all or part of the Public Health Foundation's share holdings through a private placement.*
- D. Section 4 of the Registration Rights Agreement allows the stock holding company to match the price per share negotiated in a private placement.*
- E. The proposed Public Health Foundation has no preemptive or preferential rights to purchase or subscribe to the stock holding company's common or preferred shares.*

The Committee determined that, given the Foundation's proposed purpose and structure, it would be inappropriate to allow the Foundation to acquire any more equity from UHG except that received as a result of a stock split or some other form of corporate reorganization. The Foundation's main task is to divest the equity on a timely basis at maximum value. In addition, no other Blue foundation possesses such equity purchase rights.

However, the Committee also notes the Application grants UHG three (3) separate and distinct rights: (i) the right to purchase the Foundation's UHG stock subsequent to receipt of a Demand right; (ii) the right of first refusal to purchase UHG stock that is proposed to be sold in a private placement by the Foundation; and (iii) the right to unilaterally purchase Foundation UHG stock. These rights are described in greater detail below:

(i) UHG's Right to Purchase Foundation Stock Pursuant to a Demand Right: UHG has the right to acquire Foundation UHG stock based on the then-current market price after the Foundation has requested that UHG file a registration statement for UHG stock owned by the Foundation. The purchase price formula provides for the acquisition of the Foundation's UHG stock by UHG at 97% of the then-current market trading price. If UHG chooses to exercise this purchase right, it must either acquire all of the Demand stock or leave at least \$30 million of the Demand stock behind so that a registration statement can still be filed (the Application states that UHG shall not be compelled to make a registration effective for amounts less than \$30 million).

Both RIT and WLP have the right to acquire stock that their respective foundations have requested be registered for sale, but in both cases the purchase price is 100% of the recent market trading prices. In addition, for RIT the notice period is 15 days (versus 30 in UHG) and the transaction has to close within 30 days (versus 60 days in UHG). The Committee believes it appropriate that UHG mirror these particular RIT rights.

(ii) UHG's Right of First Refusal for Private Placements by the Foundation: UHG has the right to acquire any Foundation UHG stock that the Foundation proposes to sell in a private placement, on identical terms and conditions. The Application mandates that the Foundation provide UHG with 45 days notice of any pending private equity placement. If UHG chooses to exercise its right, it assumes the position of the original buyer

This right of first refusal, which is identical to that in RIT (but is absent from WLP and Empire), effectively prevents the Foundation from selling its stock privately, as it is highly unlikely that a potential buyer would enter negotiations with the Foundation with knowledge of the existence of this right of first refusal in favor of UHG. As a result, this provision can only have a negative impact on realizable valuation by severely limiting the universe of potential buyers to those below the BCBSA 5/10/20 limits, at prices that are at a discount to more "free market" based valuations.

(iii) UHG's Right to Unilaterally Purchase Foundation Stock: This right allows UHG, at any time after the Foundation has liquidated a *de minimus* amount of stock (\$10 million), to unilaterally acquire some or all of the Foundation's remaining stock at various formula-driven prices. These formulae effectively allow UHG to take advantage of a temporarily weak stock market price for UHG equity (such conditions have to exist for a two month period) or a particularly discounted private placement price, if ever achieved, and acquire the Foundation's stock cheaply. This right effectively removes any up-side that the Foundation would otherwise retain, as the Foundation cannot prevent the right's exercise. The Committee further noted that the Foundation would operate without current strategic information because it has no access to the board of UHG. As a result, the Foundation would not be in a position to properly assess whether the decline in stock price was temporary or permanent. It is, therefore, possible for the board of UHG to utilize its knowledge of the prospects of UHG to time the purchase of the stock from the Foundation to UHG's maximum advantage and potentially to the Foundation's detriment.

The Committee also noted that in order to exercise such rights, UHG not only needs access to significant amounts of liquidity, but it also needs to have significant amounts of excess capital, as the buying back of stock into treasury reduces capital.

F. The effect that ownership by an Employee Stock Ownership Plan ("ESOP") or other employee benefit plan would have on the valuation of United Heartland Group, Inc.

The Committee reviewed the publicly-traded managed care universe and the public Blues to ascertain how, and in what way, these companies use stock option and ESOP plans. Section 5 of Exhibit 1 contains the summary data reviewed by the Committee. The Committee has concluded that it is normal and appropriate for companies such as UHG to have various types of director, manager and employee equity-related incentive plans. The Committee noted that it would be preferable for there to be singularity in structure and purpose for such plans. In other words, it would be preferable for UWS options to be granted only to UWS employees/directors, not BCBSUW (as the Committee noted has been the case).

