

1 **Q. PLEASE STATE YOUR NAME, POSITION AND BUSINESS ADDRESS.**

2 **A.** My name is Maurice S. Smith, and I am the Divisional Senior Vice President, Business
3 Development and Subsidiary Management of Health Care Service Corporation, a Mutual
4 Legal Reserve Company ("HCSC"). My business address is 300 East Randolph Street,
5 Chicago, Illinois 60601.

6 **Q. PLEASE DESCRIBE YOUR EDUCATIONAL BACKGROUND AND**
7 **CERTIFICATIONS.**

8 **A.** In 1995 I received a Bachelor's Degree in Business Administration with a concentration
9 in Accounting from Roosevelt University in Chicago, Illinois.

10 **Q. PLEASE DESCRIBE YOUR EMPLOYMENT HISTORY.**

11 **A.** I joined HCSC in 1993. Over the past 20 years I have held various management
12 positions, including Vice President of Financial Reporting, where I oversaw all of aspects
13 of financial reporting for HCSC and its various subsidiaries. Subsequently, I was
14 promoted to Vice President, Corporate Transactions and Business Analysis. In that role I
15 negotiated various corporate mergers and acquisitions transactions on behalf of HCSC,
16 and was also responsible for HCSC's corporate financial forecasting. In May 2012, I was
17 promoted to my current role as Divisional Senior Vice President, Business Development
18 and Subsidiary Management. In my current role I am responsible for overseeing HCSC's
19 corporate mergers and acquisitions strategy, the formation of strategic partnerships with
20 various corporate entities, as well as managing HCSC's relationship with its 33
21 subsidiaries. I am also the Chairman of the Board of Directors of HCSC's largest

1 subsidiary. I am responsible for overseeing approximately 1,000 HCSC and subsidiary
2 employees in my current role.

3 **Q. HAVE YOU PREVIOUSLY TESTIFIED IN FORMAL PROCEEDINGS BEFORE**
4 **AN OFFICER OF THIS STATE OR IN FORMAL PROCEEDINGS IN ANY**
5 **OTHER STATE OR FEDERAL AGENCY?**

6 **A.** I have not.

7 **Q. PLEASE PROVIDE A BRIEF SUMMARY OF YOUR TESTIMONY.**

8 **A.** My testimony will include: background information on HCSC, including its financial
9 condition; and (b) facts surrounding the proposed transaction, including background on
10 how the transaction is structured and some of its key financial terms and impacts.

11 **Q. WHAT TYPE OF COMPANY IS HCSC?**

12 **A.** HCSC is an Illinois mutual legal reserve company doing business under its articles of
13 incorporation and by-laws as a non-profit health care service plan. HCSC currently
14 operates Blue Cross and Blue Shield (“Blue”) plans in Illinois, New Mexico, Oklahoma,
15 and Texas pursuant to a license agreement with the Blue Cross and Blue Shield
16 Association (“BCBSA”).

17 **Q. WHO OWNS HCSC?**

18 **A.** HCSC is a customer-owned organization, meaning HCSC is owned by the members it
19 serves. HCSC is not a public company and does not distribute its profits to outside
20 investors. Instead, HCSC reinvests its earnings to benefit the health and wellness of its
21 customers.

22 **Q. PLEASE DESCRIBE HCSC’S SIZE AND SCALE.**

1 A. HCSC is the country's largest customer-owned health insurer and fourth largest health
2 insurer overall. HCSC has over 13 million members in its Blue plans across its four
3 states. Over 6 million of those members reside outside the State of Illinois.

4 **Q. PLEASE DESCRIBE HCSC'S OVERALL FINANCIAL CONDITION.**

5 A. HCSC is one of the strongest Blue plans in the United States with total annual revenue on
6 a statutory basis of approximately \$19.9 billion. HCSC had 2011 earnings after federal
7 income taxes of approximately \$1.2 billion. HCSC has an A.M. rating of A+ (Superior),
8 a Standard & Poor's rating of AA- (Very Strong) and a Moody's rating of A1 (Good).

