THE COMMONWEALTH OF MASSACHUSETTS

OFFICE OF CONSUMER AFFAIRS AND BUSINESS REGULATION

Division of Insurance

Report on the Statutory Examination of

Fallon Community Health Plan, Inc.

Worcester, Massachusetts

As of December 31, 2004

NAIC COMPANY CODE: 95541

EMPLOYERS ID NUMBER: 23-7442369
Commonwealth of Massachusetts Division of Insurance
REPORT ON THE STATUTORY EXAMINATION OF
FALLON COMMUNITY HEALTH PLAN, INC.

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Honorable Julianne M. Bowler
Secretary, Northeastern Zone, NAIC
Commissioner of Insurance
Division of Insurance
Commonwealth of Massachusetts
One South Station
Boston, MA 02110

Honorable Alfred W. Gross
Chair, Financial Condition (E) Committee, NAIC
Commissioner, Bureau of Insurance
Commonwealth of Virginia
P. O. Box 1157
Richmond, VA 23218

Honorable Commissioners:

Pursuant to your instructions and in accordance with Massachusetts General Laws, Chapter 176G, Section 10, an examination has been made of the financial condition and affairs of the

FALLON COMMUNITY HEALTH PLAN, INC.

at its home office located at:

10 Chestnut Street
Worcester, MA 01608

The following report thereon is respectfully submitted.
SCOPE OF EXAMINATION

This statutory examination of Fallon Community Health Plan, Inc., hereinafter referred to as "the Company", “FCHP”, “Fallon”, “the Plan”, or "the Corporation" is as of December 31, 2004, including any material transactions and/or events occurring subsequent to the examination date and noted during the course of this statutory examination. KPMG LLP (KPMG) has applied certain agreed upon procedures to selected records and transactions of the Company. Such procedures were reviewed and approved by the Commonwealth of Massachusetts Division of Insurance (the Division).

The current examination was conducted at the direction of, and under the overall management and control of the examination staff of the Division. The statutory examination was performed at the Company's home office in Worcester, Massachusetts. KPMG was engaged to perform certain agreed-upon procedures, which are in compliance with the **NAIC Financial Condition Examiners’ Handbook**. KPMG’s actuaries were involved in the performance of those procedures to the extent that such procedures related to the Company’s reserves for unpaid claims and loss adjustment expenses and provider risk sharing settlements as of December 31, 2004. KPMG's Information Risk Management (IRM) personnel were engaged to perform an Evaluation of Controls in Information Systems Questionnaire in a form substantially similar to the one established in the **NAIC Financial Condition Examiners’ Handbook**. The IRM Specialists performed examination procedures pertaining to the examination of the I/T systems as outlined in the **NAIC Financial Condition Examiners’ Handbook**. All procedures were performed under the management and control and general supervision of the examination staff of the Division.

The examination was conducted in accordance with standards and procedures established by the National Association of Insurance Commissioners (NAIC) Financial Condition (E) Committee and prescribed by the current **NAIC Financial Condition Examiners Handbook**.

In addition to a review of the financial condition of the Company, the examination included a review of the Company’s business policies and practices, corporate records, provider contracts, reinsurance treaties, conflict of interest disclosure statements, fidelity bonds and other insurance, employees’ pension and benefits plans, disaster recovery plan, and other pertinent matters to provide reasonable assurance that the Company was in compliance with applicable laws, rules and regulations. In planning and conducting the examination, consideration was given to the concepts of materiality and risk and examination efforts were directed accordingly.

In determining the scope of the statutory examination, after review and evaluation, the Division placed reliance on certain workpapers provided by the Company's external auditors, Ernst & Young, LLP (E&Y). Wherever possible and wherever deemed appropriate and effective, their independent work product was used to define, support, document and expedite the overall examination process.

DESCRIPTION OF COMPANY

History

Fallon Community Health Plan is a Health Maintenance Organization providing comprehensive health care services, on a prepaid basis, to subscribing individuals and groups primarily in Central Massachusetts. The Company is a not-for-profit organization, exempt from federal income taxes under Section 501 (c)(3) of the Internal Revenue Code. Its wholly owned subsidiary, Fallon Health and Life Assurance Company, Inc. (FHLAC) is a Massachusetts stock life and health insurance company focusing on indemnity insurance, PPO and administrative services only type arrangements.

The Corporation was incorporated in 1975 as a nonprofit organization and became fully operational as a group model health maintenance organization (HMO) in February 1977 under the provisions of M.G.L. Chapter 176G. The Corporation was established through a joint effort of the Fallon Clinic and Blue Cross Blue Shield of Massachusetts, Inc. to provide prepaid health care to the Worcester County community. Specifically, the purpose of Fallon, as stated in the Articles of Organization, is to provide comprehensive prepaid health insurance in a managed, cost effective manner.
In November 1978, the Corporation was federally qualified by the Department of Health, Education and Welfare. Since 1978, Fallon’s federally approved service area has been expanded four times and currently includes ninety-one communities in Central and Eastern Massachusetts.

In January 1980, a contract with the Commonwealth of Massachusetts established a Fallon Medicaid HMO program to provide continuity of care to qualified Medicaid members of Central Massachusetts in a cost effective manner.

In April 1980, the Fallon Senior Plan became operational as a demonstration project to determine whether an HMO could serve the needs of the Medicare population in a cost effective manner. The five-year demonstration phase ended and in April of 1985, a contract was established with the Health Care Financing Administration to continue the program.

In 1986, the Direct Enrollment Program began offering non-group coverage directly to the public. In 1988, Blue Cross Blue Shield of Massachusetts, Inc. withdrew as a sponsoring organization of Fallon with the intention of developing its own prepaid health care plans.