In the healthcare and managed care universe reviewed by the Committee, only one company has an ESOP. Since ESOP participants (i.e. employees) typically vote their shares as directed by the board, the existence of such plans generally does not jeopardize board control or offer the possibility of a block of stock falling into unfriendly hands. As delineated within Exhibit 1, the Committee noted that in January 2000, in keeping with its historical compensation practices UWS provided its senior staff with stock options. UWS has common senior management with BCBSUW. The Committee did not find reason to believe that this action was undertaken in anticipation of the Conversion. However, the Committee commented that while the strike price of the new options issued was at "current" market, the volume of stock options issued in January 2000, significantly increased compared to prior years. This increase is to compensate for the discontinuance at UWS of the Long Term Incentive Plan in 1998 and the lack of payout in 2000 under the Short Term Compensation Plan and the Management Bonus Plan. The Committee further noted that these options will vest ratably over the next four (4) years. It was noted that stock options are designed to provide a long-term incentive for management and employees to increase earnings of a company which should have the effect of increasing stock price. The UWS stock option program should align the interests of the company with the Foundation so long as the incentive is to also increase the earnings of BCBSUW/UHG.

The Committee noted that, while it is not possible to determine the exact impact on value that the existence of employee stock options and various employee stock ownership could have, the Committee believes that the alignment of incentives and interest between the Foundation (as a major equity owner) and the management is a positive attribute of the Application that should be supported. In this regard, the Committee has provided several specific recommendations.

G. The effect on the valuation of UHG of the BCBSA ownership limitations.

Many pension funds and other equity managers operate under minimum float and liquidity requirements. If particular stocks do not appear to promise that minimum level of liquidity, such managers do not purchase nor hold these stocks. In addition, certain funds are of such a size that if they cannot own a significant enough block of stock (measured in value), it is not worth their time to follow the stock. In addition, companies with smaller market capitalizations typically find it more difficult to obtain adequate equity research coverage and a commitment by the brokerage firms to make a market in the stock which are both important factors for institutional and retail equity investors. The Committee also expects that the reduced ability for investors to influence corporate governance (as previously described) compared to other publicly-traded healthcare and managed care companies will also act to reduce investor interest somewhat in converted Blues Plans such as UHG.

The Application provides the Foundation with the ability to require UHG to register for sale some or all of its UHG stock; however, this stock may only be sold to investors who will not exceed the BCBSA 5/10/20 limits after the transaction has been completed. The Committee noted that the BCBSA license agreement provides for automatic termination of the license in the event that the

BCBSA 5/10/20 limits are exceeded or a non-Blue company buys UHG. The Committee believes that the BCBSA 5/10/20 limits, when applied to a company the size of UHG, can be reasonably expected to act to reduce institutional interest in the stock of a converted, publicly-listed UHG and therefore reduce the ultimate value realized by the Foundation.

In conclusion, the Committee believes that the proposed corporate governance provisions, particularly those related to change in control, required by the BCBSA, will likely adversely impact the value of UHG's stock. The Foundation will be denied, due to the BCBSA requirements, most of the basic rights afforded to common stock owners in the US. In the proposed Application, further, the Foundation will be disadvantaged in many other respects (particularly with regard to access to information) that will make its stated purpose much harder to achieve. In addition, value will be impaired because there is an extremely limited universe of buyers for UHG and any such proposal must first be acceptable to UHG management before being presented to shareholders. However the Committee recognizes that many of these provisions are necessary and in some cases desirable to maintain the value of the Blue service marks. The Committee also notes that, while preservation of local management with a Wisconsin focus and Wisconsin resident employment base are not directly related to value, they are, nevertheless, concerns the Commissioner may consider in evaluating the public interest. The Committee believes that the BCBSA requirements do not prohibit the Foundation from gaining access to such information, and believes that the Foundation should have access to UHG information as UHG's major, and for some period only, shareholder. Accordingly, the Committee developed various recommendations for changes to the governance provisions.

Issue # 4: What is the value of the BlueCross BlueShield Association Service marks as an intangible asset?

The Committee identified this as an important issue because it believed that it could not recommend this Conversion Application unless it concluded that the value retained by maintaining the BCBSA license agreement exceeded the negative impact on the valuation of UHG stock caused by the various governance and ownership restrictions and limitations imposed by BCBSA.

The management of BCBSUW and UWS clearly believes that the BCBSA license has considerable value. The Committee noted that in August 1999, BCBSUW increased its stock ownership of UWS to enable Compcare, the UWS subsidiary, to become a “controlled affiliate” and to utilize the Blue service mark in its business operations. This action was taken because the BCBSUW/UWS management team believes that the use of the mark will significantly improve Compcare’s positioning in the market.

The Committee found that this issue is, by definition, hypothetical; there is no single or known answer. Valuation outputs that resulted from any of the various analyses are highly subject to the quality and validity of the various assumptions used in the analysis. As a result, the Committee determined that it was preferable to examine several different valuation approaches, and attempt to determine the minimum likely diminution in value of BCBSUW that would result from the loss of the BCBSA license.

In other Blue Plan conversions such as Empire, the converting Plan and various regulatory bodies have also struggled with this issue: because of the geographic exclusivity of a BCBSA license, there are no directly comparable companies to use as benchmarks. In addition, the number of cases of loss of license are very rare (BCBS Mutual of Ohio in 1996 was the most recent, and this occurred in connection with a failed merger transaction with a non-Blue entity and related corporate events).