9 **Q. WHAT IS "SURPLUS" OR "RESERVES"?**

10 A. In general terms, surplus is the amount of assets that a company has that exceeds its
11 liabilities. A surplus ensures that anticipated (and unanticipated) claims by a health
12 insurer's policyholders for health care services can be paid promptly. A health insurer's
13 surplus is measured relative its risk profile to determine the minimum "risk-based
14 capital" ("RBC") requirements for that company. RBC requirements were developed by
15 the National Association of Insurance Commissioners to uniformly measure insurance
16 companies relative to the degree of risk assumed by a company within its business
17 operations. RBC limits the amount of risk a company can take. Companies with higher
18 amounts of risk need to have higher amounts of surplus to protect the company from
19 insolvency.

20 **Q. IS IT IMPORTANT TO HCSC TO MAINTAIN A SUFFICIENT RBC?**

21 A. Yes. HCSC has over 13 million members so it needs sufficient RBC to be able to cover
22 claims in the event of a widespread catastrophic event like a flu pandemic. In addition,

1 because HCSC is member owned and does not have the same access to capital markets
2 that a public company has, HCSC believes it is important to maintain sufficient RBC so
3 that it has the flexibility to make strategic alliances like this one. Because of HCSC's
4 strong RBC it is able to comfortably cover the RBC requirements of new BCBSMT
5 members.

6 **Q. HOW MUCH SURPLUS DOES HCSC HAVE?**

7 **A.** As reported in BCBSMT's and HCSC's Application for Approval of Alliance, HCSC
8 had a December 31, 2011, statutory surplus of approximately \$8.9 billion, and a surplus
9 of \$9.5 billion as of September 30, 2012.

10 **Q. WHY IS IT IMPORTANT FOR HCSC TO MAINTAIN THAT LEVEL OF**
11 **SURPLUS?**

12 **A.** As I mentioned earlier, our reserves are in place to ensure that anticipated and
13 unanticipated claims by our members for health care services are paid promptly and to
14 help to protect policyholders and other stakeholders, including health care providers,
15 from the economic consequences of a major health care crisis such as a flu pandemic. In
16 addition, HCSC's robust surplus provides its groups and members the security of
17 knowing that HCSC will be able to handle risk associated with insurance, while
18 remaining financially strong enough to invest in enhancements and infrastructure
19 necessary to serve our members, such as state of the art technology platforms, cost
20 containment programs and wellness and other initiatives that benefit all of our members.
21 Finally, as a customer-owned, mutual insurance company, reserves help address the fact
22 that HCSC'S options in terms of accessing capital markets are not as broad as they are for

1 public companies, which can issue additional shares of stock to raise money that may
2 become necessary to promptly pay claims.

3 **Q. ARE YOU FAMILIAR WITH THE PROPOSED TRANSACTION BETWEEN**
4 **HCSC AND BCBSMT?**

5 **A.** Yes, I am.

6 **Q. HOW ARE YOU FAMILIAR WITH THAT TRANSACTION?**

7 **A.** I was a member of the HCSC transaction team and was responsible for financial review
8 and analysis of proposed transaction terms, evaluation of the financial status of BCBSMT
9 as a stand-alone entity, exploring and developing a transaction structure, and for advising
10 the HCSC Board of Directors on financial issues related to the transaction.

11 **Q. WHAT IS THE STRUCTURE OF THE PROPOSED TRANSACTION?**

12 **A.** The proposed transaction is structured as an asset purchase transaction. The terms of the
13 transaction will be governed by the Asset Purchase Agreement, entered into between
14 BCBSMT and HCSC on November 14, 2012 ("APA"). In general, BCBSMT will
15 transfer and HCSC will acquire certain assets owned by BCBSMT that are part of its core
16 insurance business, including its insurance and self-insured plan administration (or
17 "ASO") contracts, provider contracts, and related assets used in that business ("Acquired
18 Business").

19 **Q. WHY WAS AN ASSET PURCHASE STRUCTURE USED?**

20 **A.** It is very important to HCSC for strategic and financial reasons that the transaction be
21 structured as an asset purchase transaction. HCSC is only interested in acquiring the
22 assets related to BCBSMT's core insurance business operations. It is not interested in

1 acquiring other non-core assets that do not fit naturally into the current HCSC enterprise.
2 Some examples of these non-core assets include certain investments in subsidiaries which
3 are not primarily related to health operations and similar real estate investments.

4 **Q. PLEASE DESCRIBE THE KEY FINANCIAL TERMS OF THE PROPOSED**
5 **TRANSACTION.**

6 **A.** Under the asset purchase agreement, in exchange for certain agreed core insurance
7 business assets, HCSC will pay \$17.6 million. As part of the transaction, HCSC will also
8 assume certain BCBSMT liabilities related to BCBSMT's core insurance business,
9 including claims liabilities under insurance and ASO contracts and specified pension
10 liabilities, in the approximate amount of \$180 million. At closing, BCBSMT will transfer
11 to HCSC an equal amount in assets and cash to support the liabilities.