In July 1990, the Corporation acquired the right to appoint the Corporate Members of the St. Vincent Hospital System (SVHS). Historically, Fallon has maintained a close working relationship with St. Vincent Hospital of Worcester, Massachusetts.

In March 1991, The Fallon Foundation was substituted for Fallon as the entity holding rights to appoint the Corporate Members of SVHS. Together with the Fallon Clinic, Inc. (the Clinic), the Fallon Foundation effectively created a vertically integrated health care delivery system.

In October 1992, the Corporation formed and owns 100% of its subsidiary, Fallon Health and Life Assurance Company, Inc. (FHLAC), which is licensed in Massachusetts only to sell accident and health products.

In 1996, Tenet Healthcare Corp. (Tenet) became the majority shareholder of Saint Vincent Hospital, LLC (SVHLLC), formerly SVHS. Tenet also acquired a minority interest in the Clinic and has certain special liquidation preferences and minority shareholder rights, including representation on the Board of Directors and approval of most major transactions.

On October 1, 1996, Fallon, the Clinic and SVHLLC entered into long-term provider and administrative services agreements covering the majority of Fallon’s members. Under these agreements, referral, hospital and nursing home services, which were previously expensed as incurred, are capitated. The capitation is based on earned premiums. In addition, medical facilities costs in excess of the applicable capitation are subject to a risk sharing arrangement.

Effective January 1, 2003, the Plan no longer pays SVHLLC capitation, but rather pays claims based upon contracted rates for hospital services. Additionally in 2003, medical facilities’ costs that exceed the related capitation are subject to a risk-sharing arrangement between the Plan and the Clinic.

Effective January 1, 2004, the Board of Directors of both the Fallon Foundation and FCHP agreed to restructure the governance of FCHP. This restructure was accomplished by a change in the bylaws of FCHP under which Fallon Foundation ceased to: (a) be of member of FCHP; (b) elect members of the board of directors of FCHP; and (c) exercise approval powers over FCHP. While FCHP remains a membership corporation, under the new bylaws, its members will at all times be those individuals then serving as directors. Consistent with this change, all directors of FCHP affiliated with Fallon Foundation or Fallon Clinic resigned.

**Organization**
FCHP is a not-for-profit health maintenance organization domiciled in Massachusetts. Fallon has a wholly-owned subsidiary, Fallon Health and Life Assurance Company, Inc., which is a Massachusetts stock life and health insurance company focusing on indemnity health insurance and administrative services only type arrangements. FCHP and FHLAC are established for the purpose of arranging for the delivery of comprehensive health care services, on a pre-paid basis, to subscribing individuals and groups.

**Net Worth**

As a nonprofit organization, Fallon does not have issued capital. Net worth represents the excess of revenues over expenses since inception. The total admitted assets, total liabilities and net worth of the Company from 2002 to 2004 is shown in the following schedule.

<table>
<thead>
<tr>
<th>Year</th>
<th>Total Admitted Assets</th>
<th>Total Liabilities</th>
<th>Net Worth</th>
</tr>
</thead>
<tbody>
<tr>
<td>2002</td>
<td>$141,854,602</td>
<td>$81,653,244</td>
<td>$60,201,358</td>
</tr>
<tr>
<td>2003</td>
<td>$191,265,186</td>
<td>$113,204,990</td>
<td>$78,060,196</td>
</tr>
<tr>
<td>2004</td>
<td>$211,644,206</td>
<td>$105,744,943</td>
<td>$105,899,263</td>
</tr>
</tbody>
</table>

**MANAGEMENT AND CORPORATE RECORDS**

**Articles of Organization and Bylaws**

The Company’s Bylaws may be amended or repealed and new Bylaws may be adopted, by the affirmative vote of the Board of Directors at any annual meeting of the Board of Directors or at any special meeting of the Board of Directors called for that purpose; provided, further that the notice of which shall either specify the articles to be affected or the subject matter of the proposed amendment or repeal.

**Members and Membership**

The Company’s Bylaws indicate the following regarding its corporate membership:

- The Corporation shall be a membership organization. The “Members” shall be comprised of individuals who are serving as members of the Board of Directors (pursuant to Article 4), excluding the President of FCHP.

- The meetings of the Members shall be held at the principal office of FCHP in Massachusetts or at such other place as may be named in the call of the meeting. The annual meeting of the Members shall be held in the month of June, at such hour and place as may be named in the call of the meeting, or at such other time and date as may be set by the Board of Directors. The purposes for which an annual meeting is to be held, in addition to those prescribed by the law, by the Articles of Organization, and by the Bylaws, may be specified by the Board of Directors or by a writing signed by any of the Chair of the Board, President, Vice Chair, or a quorum of the Directors. In the event the annual meeting is not held on such date, a special meeting in lieu of the annual meeting may be held with all the force and effect of an annual meeting.

- Special meetings of the Members may be called by the Chair of the Board, President, or by a quorum of the Directors, and shall be called by the Clerk, or in the case of the death, absence, incapacity or refusal of the Clerk, by any other officer of the Corporation. Such call shall state the time, place and purpose of the meetings.

**BOARD OF DIRECTORS**

The Company’s Bylaws indicate the following regarding its Board of Directors (the Board):

6
• The Board of Directors shall have and may exercise all the powers of FCHP except such powers as are conferred upon the Members by law, by the Articles of Organization, or by the Bylaws.

• The Board of Directors will consist of not less than five (5) nor more than thirteen (13) voting members, with the exact number being set by the Board of Directors from time-to-time. The President of FCHP shall serve as an ex officio member of the Board of Directors with vote and shall be counted for purposes of determining the total number of Directors set forth in the preceding sentence.