In Empire, the company and its advisors relied upon three basic approaches to determining an appropriate range of value for the BCBSA license:

- (i) the one-time cost of license termination penalties to BCBSA (in the case of BCBSUW this would be approximately \$10.3 million after-tax);
- (ii) the explicit mechanism for a downward adjustment of the purchase price in the 1996 merger of Columbia/HCA and BCBS Mutual of Ohio should the target lose its BCBSA license as a result of the merger (which valued the license at approximately \$50 million, which represented approximately 17% of the valuation for the company, which would be in addition to (i) above); and
- (iii) company-specific anticipated changes in earnings due to the loss of the BCBSA license (for BCBSUW/UWS, based on information provided by BCBSUW/UWS, this values the license at approximately \$75 million after-tax, which would be in addition to (i) above)

With regard to item (iii), the Committee noted that the value of the BCBSA license to BCBSUW/UWS is derived from several sources:

- geographical exclusivity on use of name/logo for marketing purposes (at a time when the name/logo is undergoing a significant recovery in customer appeal and respect)
- volume of business received from national accounts that are domiciled in other states but whose users travel/live in WI and utilize UHG’s facilities and/or provider network
- volume of business received from national accounts that are domiciled in WI and use the BCBS national network
- FEP contracts
- those Medicare A processing contracts awarded by BCBSA only to its members
- ability to negotiate significant price discounts (up to 12%) from various in-state PPO/POS providers as a result of the volume of business that flows through UHG (in part, due to its BCBSA license)

In addition, BCBSUW utilizes its human resources in such a way as to maximize the benefit from “cost-plus” contracts, such as the Medicare processing contracts. By locating these processing operations in downtown Milwaukee and assigning the majority of its union contracted labor force to these businesses, BCBSUW is able to honor its union commitments with full absorption of the union contract labor. These contracts also allow BCBSUW to defray a significant portion of its fixed overhead, which would (presumably) have to be reallocated to other parts of the business should the contracts be terminated.

The Committee reviewed the value of specific anticipated changes to the revenue and expense items provided by BCBSUW/UWS. Based on these anticipated changes, the Committee noted that the impact on value of BCBSUW that would result from the loss of the BCBSA license could be estimated as follows:

<u>Item</u>	<u>Description</u>	<u>Present Value After-Tax Impact⁵</u>
Termination Fee	Due to BCBSA, \$12.90 million, one-time	\$10.32 million
BCBSA Dues	BCBSA annual dues saved, \$0.45 million	(\$ 3.58 million)
Unabsorbed Overhead	Existing annual overhead that could not be easily reduced, \$12.60 million	\$40.08 million
Reduced Discounts	Reduction of 12% discount to 6% on 46% of \$307 million Claims Cost (insured only)	\$30.67 million
Lost Profit on Individual business	For insured business only, profit lost on \$27.4 million annual premium	<u>\$12.40 million</u>
	TOTAL	\$89.89 million

In addition, the Committee was advised by BCBSUW that there is potential tax liability from a loss of the BCBSA license. In 1998, UWS received a private letter ruling from the IRS that stipulated (among other things) that the AMS spin-off would be tax-free to the participants provided that Compcare be “branded” Blue within a one-year period. Should BCBSUW/UHG lose its BCBSA license, it would be in violation of this stipulation from the IRS. BCBSUW has estimated this potential tax liability at \$15 million pre-tax, which is not included in the table above.

The Committee concludes that the BCBSA service marks, as codified in the BCBSA License Agreement, are of considerable value to BCBSUW and its affiliates, and hence to UHG. The Committee believes that the benefits obtained from the license and UHG’s role in the national network of Blues plans are significant enough to justify agreeing to continue to be strategically and tactically limited by the BCBSA restrictions, subject to the changes recommended by the Committee. Put differently, the loss of the BCBSA service marks would have a material, negative impact on BCBSUW’s and UWS’s businesses and, thereby, their value.

Based off the analysis reviewed, the Committee concludes that the BCBSA license is worth at least \$85 million to BCBSUW and therefore to UHG, which represents a significant portion of book value (approximately 40%) and 34% of the \$250 million valuation placed upon BCBSUW by Donaldson, Lufkin & Jenrette, the applicant’s investment banking firm, in May 1999. Therefore the Committee believes it is in the Foundation’s best overall interests to accept the UHG stock and to operate within the proposed governance and ownership guidelines, as amended in the Recommendation section below.

⁵ This table assumes that changes in annual amounts would be in effect for 5 years (except the BCBSA Dues, which were assumed in perpetuity) and assumed a discount rate of 10%, which is consistent with the historical pre-tax investment portfolio return of BCBSUW, mid-year convention, and a tax rate of 20% (assuming AMT rates apply)

Issue # 5: What effect, if any, can past and present transactions among Blue Cross & Blue Shield United of Wisconsin and its affiliates be expected to have on the valuation of United Heartland Group, Inc.?

