



**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, 2007*

**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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**COMMONWEALTH OF MASSACHUSETTS**  
**Office of Consumer Affairs and Business Regulation**  
**DIVISION OF INSURANCE**

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COMMISSIONER OF INSURANCE

April 6, 2009

The Honorable Alfred W. Gross, Chair  
Financial Condition (E) Committee, NAIC  
Commissioner  
Virginia Bureau of Insurance  
State Corporation Commission  
1300 East Main Street  
Richmond, Virginia 23219

The Honorable Joel Ario  
Secretary, Northeastern Zone NAIC  
Commissioner of Insurance  
Pennsylvania Insurance Department  
1326 Strawberry Square  
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The Honorable Nonnie S. Burnes  
Commissioner of Insurance  
Commonwealth of Massachusetts  
Office of Consumer Affairs and Business Regulation  
Division of Insurance  
One South Station  
Boston, Massachusetts 02110-2208

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

**Fallon Community Health Plan, Inc.**

at its main administrative office located at:

10 Chestnut Street  
Worcester, MA 01608-2810

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,” “the Corporation” or “FCHP,” is as of December 31, 2007, including any material transactions and 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 main administrative office in Worcester, Massachusetts. KPMG was engaged to perform certain agreed-upon procedures, which are in compliance with the *National Association of Insurance Commissioners (NAIC) Financial Condition Examiners' Handbook*. KPMG's Health 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, 2007. KPMG's Information Technology Advisory Services (ITAS) 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 ITAS specialists performed examination procedures pertaining to the examination of the IT 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 NAIC Financial Condition (E) Committee and prescribed by the current *NAIC Financial Condition Examiners' Handbook*. The principal focus of the examination was 2007 activity; however, transactions both prior and subsequent thereto were reviewed as deemed appropriate.

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 examination team placed reliance on certain workpapers provided by the Company's independent auditor, Ernst & Young LLP (E&Y). Wherever possible and wherever deemed appropriate and effective, E&Y's independent work product was used to define, support, document and expedite the overall examination process.

## **DESCRIPTION OF COMPANY**

### **History**

Fallon Community Health Plan, Inc. is a Health Maintenance Organization (HMO) providing comprehensive health care services on a prepaid basis to subscribing groups and individuals in Massachusetts. FCHP was incorporated in 1975 and commenced operations in 1977 through a joint effort of the Fallon Clinic, Inc. (Fallon Clinic) and Blue Cross and Blue Shield of Massachusetts, Inc. (BCBSMA). The Company is a not-for-profit organization, exempt from federal income taxation under Section 501(c)(3) of the Internal Revenue Code.

FCHP was an early developer of HMO coverage for Medicare and Medicaid beneficiaries, having established the Fallon Senior Plan to serve Medicare beneficiaries and the Fallon Medicaid HMO to serve Medicaid beneficiaries in 1980.

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BCBSMA withdrew as a sponsoring organization of FCHP in 1988. In 1990, FCHP acquired the right to appoint the Corporate Members of the St. Vincent Hospital System (SVHS) of Worcester, MA, which has historically maintained a close working relationship with FCHP. In 1991, the Fallon Foundation, Inc. (Fallon Foundation) was substituted for FCHP as the entity which held rights to appoint the Corporate Members of SVHS; combined with the Fallon Clinic, this arrangement effectively created a vertically integrated health care delivery system.

In 1992, FCHP formed Fallon Health and Life Assurance Company, Inc. (FHLAC), a Massachusetts stock life and health insurance company. FHLAC commenced operations in 1993. FHLAC is a wholly-owned subsidiary of FCHP, and focuses on Preferred Provider Organization (PPO) coverage, indemnity insurance and administrative services only (ASO) arrangements.