• The terms of the Directors shall be staggered with approximately one-third (1/3) of the total number of Directors to be elected at each annual meeting of the Board of Directors. Except as necessary to stagger the terms of the Directors, each Director shall be elected for a three-year term. Each Director, except for an ex officio Director, will be limited to a maximum of three, three-year terms, and shall serve until his or her respective successor is elected and qualified. A partial term or term of less than three years shall not be considered as a three-year term for purposes of the preceding. Ex officio Directors shall serve for so long as they hold their underlying office position.

• Regular meetings of the Board of Directors shall be held at such places, within or without the Commonwealth of Massachusetts, and at such times as the Board of Directors may, by vote from time to time, determine, provided that the Board of Directors shall meet at least quarterly.

• Special meetings of the Board of Directors may be held at any time and at any place, within or without the Commonwealth of Massachusetts, when called by the Chair of the Board, President or by two or more members of the Board of Directors.

• At any meeting of the Board of Directors, the presence of a majority of the Directors in office shall constitute a quorum for the consideration of any questions, but a smaller number of Directors may adjourn any meeting from time to time, and the meeting so adjourned may be held without further notice when a quorum is secured. When a quorum is present at any meeting, the vote of a majority of the Directors present and entitled to vote on the question, shall, except where a larger vote is required by law, by the Articles of Organization, or by the Bylaws, decide any question brought before such a meeting; provided that no question may be decided by less than a majority of all Directors then in office and entitled to vote thereon.

At December 31, 2004, the Board was comprised of ten (10) directors, which is in compliance with the Company Bylaws.
Directors duly elected and serving at December 31, 2004, with addresses and business affiliations, are as follows:

<table>
<thead>
<tr>
<th>Director</th>
<th>Principal Occupation</th>
<th>Term Expires</th>
</tr>
</thead>
<tbody>
<tr>
<td>Christopher F. Egan</td>
<td>Managing Partner - Carruth Capital, LLC</td>
<td>June 2005</td>
</tr>
<tr>
<td>Karen H. Green</td>
<td>President &amp; CEO - VNA Care Network</td>
<td>June 2007</td>
</tr>
<tr>
<td>David W. Hillis</td>
<td>President &amp; CEO - AdCare, Inc.</td>
<td>June 2007</td>
</tr>
<tr>
<td>Richard Houlihan, Esq.</td>
<td>Attorney</td>
<td>June 2006</td>
</tr>
<tr>
<td>Sandra L. Kurtinitis, Ph.D.</td>
<td>President - Quinsigamond Community College</td>
<td>June 2005</td>
</tr>
<tr>
<td>Charles F. Monahan</td>
<td>President - Massachusetts College of Pharmacy</td>
<td>June 2007</td>
</tr>
<tr>
<td>Robert P. Restrepo, Jr.</td>
<td>President – Allmerica Financial</td>
<td>June 2005</td>
</tr>
<tr>
<td>Eric H. Schultz</td>
<td>President - Fallon Community Health Plan</td>
<td>N/A</td>
</tr>
<tr>
<td>Nicola S. Tsongas</td>
<td>Program Development – Middlesex Community College</td>
<td>June 2006</td>
</tr>
</tbody>
</table>

Committees of the Board

The current standing committees of the Board are as follows:

Executive Committee
The Board of Directors may appoint, from its members, at its first meeting held after the annual meeting of the Members in each year, an Executive Committee consisting of not less than three (3) nor more than five (5) Directors, with the exact number being set by the Board of Directors from time-to-time. Such committee may be delegated, from time to time until further order of the Board of Directors, any or all of the powers of said Board of Directors in connection with the affairs of FCHP except as may be limited by Chapter 180 of the General Laws of Massachusetts – Corporations For Charitable and Certain Other Purposes (“the Act”). Quorum and voting requirements shall be the same for the Executive Committee as they are for the Board of Directors.

Additional Standing Committee
The Board of Directors may appoint from within or without its own membership any standing or other committee it considers necessary to carry out the functions of FCHP. All such committees shall have such duties as the Directors may prescribe and shall be subject to the general supervision of the Board of Directors and requirements of the Act. Notwithstanding the foregoing, any committee that is delegated the power of the Board of Directors to act on behalf of the Corporation shall be comprised solely of Directors.
Patient Care Assessment Committee
There shall be a Patient Care Assessment Committee. This Committee shall serve as the “Patient Care Assessment Committee” of the Plan as defined in the Qualified Patient Care Assessment Program Regulations of the Board of Registration in Medicine (the “Regulations”). The Board of Directors shall adopt and shall review annually a “Qualified Patient Care Assessment Program” in compliance with the requirements of the Regulations. There shall be at least one member of the Board of Directors on this committee.

Nominating Committee
There shall be a Nominating Committee that is composed of no more than three (3) members. The President shall not be a voting member of the Nominating Committee, but may attend and participate in the Nominating Committee’s deliberations. Prior to the annual meeting of the Board of Directors and prior to any special meeting of the Board of Directors at which the election of Directors is to be held, the Nominating Committee shall recommend to the Board of Directors a slate of nominees for election as Directors. The Board of Directors shall attach the slate of nominees to the notice of the meeting.

The active committees of the Board are as follows:

- Audit and Compliance Committee
- Finance Committee
- Service & Quality Oversight Committee
- Executive Evaluation and Compensation Committee

OFFICERS

FCHP, shall have, as its officers, a Chair of the Board, Vice Chair, President and CEO, Treasurer, Clerk and such other officers, including but not limited to Vice Presidents, as the Board of Directors, in its discretion, from time-to-time shall appoint. The Chair of the Board, the Vice Chair, the Treasurer and the Clerk shall be elected annually by the Board of Directors at the annual meeting after the Board of Directors’ election. The President and CEO shall be appointed by the Board of Directors.