The Committee dedicated a considerable amount of time to examining the impact that past transactions between BCBSUW and its affiliates have had on the value of BCBSUW today. The Committee reviewed in detail the inter-company transactions that were subject to OCI's approval or non-disapproval. The Committee's review focused on (i) identifying transactions where value could have been transferred outside of BCBSUW's ownership interests and (ii) quantifying, where possible, the economic value of that transfer.

The Committee, with the assistance of its advisers, classified all the historical transactions into two groups: (i) transactions prior to the October 24, 1991, initial public offering of UWS, and (ii) transactions after this date. In addition, the Committee further classified transactions post October 24, 1991, into two groups: (a) transactions inside UWS or inside BCBSUW and (b) transactions that crossed the corporate line between UWS and BCBSUW. The Committee determined that it would not examine in detail the transactions prior to October 24, 1991, nor those that occurred post October 24, 1991, that were intra-company transactions (i.e. did not cross corporate lines), as neither of these types of transactions could possibly transfer economic value outside of BCBSUW.

Section 9 of Exhibit 1 contains the summary of the historical transactions reviewed by the Committee. The Committee found that BCBSUW had been diligent in documenting inter-company transactions, and that appropriate care appeared to have been taken to ensure that these types of transactions were "visible" and capable of review by outside parties. Appropriate dispute mechanisms appeared to be in place, and neither party to an inter-company service agreement was obligated to continue purchasing such services from the other party. These transactions and agreements were contemporaneously reviewed and non-disapproved by OCI as part of its regulatory oversight responsibilities of affiliate transactions. Most agreements operate on an "allocated cost" basis, with the remaining contracts on a fixed price or a fixed percentage of price/cost basis.

The Committee examined the actual dollar and net present value (at February 2000) of BCBSUW's investments in, and contributions to, UWS (including stock purchased, dividends re-contributed and re-invested) versus the actual dollar and net present value of BCBSUW's receipts from UWS (consisting of actual cash received from dividends, tax-sharing payments, the sale of stock as well as the current market value of BCBSUW's current holdings of UWS and AMS), adjusted for the subsidization of UWS' borrowing costs. The Committee found that the net actual dollar amount received by BCBSUW in excess of its investment was approximately \$104.4 million which is worth approximately \$116.8 million on a present value basis⁶.

The Committee determined that there were primarily three areas where economic value was transferred between the BCBSUW and UWS corporate groups without the explicit receipt of currency or services, two of which, if judged solely by their own merits in isolation from other factors, could be considered detrimental to the interests of BCBSUW.

1. The Re-contribution of Dividends paid by UWS from September 1991 – March 1995 for No Consideration (Detrimental to BCBSUW): As part of the underwriting agreement for the IPO in 1991, BCBSUW agreed with the underwriters that, to the extent that UWS paid dividends on its common stock (of which BCBSUW would still hold over 81% after the IPO), BCBSUW would re-contribute (or forego) these dividends in their entirety back to UWS for no additional consideration. Given the conditions in the equity market place in 1991, and the fact that this

⁶ To calculate net present value, the Committee examined the actual rates of return realized by BCBSUW on its own investment portfolio (excluding the impact of UWS) in order to determine BCBSUW's historical opportunity cost of capital.

IPO was targeted toward retail investors, the Committee found reason to agree that the dividend adopted was necessary for this target investor group; thus the commitment to re-contribute dividends was not sought from the IPO investors. However, UWS sought this agreement from BCBSUW to prevent the newly-raised capital at UWS, that was needed to support the growth in UWS' Health Maintenance Organization ("HMO") business, from being paid back to BCBSUW, undermining the rationale for the IPO in the first place.

As a result, as BCBSUW owned only 81% of UWS after the IPO, \$0.19 of every \$1.00 of dividends re-contributed to UWS could be considered to have accrued to the benefit of the public investors, i.e. not BCBSUW. The Committee noted, however, that these re-contributed dividends were retained by UWS to support the growth of the business, and not actually paid out to the public investors. The Committee noted that total dividends received by BCBSUW from UWS between 1991 and 1999 were \$24.5 million (\$38.3 million in February 2000 dollars). The Committee found that the value (in actual dollars) of dividends forfeited by BCBSUW was \$13.2 million, with \$3.1 million accruing to the benefit of the public investors. When valued in current (February 2000) dollars, these amounts are \$23.7 million and \$5.4 million, respectively.