Effective January 1, 2004, FCHP deaffiliated with the Fallon Foundation. Prior to this restructuring, the Fallon Foundation was the sole corporate member of FCHP. The Fallon Clinic was, in turn, the sole corporate member of the Fallon Foundation and had maintained majority representation on FCHP's Board of Directors. Concurrent with the deaffiliation, all FCHP Directors who were affiliated with either the Fallon Foundation or the Fallon Clinic resigned. Since the deaffiliation took effect, the Fallon Foundation has ceased to be a member of the Company, to elect members of the FCHP Board of Directors and to exercise approval powers over FCHP. FCHP has remained a membership corporation since the deaffiliation became effective, but pursuant to the Company's By-Laws, its corporate membership consists of those individuals who serve as FCHP Directors.

On August 31, 2006, FHLAC acquired UltraBenefits, Inc. (UltraBenefits), a third party administrator in Massachusetts, for cash and future cash considerations based upon certain client retention provisions and profitability targets. UltraBenefits provides medical, dental and disability claims processing, as well as claims management services, premium and fee-billing services and administration of Flexible Spending Accounts, Health Reimbursement Accounts and COBRA.

### **Capital and Surplus**

Capital and Surplus consists of capital contributed to the Company and the excess of revenues over expenses since inception. The total admitted assets, total liabilities and capital and surplus of the Company for the years ended 2005 through 2007 are shown in the following schedule:

<u>Year</u>	<u>Total Admitted Assets</u>	<u>Total Liabilities</u>	<u>Capital and Surplus</u>
2007	\$300,046,293	\$128,576,343	\$171,469,950
2006	275,607,938	121,959,043	153,648,895
2005	227,031,058	92,695,438	134,335,620

### **MANAGEMENT**

#### **Articles of Organization and By-Laws**

The Company's By-Laws may be amended or repealed and new By-Laws 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 By-Laws 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, 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 Company's By-Laws, 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 By-Laws indicate the following regarding its Board of Directors (the "Board"):

- 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 Company's By-Laws.
- 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. 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 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 may determine by vote from time to time, 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.
- At any meeting of the Board, the presence of a majority of the Directors then in office shall constitute a quorum for the consideration of any questions, but a smaller number of Directors may adjourn any meeting, and the meeting so adjourned may be held without further notice when a quorum is secured. When a quorum is present at any meeting, subject to the provisions of the Company's Conflicts of Interest policy regarding Interested Directors, the

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vote of a majority of all of the Directors then in office entitled to vote on the question shall decide any question brought before such meeting, except where a larger vote is required by law, by the Articles of Organization or by the Company's By-Laws.

- Any action required or permitted to be taken at any meeting of the Board may be taken without a meeting if all Directors entitled to vote on the matter consent to the action in writing and the written consents are filed with the records of the meetings of the Board. Such consents shall be treated for all purposes as a vote at a meeting of the Board.
- Any Director may resign at any time by delivering his or her resignation in writing to a meeting of the Board of Directors or to the President. Any Director may be removed from office, with or without cause, by a vote of the majority of the remaining Directors then in office at any meeting called for that purpose, provided that an *ex officio* Director shall only be removed by removal from his or her underlying office position. Directors then in office may act despite a vacancy or vacancies in the Board, and shall for this purpose be deemed to constitute a full Board of Directors. Any vacancy in the Board of Directors, however occurring, may be filled by the election of a successor by majority vote of the remaining Directors then in office from a list of nominees prepared by the Nominating Committee. Each successor elected to fill a vacancy created by an unexpired term shall hold office for the balance of the unexpired term, and until his or her successor shall be elected or appointed and qualified.

At December 31, 2007, the Board was comprised of nine (9) Directors, which is in compliance with the Company's By-Laws. Directors duly elected and serving at December 31, 2007, with addresses and business affiliations, were as follows:

<u>Director</u>	<u>Term Expires</u>	<u>Principal Occupation</u>
Karen H. Green Worcester, MA	June 2010	President & CEO, VNA Care Network, Inc.
David R. Grenon Sutton, MA	June 2008 <sup>1</sup>	Retired CEO, Protector Insurance Group, Inc.
David W. Hillis Worcester, MA	June 2010	President & CEO, AdCare Hospital of Worcester, Inc.
Richard P. Houlihan, Esq. Holden, MA	June 2009	Retired Attorney
Sandra L. Kurtinitis, Ph.D. Baltimore, MD	June 2008 <sup>2</sup>	President, The Community College of Baltimore County
Christian W. McCarthy Worcester, MA	June 2008 <sup>3</sup>	Executive VP of Finance and Treasurer, Assumption College
Charles F. Monahan Boston, MA	June 2010	President, Massachusetts College of Pharmacy and Health Sciences
Rev. John J. Paris, S.J. Chestnut Hill, MA	June 2009	Professor of Bioethics, Boston College
Eric H. Schultz Worcester, MA	<i>Ex officio</i>	President and CEO, Fallon Community Health Plan, Inc.