The Chair of the Board, the Vice Chair, and the Treasurer shall be Directors. The Clerk shall be a resident of Massachusetts, but need not be a Director. So far as permitted by law, any two or more offices may be filled by the same person.

Any officer or agent may resign at any time by delivering his or her resignation, in writing to the Chair of the Board, President, or Clerk, or to a meeting of the Board of Directors. The Board of Directors may remove from office, with or without cause, any officer appointed by the Board of Directors or terminate or modify the authority of any such officer or any agent; provided, however, that in the case of the President, any such removal shall be consistent with the terms of any employment with such officer.

If the office of the Chair of the Board, the Vice Chair, the Treasurer, or the Clerk, or any other officer becomes vacant by reason of death, resignation or removal, the Board of Directors may elect a successor. If the office of the President becomes vacant by reason of death, resignation or removal, the Board of Directors may appoint a successor. Each such successor shall hold office of the unexpired term, and continue thereafter until his or her successor shall be elected or appointed and qualified.

The President and CEO shall be elected or appointed by the Board of Directors in the manner and for the term set forth in the Bylaws.

The elected officers and their respective titles at December 31, 2004 were as follows:
CONFLICT OF INTEREST PROCEDURES

Each Director and Officer of FCHP, in a manner and form prescribed by the Company’s Conflict of Interest Policy, shall be required to disclose fully any conflict of interest as defined in the Policy or in the Company's Bylaws. Should a conflict arise, the interested Director may make a presentation regarding the transaction in question, after which the remaining disinterested directors discuss and vote on the transaction. If appropriate, a disinterested Director or committee may be appointed to investigate alternatives to the transaction in question. After exercising due diligence, the Board of Directors shall determine whether the Company, through reasonable efforts, can obtain a more advantageous transaction that would avoid the conflict of interest. If such an alternative is not available, the Board of Directors shall determine by a majority vote of the disinterested Directors whether the transaction is in the Company’s best interest and whether it is fair and reasonable to the company. In case FCHP enters into a contract or business transaction that would involve a Director or Officer conflict of interest, such contract or transaction is not invalidated by the fact that one or more Directors or Officers have interests that may be adverse to the interests of the Company.

The completed Conflict of Interest Statements were reviewed, and no discrepancies were noted in the response to the General Interrogatories regarding conflicts of interest as reflected in the Company’s 2004 Annual Statement.

CORPORATE RECORDS

Articles of Incorporation and Bylaws

The Bylaws and Articles of Incorporation and amendments were reviewed for the examination period. The Corporation is operating in accordance with the purpose, functions and policies as set forth in the Bylaws and Articles of Incorporation.

Board of Directors Minutes

The minutes of the Board of Directors meetings were reviewed and found to contain all the necessary votes and authorizations, which are in compliance with the Corporation’s Bylaws and laws of the Commonwealth of Massachusetts.

ACQUISITIONS, Mergers, Disposals, Dissolutions and Purchases or Sales

None.

MANAGEMENT CONTINUITY AND NATIONAL EMERGENCY

The Company provides for the continuity of management and operations in the event of a catastrophe or national emergency in accordance with Massachusetts General Laws, Chapter 175 § 180M-180Q.

AFFILIATED COMPANIES

Subsidiaries and Affiliated Companies
The Company has a wholly-owned subsidiary, Fallon Health and Life Assurance Company, Inc. (FHLAC). FHLAC is a Massachusetts stock life and health insurance company. FHLAC has no employees and, accordingly, the Company provides all administrative services to FHLAC, including premium collection, claims processing and operational management in return for an administrative fee that is included as an offset to expense. The total fees for the years ended December 31, 2004 and 2003 amounted to approximately $871,000 and $462,000, respectively. The settlement of intercompany activity takes place monthly.

**RELATED PARTY TRANSACTIONS**

- Medical capitation to the Clinic were approximately $189,000 and $191,000 in 2004 and 2003, respectively. Amounts receivable from and payable to the Clinic consist primarily of unpaid medical capitation and other intercompany transactions. At December 31, 2004 and 2003, medical services and shared-risk arrangements included approximately $4.9 million payable to the Clinic in 2004 and $3.45 million receivable from the Clinic in 2003.

- The Clinic provided the Plan with certain administrative services totaling approximately $400,000 and $2.3 million in 2004 and 2003, respectively.

- Fallon made cash donations to the Foundation of approximately $400,000 and $590,000 in 2004 and 2003, respectively, which has been recorded in general and administrative expenses.

**FIDELITY BOND AND OTHER INSURANCE**

The Corporation maintains fidelity bond coverage with an authorized Massachusetts insurer. The aggregate limit of liability is within the NAIC suggested minimum.

In addition to the bond insurance, the Corporation has other insurance purchased from authorized insurers in the form of professional liability and excess professional liability coverage.

**PENSION AND INSURANCE PLANS**

**Employees’ Retirement Plan**

FCHP maintains a defined benefit pension plan that covers all of the Company’s eligible full-time employees. Benefits are based on years of credited service and the employee’s annual pay credits, which are the product of the employees’ compensation for each year of service. The Company makes contributions in amounts sufficient to meet the minimum funding requirements of the Employee Retirement Income Security Act of 1974 (ERISA). The Plan has a December 31 measurement date. Pension plan assets principally consist of common stock, debt securities and mutual funds. At December 31, 2004, the plan was under-funded as the actuarial present value of the benefit obligations exceeded plan assets.