2. Subsidized Borrowing Rates (Detrimental to BCBSUW): From 1993 to the present, UWS has from time to time borrowed from BCBSUW at BCBSUW's own borrowing rate and/or borrowed from M&I Bank, also at BCBSUW's borrowing rate. In neither situation did UWS pay commitment fees or facility fees for access to credit. In other words, UWS obtained access to borrowing capacity that (a) may not otherwise have been available or (b) was priced at rates below UWS's standalone borrowing rate. The Committee has found that the value (in actual dollars) of this lower cost of funding for UWS was approximately \$2.2 million with approximately \$1.2 million accruing to the benefit of the public investors. When valued in current (February 2000) dollars, these amounts are approximately \$2.8 million and approximately \$1.6 million, respectively.
3. BCBSUW/UWS Tax-sharing Agreement September 1991 – June 1994 (Beneficial to BCBSUW)⁷: This agreement was possible because BCBSUW deliberately kept its ownership interest in UWS above 80% (in order to comply with the Internal Revenue Service tax code). As a result, BCBSUW was able to use current-year net operating earnings from UWS (and BCBSUW where applicable) to offset significant net operating losses carry-forwards ("NOLs") that BCBSUW and UWS had accrued in previous years. The mechanism used to effect this agreement was for UWS to pay in cash its full-rate taxes to BCBSUW that then retained a portion of those tax payments due to the utilization of the NOLs. The Committee concluded that this arrangement did indeed provide a net cash benefit (in actual dollars) to BCBSUW in the amount of \$14.2 million between 1991 and 1994. When valued in current (February 2000) dollars, this amounted to a benefit to BCBSUW in the amount of \$26.0 million. However, the Committee noted that by utilizing all of UWS and BCBSUW earnings to absorb all of BCBSUW's NOLs by June 1994, BCBSUW was denied the opportunity to use its own earnings from the second half of 1994 and all of 1995 to absorb NOLs. On a pro forma basis, this would have resulted in BCBSUW paying \$2.4 million more in taxes over those periods (which is worth \$3.7 million in February 2000 dollars). Accordingly, the net tax benefit to BCBSUW of the tax-sharing agreement was \$11.8 million (actual) and \$22.2 million (February 2000 dollars). The Committee notes that UWS was not required to enter into this Agreement and that by doing so it granted benefits to BCBSUW that more than offset the effects of the transactions described above.

⁷ The Committee noted that while there was no mandatory link between the tax-sharing agreement and the dividend re-contribution agreement, these two arrangements were intended to co-exist and co-terminate

The Committee concluded that, with regard to value transfers, BCBSUW and UWS did indeed engage in activities that had the effect of transferring value between the two entities and, in some cases, away from BCBSUW and to the benefit of external investors. However, the Committee determined that the net impact of these transfers was overwhelmingly in favor of BCBSUW, on an actual dollar and on a current value basis, (see Exhibit 1).

With regard to the Committee's review of the other transactions between UWS and BCBSUW, the Committee found no evidence to suggest that BCBSUW has been, or is being, economically harmed by its relationships with UWS. Indeed, the Committee found that the net economic result of having financed the growth of UWS, first inside BCBSUW and then, post 1991, in the public arena, was overwhelmingly positive. The Committee further recognizes that BCBSUW was unable to finance UWS's growth from internal sources after 1991. The Committee found that UWS succeeded in raising \$65.6 million of additional, non-BCBSUW capital between 1991 and 1999. This capital, which was not available from BCBSUW, was used to support the growth in UWS' managed care and related businesses, a significant portion of the benefit of which was and is enjoyed by BCBSUW, as the largest single owner of UWS. In addition the Committee noted that BCBSUW itself received \$78.8 million in gross proceeds from the sale of UWS stock in 1994 and 1995 via follow-on offerings.

The Committee further noted the existence of a \$70 million inter-company loan made by BCBSUW to UWS to partially finance the acquisition of AMS. The Committee concluded that appropriate fair value consideration must be given to BCBSUW (and ultimately to the Foundation as owner of the UHG stock) in any merger with UWS and with appropriate third-party oversight.

The Committee also considered whether BCBSUW would have been financially or strategically better positioned today had it not spun off UWS in 1991. Had it retained UWS, there would not have been any transfer of value outside the BCBSUW group. In addition, the BCBSUW group today might, arguably, be larger and therefore better positioned to achieve a higher valuation in the public equity markets due to its singularity and clarity of corporate organization as well as its (presumably) larger book value. During the 1990s the management teams of BCBSUW and UWS would not have needed to negotiate and operate various inter-company service agreements, and would not have had to deal with the daily conflicts of how to apportion each manager's time and efforts. However, after examining the record, in particular the \$65.6 million of external capital raised that allowed the build-out of UWS' managed care operations (which would not have been possible for BCBSUW as a private service insurance corporation with very little access to capital), and the \$78.8 million raised directly by BCBSUW from the sale of UWS stock, the Committee must conclude that the preponderance of evidence supports BCBSUW's actions.

The Committee found that the net impact of BCBSUW's relationships and transactions with UWS was economically beneficial to BCBSUW, and that while there has been some transfer of value outside BCBSUW, the value received by BCBSUW in the form of cash received, tax benefits and the current value of stock owned has been significantly greater than otherwise could have been obtained by BCBSUW. BCBSUW received access to capital for its UWS subsidiary, direct benefits (such as the tax payments), indirect benefits (such as an increase in statutory surplus recognized from a mark-to-market of UWS stock) and most significantly, a higher than otherwise obtainable return on assets as a result of the transfers outside of BCBSUW. All of these significantly enhanced the value of BCBSUW and are reflected in the value of the stock to be issued to the Foundation. The Committee concludes that the Foundation's receipt of 100% of the stock of UHG does in fact represent appropriate value for the converted BCBSUW.