<sup>1</sup>Mr. Grenon was appointed in December 2007 to complete the term of Christopher F. Egan, who resigned as a Director effective October 31, 2007. Mr. Grenon was reappointed to a new term in June 2008, which expires in June 2011.

<sup>2</sup>Dr. Kurtinis was reappointed to a new term in June 2008, which expires in June 2011.

<sup>3</sup>Mr. McCarthy was reappointed to a new term in June 2008, which expires in June 2011.



### **Committees of the Board**

The Company's By-Laws indicate the following regarding committees of the Board:

**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. Such committee may be delegated, from time to time until further order of the Board of Directors, any or all of the powers of the Board in connection with the affairs of FCHP except as may be limited by the General Laws of Massachusetts, Chapter 180 – Corporations For Charitable and Certain Other Purposes. Quorum and voting requirements shall be the same for the Executive Committee as they are for the Board of Directors.

**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.

**Patient Care Assessment Committee:** There shall be a Patient Care Assessment Committee. This Committee shall serve as the "Patient Care Assessment Committee" of FCHP as defined in the Qualified Patient Care Assessment Program Regulations of the Board of Registration in Medicine. 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.

**Additional Standing Committees:** 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 applicable state laws. 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.

The current standing committees of the Board and committee membership as of December 31, 2007 were as follows:

#### **Committee**

Audit and Compliance Committee  
Executive Evaluation and Compensation Committee  
Executive Committee  
Finance Committee  
Governance and Nominating Committee  
Service and Quality Oversight Committee

#### **Membership**

Rev. John J. Paris, S.J. (Chair); Karen H. Green; David R. Grenon  
Richard P. Houlihan, Esq. (Chair); David W. Hillis; Charles F. Monahan;  
Eric H. Schultz  
David W. Hillis (Chair); Karen H. Green; Richard P. Houlihan, Esq.;  
Christian W. McCarthy; Eric H. Schultz  
Christian W. McCarthy (Chair); Sandra L. Kurtinitis, Ph.D.; Eric H.  
Schultz  
Charles F. Monahan (Chair); Karen H. Green; Richard P. Houlihan, Esq.;  
Eric H. Schultz  
Lynda Young, M.D. (Chair); Jerry Gurwitz, M.D.; Robert Klugman, M.D.;  
Sandra L. Kurtinitis, Ph.D.; Janis Liepins; Charles F. Monahan;  
Christopher Seidler, M.D.;



## **OFFICERS**

FCHP may have as its officers a Chair of the Board, a Vice Chair, a President and Chief Executive Officer ("President and CEO"), a Treasurer, a Clerk, and may have such other officers, including but not limited to Division Presidents and Executive Vice Presidents, as the Board in its discretion shall appoint. The Chair of the Board, the Vice Chair, the Treasurer and the Clerk shall be elected annually by the Board at the annual meeting after the Directors' election.

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 it is permitted by law, any two or more offices may be filled by the same person.

The President and CEO shall be appointed by the Board and shall be the chief executive of FCHP. The President and CEO shall have general control and charge over the management of the ordinary affairs of FCHP. The term of the President and CEO shall be determined by the Board and may be contained in any employment agreement between FCHP and the President and CEO.

FCHP may have such Division Presidents and Executive Vice Presidents as recommended by the President and CEO and approved by the Board. Such Division Presidents and Executive Vice Presidents shall perform such duties and have such powers as are recommended by the President and CEO and approved by the Board.