12 **Q. HOW WAS THE PURCHASE PRICE DETERMINED?**

13 **A.** BCBSMT and HCSC negotiated all of the terms and conditions of the APA, except for
14 the purchase price. Pursuant to Montana's conversion statute (Montana Code Annotated
15 § 50-4-707(g)), BCBSMT obtained an independent valuation of the fair market value of
16 BCBSMT. The \$17.6 million purchase price was determined under an independent
17 actuarial valuation performed by Actuarial and Financial Modeling, Inc. to be the value
18 of BCBSMT's core insurance business. That valuation was then incorporated into an
19 overall independent valuation of the fair market value of the total BCBSMT entity,
20 performed by Moss Adams LLP.

21 **Q. HOW WAS HCSC INVOLVED WITH THOSE VALUATIONS?**

1 A. HCSC was not involved with the valuations before they were completed by the experts.
2 BCBSMT retained both expert firms and was responsible for ensuring that the valuations
3 were completed. The reports were provided to HCSC by BCBSMT so that the parties
4 could incorporate into the transaction the purchase price determined by the independent
5 experts. HCSC did not provide any factual inputs or projections to BCBSMT or the
6 experts relating to the valuations and did not interact with either of the experts as they
7 were conducting their work.

8 **Q. HAVE EITHER ACTUARIAL AND FINANCIAL MODELING, INC. OR MOSS**
9 **ADAMS LLP PERFORMED ANY WORK ON BEHALF OF HCSC IN THE**
10 **PAST?**

11 A. No.

12 **Q. ARE YOU FAMILIAR WITH BCBSMT'S FINANCIAL CONDITION?**

13 A. Yes. As part of the due diligence process, I was responsible for leading those on HCSC's
14 internal due diligence team who reviewed financial information pertaining to BCBSMT,
15 including its statutory accounting and generally accepted accounting principles, or
16 GAAP, financial statements.

17 **Q. BASED ON YOUR REVIEW OF BCBSMT'S FINANCIAL STATEMENTS,**
18 **PLEASE SUMMARIZE THE ASPECTS OF BCBSMT'S FINANCIAL**
19 **CONDITION THAT ARE IMPORTANT TO HCSC IN LOOKING AT THIS**
20 **TRANSACTION.**

21 A. As evidenced by the financial statements, BCBSMT'S revenues have increased from
22 approximately \$650 million in 2007 to \$815 million in 2011, as reported on GAAP basis.

1 However, the last time BCBSMT was able to generate an underwriting profit was in
2 2007. BCBSMT has generated underwriting losses since 2008, and those underwriting
3 losses have ranged from -\$0.8 million to -\$17.6 million.

4 **Q. BASED ON YOUR REVIEW OF BCBSMT'S FINANCIAL STATEMENTS, DID**
5 **BCBSMT GENERATE POSITIVE NET INCOME OR PROFIT SINCE 2007?**

6 **A.** Yes. Other than in 2009, BCBSMT has generated positive net income according to its
7 audited financial statements; however, the positive income was related to subsidiary
8 business and not insurance business.

9 **Q. IS IT SIGNIFICANT THAT BCBSMT HAD POSITIVE NET INCOME AND AN**
10 **UNDERWRITING LOSS?**

11 **A.** Yes. Underwriting gains or losses measure an insurer's ability to generate a profit based
12 on its core business of underwriting insurance policies. A company may have other items
13 on its financial statements, such as investment gains or losses, and gains or losses from
14 other operations not related to its core business, which generate a bottom line profit.
15 However, with respect to BCBSMT, since 2007 it has not been able to generate a profit in
16 its core health insurance business. The assets that HCSC would be acquiring are
17 BCBSMT's assets from its core health insurance business, which has not been profitable
18 since 2008.

19 **Q. DID YOU GET ADDITIONAL INFORMATION IN MEETINGS WITH BCBSMT**
20 **MANAGEMENT THAT CONTRIBUTED TO YOUR VIEW OF BCBSMT'S**
21 **FINANCIAL CONDITION?**

1 A. As the due diligence process proceeded, we had various meetings with BCBSMT. During
2 that process, I learned that significant capital expenditures would be required for
3 BCBSMT to be viable in the future.