Issue # 6: How would the various alternatives for monetizing the Foundation's equity in UHG impact valuation?

As proposed in the Application, the Committee noted that there is effectively no provision for immediate or long-term liquidity for the Foundation's UHG stock. As a relatively small, private company whose surplus is highly dependent upon the value of its equity ownership of two different publicly-traded companies (American Medical Security Group, Inc. ("AMS") and UWS: UWS shares BCBSUW's management team), and which is subject to the various BCBSA ownership limits, the Committee believes that the Foundation has very few options for (i) achieving the initial 1-year 20% divestiture requirement and (ii) achieving long-term liquidity within the proposed divestiture period.

The BCBSUW/UHG management team has represented to OCI and DBSI that it expects to initiate discussions with UWS to structure a merger of the two entities. As a result of this transaction, the Committee understands that the Foundation would receive newly-issued, registerable UWS shares in exchange for its UHG stock. Therefore, a critical determinant of value for the Foundation will be the exact exchange ratio that the UWS and UHG boards agree upon. The Committee notes that the Foundation has no right to approve or disapprove the terms of a merger with UWS as these rights are specifically denied in the Application. Thus, the Foundation might have liquidity thrust upon it at a price and upon terms that are detrimental to it, that reduce value and that impact its future liquidity options. The Committee notes further that there are tax issues relating to the 1998 AMS spin-off that may preclude concluding such a merger until September 2000, although the Committee did not receive definitive information regarding the outcome on the timing of the merger as a result of the tax issue.

Alternatively, UHG could continue as a stand-alone entity and seek other liquidity alternatives. The Committee noted, however, that there is the potential for a divergence of interests between UHG and the Foundation, as UHG is not subject to the divestiture guidelines and presumably would not want to be forced into a corporate transaction at what may be an inappropriate time simply to accommodate the Foundation. While the Committee notes that the divestiture issue is in some respects a "shared" issue, the Application as proposed contains automatic provisions that remove "excess" UHG equity from the Foundation if it breaches the divestiture schedule. However, there are no sanctions against UHG.

Indeed, there are a variety of corporate transactions that may be appropriate for UHG, only some of which provide a logical liquidity mechanism for the Foundation. The Committee believes that the most likely series of corporate transactions are:

<u>UHG Action</u> ⁸	<u>Foundation Liquidity Analysis</u>
1 a merger with UWS creating a publicly-traded combined entity; follow-on equity offerings	Some near- and long-term liquidity via follow-on equity offerings, the size and timing of which depend primarily upon UHG's capital requirements and financial performance and general equity market conditions
2 an initial public offering ("IPO") of UHG stock, follow-on equity offerings	Some initial liquidity (assuming that the Foundation can participate in the IPO) but at a discounted valuation (due to UHG's size, structural complexities, shared management with UWS etc.). Subsequent medium-term liquidity could come from follow-on equity offerings depending upon UHG's capital requirements and financial performance and general equity market conditions
3 a merger transaction with another converted public Blues Plan (i.e. sale to strategic acquirer)	Opportunity to achieve near-term higher valuation (merger premium) and final determination of value; liquidity will be a function of the form of consideration
4 a merger transaction with another converted non-public Blues Plan ("merger of equals")	Opportunity to achieve higher valuation (merger premium) and final determination of value; short-term liquidity will likely be highly restricted as consideration would be in the form of private stock.

While a merger with a non-Blues entity is possible and legal according to the Application, it is highly unlikely that a strategic acquirer could obtain enough value from UHG without its BCBSA license to justify paying the highest price (assuming an auction situation).

The Committee concludes that the value of the Foundation's UHG stock, and its ability to obtain this value from a liquidation of its UHG stock is almost solely dependent upon the actions of UHG's management. The Committee believes that, as currently proposed, there is no single liquidity event that the Foundation can look towards to ensure that it will be able to meet the required divestiture schedule. Therefore, the Committee makes certain liquidity-related recommendations to the Commissioner in a following section of this Report in order to address these concerns.

⁸ Options 3 and 4 could occur after options 1 and 2

Issue # 7: What are the conditions of the marketplace for health insurance equities in general, and the valuations being accorded to previously converted Blue Plans in particular?

As part of its deliberations and information-gathering procedures the Committee received briefings and updates on general trends in, and equity market valuations for, health care and managed care companies from its advisors from time to time. This was required in order for the Committee to have comparative and baseline information as it reviewed the proposed transaction in light of its charge.

Issue # 8: Are there any changes to the Application for Conversion that would improve the likelihood that a fair and reasonable value is realized by the Public Health Foundation in exchange for its shares?

The Committee concluded that the Application, as submitted, contains several structural provisions that potentially restrict the Foundation's abilities and options as it seeks to liquidate its UHG shares and obtain fair and reasonable value. To address these concerns within the constraints of the BCBSA licensing restrictions⁹, the Committee makes several recommendations as listed below.