**SPECIAL DEPOSITS**

The special deposits of the Company at December 31, 2004 are as follows:

<table>
<thead>
<tr>
<th>Description of Deposit</th>
<th>Where Deposited</th>
<th>Par or Book Value</th>
<th>Statement Value</th>
<th>Market Value</th>
</tr>
</thead>
<tbody>
<tr>
<td>USTNTS 3.5o Due 11/15/2006</td>
<td>State Treasurers Office – SSB RSD by Chapter 176 (g), Section 26</td>
<td>$1,000,000</td>
<td>$1,008,945</td>
<td>$1,008,440</td>
</tr>
</tbody>
</table>
TERRITORY AND PLAN OF OPERATION

 Territory

The Corporation is only licensed to transact business in the Commonwealth of Massachusetts.

 Plan of Operations

 Commercial Territory Summaries

 HMO Product

Previously the Corporation offered a one size fits all delivery system. After researching the health care market in Massachusetts and listening to feedback from members, providers and employees, the Corporation revised the product strategy and developed two sizes of networks to fit the needs of employers (FCHP Direct Care and FCHP Select Care—See “Products” section at Page 13).

The Corporation created two networks, two service areas and two different sets of products however, both product sets still include core medical benefits including the Peace of Mind Program which allows members access to the Boston tertiary facilities, dental and benefits and discounts, and chiropractic care. In addition, the Corporation offers other features such as an “It Fits” program which rewards members who join a fitness facility or participate in Weight Watchers®. Members also receive vision care and the exclusive Naturally Well suite of complementary care discounts. Naturally Well gives members discounts on acupuncture, chiropractic care (in addition to any chiropractic benefit their plan may have) and massage therapy from the American Specialty Health Networks, Inc. (ASHN) credentialed network of qualified providers.

 PPO Product

Fallon Preferred Care is a preferred provider organization (PPO) product that puts members in touch with a broad network of quality providers across the country. Members who see a network provider will receive the highest level of coverage. Members who choose to access a provider from outside the network will share a larger portion of the cost. The highlights of Fallon Preferred Care include a nationwide network of more than 383,000 providers, including Private Healthcare Systems (PHCS) and Fallon Clinic, in-network and out-of-network levels of benefits and no referrals required.

 Medicaid Territory Summary

 FCHP MassHealth

Note: MassHealth members who join the Corporation are only eligible to enroll in FCHP MassHealth, with a Fallon Clinic PCP.

Corporation members who are enrolled through MassHealth have some nonstandard benefits that provide additional coverage for some services through the Corporation. The Corporation coordinates access to additional coverage for MassHealth members through one of the following programs: FCHP MassHealth Standard, FCHP MassHealth Basic, and FCHP MassHealth Family Assistance. Additional benefits available to MassHealth members include reduced rates at fitness clubs and discounted network for alternative therapy such as acupuncture, chiropractic care and massage therapy.

Individuals enrolled with the Corporation through the Commonwealth of Massachusetts Division of Medical Assistance (DMA), depending upon their MassHealth category, are enrolled in one of the programs listed above. The benefits for these programs are slightly different from each other.
PRODUCTS

The Company offers the following insured managed care products:

Fallon Community Health Plan Direct Care – This HMO plan offers access to group practices from four providers in Central Massachusetts, with an emphasis on coordinated, same-site services.

Fallon Community Health Plan Select Care – This HMO plan provides an expansive health care network. If the member chooses a primary care provider (PCP) from Fallon Clinic, then they can refer themselves to any Fallon Clinic specialist.

Fallon Community Health Plan Flex Care Direct and Select - These point-of-service (POS) plans give members access to a wider selection of providers. With a Flex Care plan, the member gets the same benefits and network of physicians as the HMO plans. Plus, the member has the choice to see a provider outside the network by paying a higher percentage of the cost. Flex Care Direct and Flex Care Select plans use the respective networks offered by the Direct Care and Select Care HMO’s.

Fallon Senior Plan - This plan not only covers Medicare, but also provides additional services like routine physical exams, hearing screenings and dental benefits. Copayments apply. Premiums, limitations and restrictions may apply.

Fallon Community Health Plan Independent Care - This plan gives members the choice to have health care when they are not eligible for health insurance through another source. This is a “guaranteed issue” plan, available regardless of the member’s health condition. Massachusetts residents who live within the service area have access to this plan, which includes worldwide emergency coverage.

Major Medical - This plan is a traditional indemnity insurance product that helps members get care even if they live or work outside of the service area. Members can access any providers they like, while Fallon pays a percentage of the fee for any covered services.

Fallon Preferred Care – This preferred provider organization (PPO) product offers access to a nationwide network of health care providers and no referral requirements. Members may also choose to access out-of-network providers by paying a higher percentage of the cost.

Fallon Community Health Plan MassHealth – This plan is available to Medicaid recipients, and provides worldwide emergency coverage and access to physicians and interpreters fluent in numerous languages.

Summit ElderCare – This Program of All-inclusive Care for the Elderly (PACE) is available to senior citizens in the Worcester, Massachusetts area. This total insurance plan offers full prescription drug and hospitalization coverage, and specialized geriatric care. Participants must be Medicaid eligible and able to live independently.