4 **Q. WHAT BENEFITS WILL HCSC GET FROM THE PROPOSED**
5 **TRANSACTION?**

6 A. First, by adding BCBSMT's membership and operations to its current organization,
7 HCSC can drive scale and enhance efficiencies as an enterprise. HCSC can realize
8 immediate member growth from BCBSMT's current membership block while working to
9 expand that presence over time. Because of HCSC's existing large scale and superior
10 operations, and prior experience in successfully integrating Blues plans into its
11 operations, integrating these assets into HCSC's enterprise can be done efficiently,
12 effectively and at a relatively low cost. The new five-state entity will realize significant
13 administrative synergies, including many related to information technology systems as
14 well as enhancements to core functions such as claims processing and customer service,
15 as well as administrative services.

16 Second, geographic expansion has been identified by debt rating agencies as a way to
17 maintain and improve credit ratings and therefore lower borrowing costs. Given the
18 limitations on HCSC's access to capital markets compared to publicly traded companies,
19 this expansion provides additional protection for HCSC's high ratings.

20 Finally, and very importantly, HCSC's commitment to remaining a non-profit
21 organization that serves the members who own it is demonstrated and strong. Part of that
22 commitment is ensuring that other non-profit Blues remain viable so that the Blues
23 system as a whole remains competitive in a field of strong, well-funded national carriers.

1 HCSC believes the presence of a non-profit, customer-owned option is critical to helping
2 maintain a competitive marketplace that offers people choices and access to affordable
3 care, as well as choice and options in selecting the type of carrier who will help them get
4 that care.

5 **Q. WHAT BENEFITS DO YOU THINK BCBSMT WILL RECEIVE FROM THE**
6 **PROPOSED TRANSACTION HCSC?**

7 **A.** HCSC'S financial strength and strong capital position will benefit BCBSMT and its
8 members in several ways. As I mentioned, one of the significant challenges facing
9 BCBSMT is its financial underperformance and resulting inability to invest in the
10 infrastructure, technology and process enhancements needed to maintain and grow its
11 core insurance operations. The transaction with HCSC offers an immediate increased
12 scale for BCBSMT, which will help it reduce its administrative expenses and price more
13 competitively. Scale is extremely important in the non-profit arena where margins are
14 already substantially compressed, and will be even more imperative to competing and
15 remaining viable in an even more challenging post-Affordable Care Act marketplace. In
16 addition, HCSC's balance sheet strength will enhance BCBSMT's risk-taking abilities,
17 allowing it to underwrite more insured-market business and contribute to increasing
18 BCBSMT's membership base as well as its net income.

19 **Q. HAS HCSC DONE SIMILAR TRANSACTIONS WITH OTHER BLUES PLANS?**

20 **A.** Yes. HCSC acquired the Blue Cross and Blue Shield businesses in Texas (1998), New
21 Mexico (2001) and Oklahoma (2005).

22 **Q. ARE HCSC'S BLUES TRANSACTION ALL STRUCTURED THE SAME WAY?**

1 A. No, Blues transactions are not all structured the same way. Each Blue plan is a unique
2 business entity. That means that every transaction must be analyzed and structured based
3 on its own individual facts and circumstances, as well as determining how those facts and
4 circumstances align with HCSC's business structure and needs. In addition, state
5 regulatory requirements may play a role in determining the structure of transactions.

6 **Q. YOU HAVE MENTIONED HCSC'S SURPLUS. DO YOU BELIEVE HCSC**
7 **WILL POSSESS SURPLUS IN AN AMOUNT SUFFICIENT TO COMPLY WITH**
8 **THE SURPLUS REQUIRED UNDER MONTANA LAW AND PROVIDE FOR**
9 **SECURITY OF HCSC'S CERTIFICATE HOLDERS AND POLICYHOLDERS?**

10 A. Yes. HCSC's surplus well exceeds the RBC requirements under Montana law and the
11 BCBSA. One of the reasons HCSC maintains excess surplus is to ensure that it has the
12 flexibility to enter into strategic transactions and still maintain adequate surplus levels.