⁹ The Committee notes that the attached recommendations are made in the good faith belief that they will be acceptable, as a package, to BCBSA. The BCBSA does not publish or provide specific "bright line" rules on most governance issues for converted Plans with foundations; instead, its Board reviews each submission for conversion on its own merits, taking into account the conversion plan in its entirety. The BCBSA will not provide any assurance that any particular item or package of items will be acceptable; it is, ultimately, the decision of the BCBSA Board.

RECOMMENDATIONS

The Committee presents the following recommendations to the Commissioner. These recommendations should be considered in combination with the BCBSUW Application, the body of this Report and the attached Exhibit, as all contain valuable information and reflect the Committee's deliberations and conclusions. The recommendations are derived from the numerous discussions by, and analyses presented to, the Committee. The Committee concludes that the Application, with the implementation of the following recommendations, will provide the Foundation with opportunities by which it can be reasonably assured to realize the full, fair and reasonable value for the 100% BCBSUW it is to receive. The Committee recommends that the Commissioner adopt these recommendations as part of the approval process of the proposed transaction.

- 1) Regulatory Oversight to Prevent Potential Equity Dilution Post-Conversion: Any issuance of stock (whether as consideration for the acquisition of assets or stock, the raising of new capital or as part of an equity-linked incentive compensation package) by UHG or BCBSUW or completion of a merger post or contemporaneous with the Conversion must be explicitly approved by OCI as fair and reasonable to the Foundation prior to taking effect. This oversight, except as otherwise required by law, may be lifted by OCI after the Foundation has achieved a definitive valuation event as determined by OCI.
- 2) Mechanism to Ensure Adequate Short-Term Liquidity for Foundation and/or meet BCBSA Divestiture Schedule:
 - (i) The timing of the divestiture schedule should not start until the date the shares are transferred to the Foundation and a liquidity event occurs. In addition, BCBSUW shall provide for the 3rd year and 5th year divestiture deadlines to be extended by up to 365 and 730 days, respectively, if the Foundation has filed a Demand but UHG is not required to comply because it recently completed its own equity offering (without participation by the Foundation) or a blackout period is pending (assuming BCBSA waives any potential license violation). The maximum permitted Blackout Period should be 120 days;
 - (ii) BCBSUW should not be allowed to convert and have UHG remain a private company. Instead, BCBSUW should be given the opportunity of selecting option (A) or (B) below:
 - (A) BCBSUW should complete an IPO of UHG comprised of primary and/or Foundation UHG shares contemporaneously with the Conversion; or
 - (B) UHG should complete a merger with UWS contemporaneously with the Conversion.¹⁰

In either (A) or (B), such transaction must (x) be completed within six (6) months of the Commissioner's Order (however, the Commissioner should reserve the right to extend this period by up to six (6) months), (y) reduce the Foundation's equity stake in UHG to less than 80% and (z) result in a public float of UHG of at least \$75 million unless the Commissioner approves a lesser amount after obtaining appropriate professional advice, but in no case less than \$50 million. If (y) or (z) are not achieved as a result of (B) above, then UHG must conduct a concurrent follow-on offering of primary and Foundation UHG shares to achieve (y) and (z). In both (A) and (B) UHG must provide a mandatory investor road-show and make a good faith best efforts attempt to obtain appropriate analyst coverage.

In conducting an offering under 2(ii)(A), UHG should sell newly-issued shares in such amount that when multiplied by the offering price result in a dollar value equal to the minimum float in (z) above. However, the number of shares sold by UHG under

¹⁰ For the remainder of section 2 and 3, "UHG" shall refer to the post-merger holding company.

2(ii)(A) may be reduced by such amount of UHG shares as the Foundation may wish to offer on similar terms in such offering.

In conducting an offering under 2(ii)(B), the shares sold must be newly-issued UHG shares in such amount that when multiplied by the offering price, result in an offering value of \$75 million unless the Commissioner approves a lesser amount after obtaining appropriate professional advice, but in no case less than \$50 million. This amount may be reduced by such amount of UHG shares as the Foundation may wish to offer on similar terms in such offering.

Both options (A) and (B) require explicit OCI oversight and approval to become effective and the Conversion only becomes effective upon the completion of (A) or (B); and;

- (iii) In the event that UHG completes an IPO, OCI should retain oversight (until the Foundation has reduced its ownership position to below 20%) over any subsequent merger with UWS in order to determine that the terms of the transaction are fair and reasonable to the Foundation.