PROVIDER CONTRACTS

The Corporation has entered into a variety of contractual agreements (Health Service Agreements or “HSAs”) with providers of health care services including physicians, hospitals and ancillary providers (e.g., lab services, MRIs, pharmacies, etc.). Some of these contracts are with provider organizations such as hospitals, IPAs, PHOs, Group Practices and individual physicians. The HSAs specify the services to be covered and the financial arrangements between the parties. The HSAs are typically a one-year initial term with a twelve (12) month auto-renew thereafter until a written notice of non-renewal is sent by either party no less than 60 days prior to the automatic renewal date. A few of the Corporation’s major HSAs have multi-year terms.
Some HSAs contain a risk sharing mechanism, though the industry trend is to replace risk sharing with negotiated service rates including a pay-for-performance component. For those HSAs continuing risk relationships, the Corporation prepares an annual demographically adjusted budget that establishes utilization and cost targets for inpatient and outpatient care for each provider unit and for the Corporation collectively. Each provider unit’s actual performance is compared against its own budget. If applicable, a withhold may be returned based on the provider unit’s relative performance compared to its budget.

The provider organizations must participate in the Corporation’s utilization review and quality assurance program.

The HSAs specify the services to be covered and the financial arrangements between the Corporation and the various individual providers, groups and hospitals. The HSAs prohibit providers or provider organizations from balance billing enrollees for covered services rendered under the agreement.

The agreements are in compliance with Massachusetts statutes and regulation 211 CMR 43.10(1)(C).

RESERVES

In conjunction with KPMG’s examination of the statutory financial statements of the Fallon Community Health Plan, KPMG was engaged by the Division to review the adequacy of the Unpaid Claim Liability (UCL) of FCHP as of December 31, 2004.

KPMG actuaries prepared independent estimates of the unpaid claim liabilities for several periods prior to September 2005 based on the data provided. For December 31, 2004, completion factors for the projection of ultimate incurred claims were developed using historical payment patterns and actuarial judgment. “Low” and “High” estimates were developed by subtracting the claims paid-to-date from KPMG’s range of incurred claims estimates. As the FCHP business pays fairly quickly, the range of estimates for the December 31, 2004 UCL is narrow and KPMG’s estimates are similar to FCHP’s estimates with hindsight through September 30, 2005.

Based upon KPMG’s review, the Unpaid Claims Liability at December 31, 2004 appears to be fairly stated in aggregate in all material respects. FCHP made a separate provision for Claim Adjustment Expenses (LAE/CAE) in 2004 in accordance with standard actuarial practice. The resulting expense percentage levels used are within industry norms.

FCHP is holding a premium deficiency reserve of $2 million as of December 31, 2004. This reserve methodology is conservative; however the overall approach is within current reserving guidelines.

REINSURANCE

The Company carries reinsurance against excessive hospital utilization. Under this policy, the Company is reimbursed 50% to 90% of certain hospital claims over the policy deductibles, which range from $225,000 to $500,000. The maximum reinsurance for inpatient claims over a member's lifetime is limited to $2.0 million.

The Company remains obligated for amounts ceded in the event the reinsurer does not meet its obligations. The Company recorded $333,000 of reinsurance recoveries in 2004.

ACCOUNTS AND RECORDS

The books and records of the Company are audited annually by the independent certified public accounting firm of Ernst & Young LLP, in accordance with 211 CMR 43.14. The CPA Firm issued an unqualified opinion on the
December 31, 2004 audited financial statements. The Company is also subject to review by an internal audit department.

The internal control structure was discussed with management through questionnaires and through a review of the work performed by the Corporation’s Independent Certified Public Accountants (Ernst & Young LLP). No material internal control weaknesses were noted in connection with the examination, nor were any such matters reported in the CPA Firm’s filings with the Division.

The NAIC provides a questionnaire covering the evaluation of the controls in the EDP systems environment. The questionnaire was completed by the Company and reviewed by KPMG’s Information Risk Management (IRM) team that evaluated the adequacy of the EDP controls. No material deficiencies were noted.

The Company uses an automated general ledger system. Trial balances were traced from the general ledger and supporting documents to the 2004 Annual Statement. No material exceptions were noted.

**SUBSEQUENT EVENTS**

- First Quarter 2005 – FCHP made a capital contribution of $500,000 to FHLAC.
- Third Quarter 2005 – FCHP made a capital contribution of $250,000 to FHLAC.
- Fourth Quarter 2005 – FCHP made a capital contribution of $250,000 to FHLAC.

**COMMITMENTS AND CONTINGENCIES**

*Lease Obligations*

FCHP leases administrative facilities under operating leases with various lease terms expiring March 2020. The leases provide for base monthly rent, plus proportionate shares of real estate taxes and certain operating expenses, and include various options to extend their terms. In 2004, total lease expense was approximately $2.5 million.

*Legal Proceedings*

The Company is involved in litigation incidental to its business. Management and legal counsel believe that the results of such proceedings, in the aggregate, will not have a material adverse effect on the Company’s operations or financial position.
FINANCIAL STATEMENTS

The Financial Statement section includes the following:

- Statutory Statement of Assets, Liabilities and Capital & Surplus as of December 31, 2004: Page 17
- Analysis of Assets Exhibit as of December 31, 2004: Page 18
- Statement of Revenue and Expenses for the Year Ended December 31, 2004: Page 19
- Capital & Surplus for the Year Ended December 31, 2004: Page 20

The following financial statements are presented on the basis of accounting practices prescribed or permitted by the Commonwealth of Massachusetts Division of Insurance and by the National Association of Insurance Commissioners as of December 31, 2004.
Fallon Community Health Plan, Inc  
Statutory Statement of Assets, Liabilities and Capital & Surplus  
As of December 31, 2004