13 **Q. DO YOU BELIEVE THE PROPOSED TRANSACTION HAS THE LIKELIHOOD**
14 **OF CREATING A SIGNIFICANT ADVERSE EFFECT ON THE AVAILABILITY**
15 **OF HEALTH CARE SERVICES OR HEALTH INSURANCE COVERAGE IN**
16 **MONTANA?**

17 A. No, quite the opposite. I believe the transaction will increase Montanans access to health
18 insurance coverage and health care services.

19 **Q. DO YOU BELIEVE HCSC WILL BE ABLE TO MEET THE FINANCIAL**
20 **TERMS OF ALL THE BCBSMT POLICIES IT ASSUMES?**

21 A. Yes because of HCSC's financial strength and RBC levels, I am confident that HCSC
22 will be able to meet the terms of the policies it assumes.

1 **Q. UNDER THE PROPOSED TRANSACTION WILL ANY PART OF THE PUBLIC**
2 **ASSETS OF BCBSMT INURE DIRECTLY OR INDIRECTLY TO HCSC OR AN**
3 **OFFICER, DIRECTOR, SHAREHOLDER, OR EMPLOYEE OF HCSC OR TO**
4 **ANY OTHER PERSON THAT IS NOT A FOUNDATION OR NONPROFIT**
5 **ORGANIZATION APPROVED TO RECEIVE THE ASSETS BY THE**
6 **ATTORNEY GENERAL?**

7 **A. No.**

8 **Q. UNDER THE PROPOSED TRANSACTION WILL ANY OFFICER, DIRECTOR,**
9 **OR TRUSTEE OF BCBSMT RECEIVE ANY IMMEDIATE OR FUTURE**
10 **REMUNERATION FROM HCSC AS A RESULT OF THE PROPOSED**
11 **TRANSACTION EXCEPT FOR REASONABLE SERVICES RENDERED**
12 **PURSUANT TO A VALID CONTRACT BETWEEN THE OFFICER,**
13 **DIRECTOR, OR TRUSTEE OF BCBSMT?**

14 **A. No.**

15 **Q. ARE YOU AWARE OF ANY DISCLOSURES OF ANY CONFLICTS OF**
16 **INTEREST OF ANY BOARD MEMBER, EXECUTIVES OR EXPERTS**
17 **RETAINED BY HCSC OR BCBSMT?**

18 **A. No.**

19 **Q. DOES THIS CONCLUDE YOUR TESTIMONY?**

20 **A. Yes.**

VERIFICATION

STATE OF ILLINOIS)
) ss.
COUNTY OF COOK)

I, Maurice Smith, being first duly sworn, upon my oath, state that I have read, know and understand the contents of the foregoing testimony and that the statements contained therein are true and correct to the best of my knowledge, information and belief.

Maurice Smith

Maurice Smith

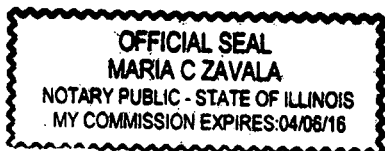
SUBSCRIBED, SWORN TO AND ACKNOWLEDGED before me this 7th day of February, 2013, by Maurice Smith.

Maria C Zavala

NOTARY PUBLIC

My Commission Expires:

4/6/16



Respectfully submitted this 8 day of February, 2013.

KELLER, REYNOLDS, DRAKE,
JOHNSON & GILLESPIE, P.C.

BY: Jacqueline T. Lenmark
Jacqueline T. Lenmark, Esq.
50 South Last Chance Gulch
P.O. Box 598
Helena, Montana 59624

CERTIFICATE OF SERVICE

I, Jacqueline T. Lenmark, KELLER, REYNOLDS, DRAKE, JOHNSON & GILLESPIE, P.C., certify that on February 8, 2013, I served a true and correct copy of the foregoing Direct Testimony of Maurice S. Smith, by mailing it first class postage prepaid to:

Ms. Sybil Shults
Office of the Commissioner of
Securities & Insurance
State Auditor's Office
840 Helena Avenue
Helena MT 59601

Honorable W. William Leaphart
1772 University Avenue
Helena, MT 59601

Jesse Laslovich, Esq.
Nick Mazanec, Esq.
Office of the Commissioner of
Securities & Insurance
State Auditor's Office
840 Helena Avenue
Helena, MT 59601

Kelley Hubbard, Esq.
Michael Black, Esq.
Montana Department of Justice
215 North Sanders, Third Floor
P.O. Box 201401
Helena, MT 59620-1401

DATED this 8 day of February, 2013.

Jacqueline T. Lenmark