3) Tighter Governance Structure to Better Align Interests between Foundation and UHG:

Foundation:

- (i) The Foundation's Articles of Incorporation should not be able to be changed except with the affirmative vote of 75% of the Foundation's board and approval of OCI;
- (ii) Foundation directors should only be able to be removed for cause and by the vote of 75% of the disinterested members of the Foundation's Board or by the Commissioner;
- (iii) The Foundation should have a governance structure that is established in a form determined by the Commissioner and that includes an independent board ;
- (iv) The Foundation shall have unrestricted voting rights to the extent of its shares with regard to all UHG-related change of control transactions, excluding a merger with UWS;
- (v) The Foundation should have the right to join litigation against UHG that alleges that the UHG Board should solicit acquisition proposals, change of control proposals or initiate a bidding process seeking proposals to acquire all of the stock of UHG; and
- (vi) The Foundation should not have a limit on the total number of Demand registrations; Demands should be able to be requested unless a Demand was already requested in the current calendar year or unless UHG completed a registration for itself or the Foundation within the last 120 days. Demand rights should be allowed starting at the Effective Date of Conversion. All registration-related expenses should be paid by UHG, except for the Foundation's counsel and underwriters' discounts and commissions pertaining to the sale of shares sold by the Foundation. Until the Foundation holds less than 50% of UHG stock, Foundation should be allowed to piggy-back on any and all non-convertible and non-option related stock offerings initiated and completed by UHG, excluding the offerings described under (2) (ii), and sell 50% of the stock sold in any such offering. In the event of a Blackout Period, UHG should be able to delay registration through the end of the Blackout Period.

UHG:

- (i) UHG should grant the Foundation observation rights at all Board meetings including any executive sessions that might be convened until such time as the Foundation has reduced its ownership of UHG stock to < 20%. In addition, UHG must consult with the Foundation prior to initiating any change-of-control transaction process and after receiving any change-of-control proposal, whether or not solicited by UHG;
- (ii) The percent of Independent directors on UHG's Board should be reduced from an initial 80%, as proposed in the Application, to 50% so that the percentage of non-Independent directors increases as public ownership of UHG common stock

increases. A mechanism should be established (that is approved by the Commissioner) that provides for the nomination and election of truly independent directors for the initial outstanding 20% of directors and until such time as the percentage of Independent directors is reduced to the 50% level and the Foundation holds less than 20% of UHG stock;

- (iii) UHG shareholders should be able to remove directors for cause with a vote of 75% of common stockholders. Cause defined as in the Application, except removal of the proven felony requirement;
 - (iii) For so long as Foundation owns more than 20% of UHG, UHG shall not change its articles of incorporation or its by-laws without OCI approval; and
 - (iv) UHG should not have any rights to purchase UHG stock from the Foundation except when the Foundation has requested that stock be registered for public sale; in this case UHG shall provide notice within 15 days, the purchase price shall be 100% of the recent trading price and such purchase should close within 30 days of notice being given.
- 4) Requirement of Dividend to the Foundation: As a condition for Conversion, BCBSUW should be required to provide a \$2,000,000 dividend or contribution which should, directly or indirectly, be paid to the Foundation, unless the Commissioner determines that funding of the expenses of the Foundation is otherwise adequately provided for.
- 5) Right of OCI to Retain External Professional Services in Conduct of Oversight: In all circumstances in which the Committee recommends that OCI retain the responsibility to review and/or approve activities subsequent to issuance of a final decision in the matter of the Conversion, the Committee recommends that OCI retain the right to obtain, at BCBSUW/UHG's expense, external professional advice, including, but not limited to, fairness opinions, as appropriate.
- 6) Limitation on Compensation to Officers, Directors, and Employees: No officer, director, or employee of UHG, BCBSUW or UWS (or any affiliates of these entities) should be awarded equity options¹¹ on UHG or UWS (as applicable) common stock (i) from the date of this Report and (ii) until 365 days have elapsed from the date on which UHG shall become a publicly traded corporation, nor should there be any vesting or changing of any of the terms of any stock options as a result of the Conversion or a merger with UWS¹². In addition, no existing or proposed change of control compensation packages for officers, directors or employees of any of these entities should be triggered by the Conversion or any merger between UHG and UWS. If, however, a new director or officer of UHG, BCBSUW or UWS (or any affiliate of these entities) should be hired during this interim period, equity options may be granted subject to the approval of the Commissioner. To the extent additional information regarding existing stock options arises subsequent to the issuing of this Report, the Committee encourages the Commissioner to review the Committee's conclusions in light of that information.

¹¹ With the limited exception of options that may be issued to the new director of UWS who is to join the Board at the UWS May 2000 shareholders meeting.

¹² The Committee notes that BCBSUW and UWS are currently drafting waivers for all of its officers, directors and employees that are to be signed prior to Conversion; these waivers will be an acknowledgement by the officers, directors and employees that the vesting of any UWS options held currently will not be deemed to accelerate in the event of a UWS merger with BCBSUW/UHG. However, some UWS options are currently held by outsiders who will not be asked to sign.

ACKNOWLEDGEMENT

The Committee wishes to acknowledge the assistance provided by Blue Cross & Blue Shield United of Wisconsin management, American Medical Security management, the BlueCross BlueShield Association, OCI staff and the investment banking firm of Deutsche Bank Securities, Inc. (conducting business as Deutsche Banc Alex. Brown), without whom the Committee would not have been able to carry out its charge.

Respectfully submitted,

Mark Femal, Chair

Patricia Lipton

Randy Blumer