<table>
<thead>
<tr>
<th></th>
<th>Annual Statement</th>
<th>Statutory Examination</th>
<th>Per Statutory Examination</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>ASSETS</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Bonds</td>
<td>$ 86,180,725</td>
<td>$</td>
<td>$ 86,180,725</td>
</tr>
<tr>
<td>Stocks:</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Common stocks</td>
<td>65,987,797</td>
<td>-</td>
<td>65,987,797</td>
</tr>
<tr>
<td>Cash, cash equivalents and short-term investments</td>
<td>49,769,017</td>
<td>-</td>
<td>49,769,017</td>
</tr>
<tr>
<td>Subtotals, cash and invested assets</td>
<td>201,937,539</td>
<td>-</td>
<td>201,937,539</td>
</tr>
<tr>
<td>Investment Income due and accrued</td>
<td>905,485</td>
<td>-</td>
<td>905,485</td>
</tr>
<tr>
<td><strong>LIABILITIES</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Claims unpaid</td>
<td>$ 54,809,562</td>
<td>$</td>
<td>$ 54,809,562</td>
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<tr>
<td>Accrued medical incentive pool and bonus amounts</td>
<td>443,109</td>
<td>-</td>
<td>443,109</td>
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<tr>
<td>Unpaid claims adjustment expenses</td>
<td>613,860</td>
<td>-</td>
<td>613,860</td>
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<tr>
<td>Aggregate health policy reserves</td>
<td>2,000,000</td>
<td>-</td>
<td>2,000,000</td>
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<tr>
<td>Premiums received in advance</td>
<td>12,261,978</td>
<td>-</td>
<td>12,261,978</td>
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<tr>
<td>General expenses due or accrued</td>
<td>5,210,044</td>
<td>-</td>
<td>5,210,044</td>
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<tr>
<td>Amounts due to parent, subsidiaries and affiliates</td>
<td>421,159</td>
<td>-</td>
<td>421,159</td>
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<tr>
<td>General Salaries and Benefits</td>
<td>4,820,568</td>
<td>-</td>
<td>4,820,568</td>
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<tr>
<td>Other Liabilities</td>
<td>25,164,663</td>
<td>-</td>
<td>25,164,663</td>
</tr>
<tr>
<td><strong>Total Liabilities</strong></td>
<td>$ 105,744,943</td>
<td>$</td>
<td>$ 105,744,943</td>
</tr>
<tr>
<td><strong>NET WORTH</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Minimum pension liability</td>
<td>$ 72,993</td>
<td>$</td>
<td>$ 72,993</td>
</tr>
<tr>
<td>Unassigned funds (surplus)</td>
<td>105,826,270</td>
<td>-</td>
<td>105,826,270</td>
</tr>
<tr>
<td><strong>Total Capital and Surplus</strong></td>
<td>105,899,263</td>
<td>-</td>
<td>105,899,263</td>
</tr>
<tr>
<td><strong>Total Liabilities, Capital and Surplus</strong></td>
<td>$ 211,644,206</td>
<td>$</td>
<td>$ 211,644,206</td>
</tr>
</tbody>
</table>
Fallon Community Health Plan, Inc.
Analysis of Assets Exhibit
As of December 31, 2004

<table>
<thead>
<tr>
<th>Assets</th>
<th>Nonadmitted</th>
<th>Net Admitted</th>
<th>Statutory Examination Adjustment</th>
<th>Per Statutory Examination</th>
</tr>
</thead>
<tbody>
<tr>
<td>Bonds</td>
<td>$86,180,725</td>
<td></td>
<td></td>
<td>$86,180,725</td>
</tr>
<tr>
<td>Stocks:</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Common stocks</td>
<td>65,987,797</td>
<td></td>
<td>65,987,797</td>
<td>65,987,797</td>
</tr>
<tr>
<td>Cash, cash equivalents and short-term investments</td>
<td>49,769,017</td>
<td></td>
<td>49,769,017</td>
<td>49,769,017</td>
</tr>
<tr>
<td>Subtotals, cash and invested assets</td>
<td>201,937,539</td>
<td></td>
<td>201,937,539</td>
<td>201,937,539</td>
</tr>
<tr>
<td>Investment Income due and accrued</td>
<td>905,485</td>
<td></td>
<td>905,485</td>
<td></td>
</tr>
<tr>
<td>Uncollected premiums and agents' balances in the course of collection</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Amounts receivable relating to uninsured plans</td>
<td>2,331,598</td>
<td>2,331,598</td>
<td></td>
<td>2,331,598</td>
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<tr>
<td>Furniture and equipment</td>
<td>1,630,289</td>
<td>1,630,289</td>
<td></td>
<td></td>
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<tr>
<td>Receivables from parent, subsidiaries and affiliates</td>
<td>285,593</td>
<td>285,593</td>
<td></td>
<td>285,593</td>
</tr>
<tr>
<td>Health care and other amounts receivable</td>
<td>6,183,685</td>
<td></td>
<td>6,183,685</td>
<td>6,183,685</td>
</tr>
<tr>
<td>Other assets nonadmitted</td>
<td>905,060</td>
<td></td>
<td>905,060</td>
<td></td>
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<tr>
<td><strong>Total Assets</strong></td>
<td><strong>214,179,555</strong></td>
<td><strong>211,644,206</strong></td>
<td></td>
<td><strong>211,644,206</strong></td>
</tr>
</tbody>
</table>
Fallon Community Health Plan, Inc.
Statement of Revenue and Expenses
For the Year Ended December 31, 2004

<table>
<thead>
<tr>
<th>Description</th>
<th>Annual Statement</th>
<th>Statutory Examination Adjustment</th>
<th>Per Statutory Examination</th>
</tr>
</thead>
<tbody>
<tr>
<td>Member Months</td>
<td>2,082,893</td>
<td>-</td>
<td>2,082,893</td>
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<tr>
<td>Net premium income</td>
<td>$ 730,646,493</td>
<td>-</td>
<td>$ 730,646,493</td>
</tr>
<tr>
<td><strong>Total Revenues</strong></td>
<td>730,646,493</td>
<td>-</td>
<td>730,646,493</td>
</tr>
<tr>
<td>Hospital and Medical:</td>
<td></td>
<td></td>
<td></td>
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<tr>
<td>Hospital/medical benefits</td>
<td>558,856,274</td>
<td>-</td>
<td>558,856,274</td>
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<tr>
<td>Other professional services</td>
<td>18,296,517</td>
<td>-</td>
<td>18,296,517</td>
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<tr>
<td>Outside referrals</td>
<td>1,086,647</td>
<td>-</td>
<td>1,086,647</td>
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<tr>
<td>Emergency room and out-of-area</td>
<td>1,165,327</td>
<td>-</td>
<td>1,165,327</td>
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<tr>
<td>Prescription drugs</td>
<td>71,864,157</td>
<td>-</td>
<td>71,864,157</td>
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<tr>
<td>Other medical</td>
<td>3,988,975</td>
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<td>3,988,975</td>
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<tr>
<td>Incentive pool and withhold adjustments</td>
<td>575,722</td>
<td>-</td>
<td>575,722</td>
</tr>
<tr>
<td><strong>Subtotal</strong></td>
<td>655,500,506</td>
<td>-</td>
<td>655,500,506</td>
</tr>
<tr>
<td>Less:</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Net reinsurance recoveries</td>
<td>333,113</td>
<td>-</td>
<td>333,113</td>
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<tr>
<td><strong>Total medical and hospital</strong></td>
<td>655,833,619</td>
<td>-</td>
<td>655,833,619</td>
</tr>
<tr>
<td>Claims adjustment expenses</td>
<td>5,724,487</td>
<td>-</td>
<td>5,724,487</td>
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<tr>
<td>General administrative expenses</td>
<td>49,381,165</td>
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<td>49,381,165</td>
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<tr>
<td><strong>Total underwriting deductions</strong></td>
<td>710,606,158</td>
<td>-</td>
<td>710,606,158</td>
</tr>
<tr>
<td>Net underwriting gain</td>
<td>20,040,335</td>
<td>-</td>
<td>20,040,335</td>
</tr>
<tr>
<td>Net investment income earned</td>
<td>4,097,638</td>
<td>-</td>
<td>4,097,638</td>
</tr>
<tr>
<td>Net realized capital (losses)</td>
<td>(477,285)</td>
<td>-</td>
<td>(477,285)</td>
</tr>
<tr>
<td><strong>Net investment gains</strong></td>
<td>3,620,353</td>
<td>-</td>
<td>3,620,353</td>
</tr>
<tr>
<td>Other (Expense)</td>
<td>(612,168)</td>
<td>-</td>
<td>(612,168)</td>
</tr>
<tr>
<td><strong>Net Income</strong></td>
<td>$ 23,048,520</td>
<td>-</td>
<td>$ 23,048,520</td>
</tr>
<tr>
<td></td>
<td>Annual Statement</td>
<td>Statutory Examination Adjustment</td>
<td>Per Statutory Examination</td>
</tr>
<tr>
<td>----------------------------------</td>
<td>------------------</td>
<td>----------------------------------</td>
<td>---------------------------</td>
</tr>
<tr>
<td>Capital and Surplus, December 31, 2003</td>
<td>$ 78,060,196</td>
<td>$</td>
<td>$ 78,060,196</td>
</tr>
<tr>
<td>Net income or (loss)</td>
<td>23,048,520</td>
<td>-</td>
<td>23,048,520</td>
</tr>
<tr>
<td>Net unrealized capital gains and losses</td>
<td>3,426,632</td>
<td>-</td>
<td>3,426,632</td>
</tr>
<tr>
<td>Change in nonadmitted assets</td>
<td>1,290,922</td>
<td>1,290,922</td>
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</tr>
<tr>
<td>Minimum Pension Liability</td>
<td>72,993</td>
<td>72,993</td>
<td>72,993</td>
</tr>
<tr>
<td>Net change in capital and surplus</td>
<td>27,839,067</td>
<td>-</td>
<td>27,839,067</td>
</tr>
<tr>
<td>Capital and Surplus, December 31, 2004</td>
<td>$105,899,263</td>
<td>$</td>
<td>$105,899,263</td>
</tr>
</tbody>
</table>
ACKNOWLEDGMENT

This is to certify that the undersigned is a duly qualified Certified Financial Examiner (CFE) and that, in conjunction with KPMG LLP, applied certain agreed-upon procedures to the accounting and corporate records of the Fallon Community Health Plan, Inc. in order for the Division of Insurance of the Commonwealth of Massachusetts to fulfill the Commonwealth’s requirements regarding periodic Statutory Examinations of Massachusetts domiciled insurers.

The undersigned’s participation in this Statutory Examination as the Examiner-in-Charge encompassed responsibility for the coordination and direction of the statutory examination performed which was in accordance with, and substantially complied with, those standards established by the Financial Condition (E) Committee of the National Association of Insurance Commissioners (NAIC) and the NAIC Financial Condition Examiners’ Handbook. This participation consisted of involvement in the planning (development, supervision and review of agreed upon procedures), administration, review of work papers and preparation of the statutory examination report.

The cooperation and assistance of the officers and employees of Fallon Community Health Plan, Inc. extended to all examiners during the course of the examination is hereby acknowledged.

John Smallwood, CFE
Chief Examiner & Examiner in Charge (EIC)
Commonwealth of Massachusetts
Division of Insurance
Boston, MA