Any officer or agent may resign at any time by delivering his or her resignation, in writing to the President and CEO, Chair of the Board 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 may terminate or modify the authority of any such officer or any agent; provided, however, that in the case of the President and CEO, 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, 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 for the unexpired term, and continue thereafter until his or her successor shall be elected or appointed and qualified.

The Company's officers and their respective titles at December 31, 2007 were as follows:

<b><u>Officer</u></b>	<b><u>Title</u></b>
Richard P. Houlihan, Esq. <sup>1</sup>	Chairman of the Board
Eric H. Schultz	President and Chief Executive Officer
Karen H. Green	Secretary
Christian W. McCarthy	Treasurer
W. Patrick Hughes	Division President, Health Plan Operations
Richard Burke <sup>2</sup>	Division President, Senior Care and Living
Charles Goheen	Chief Financial Officer
Mark Fisher <sup>3</sup>	Chief Operating Officer
Anne Doyle	Chief Compliance Officer
Barbara Chase, M.D. <sup>4</sup>	Chief Medical Officer (Interim)
Teena Osgood	Chief Human Resources Officer

<sup>1</sup>Mr. Houlihan resigned as Chairman of the Board effective December 18, 2008 and was elected Vice Chair. David W. Hillis was elected to replace Mr. Houlihan as Chairman effective December 18, 2008.

<sup>2</sup>Mr. Burke's title was amended to Division President, Senior Care Services, effective November 11, 2008.

<sup>3</sup>Mr. Fisher resigned from FCHP effective July 25, 2008. FCHP did not appoint a replacement to serve as Chief Operating Officer.

<sup>4</sup>Dr. Chase served as Interim Chief Medical Officer until Elizabeth Malko, M.D. was appointed to serve as Chief Medical Officer effective May 30, 2008.

### **CONFLICT OF INTEREST PROCEDURES**

Pursuant to the Company's By-Laws, the Company maintains a Conflict of Interest policy that is approved by the Board of Directors. Every Director and officer, in a manner and form to be prescribed by the Conflict of Interest Policy, shall be required as a condition of the office to disclose fully any conflict of interest as defined in the Conflict of Interest Policy and the Company's By-Laws. Should a conflict arise, the interested Director may make a presentation regarding the transaction in question to the Board and shall not be present during the discussion of, and vote on, the transaction in question. The Chair of the Board shall, if appropriate, appoint a disinterested Director or committee to investigate alternatives to the proposed transaction or arrangement. After exercising due diligence, the Board shall determine whether the Company, with reasonable efforts, can obtain a more advantageous transaction that would avoid the conflict of interest. If such an alternative is not available, the Board shall determine by a majority vote of the disinterested Directors whether the transaction is in the Company's best interest, for its own benefit, and 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 consistent with these procedures, 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 FCHP.

Review of the 2007 Board of Directors records identifies no significant conflicts of interest and no financial conflicts of interest.

### **CORPORATE RECORDS**

#### **Articles of Incorporation and By-Laws**

The Company's By-Laws were most recently amended as of December 13, 2007. Significant changes were made to the By-Laws since the previous examination, specifically addressing changes to the corporate membership and Board of Directors as a result of FCHP's deaffiliation with the Fallon Clinic, the appointment of Division Presidents and Executive Vice Presidents, and revisions to the By-Laws' provisions on Board of Directors conflicts of interest. These changes have been incorporated into the appropriate report sections above.

#### **Board of Directors Minutes**

The minutes of the Board and committee meetings for the period under statutory examination were reviewed and indicated that all meetings were held in accordance with the Company's By-Laws and the laws of the Commonwealth of Massachusetts. Activities of the committees were reported upon at various meetings of the Board.

### **ACQUISITIONS, MERGERS, DISPOSALS, DISSOLUTIONS AND PURCHASES OR SALES**

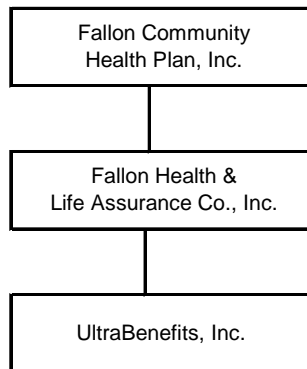
On August 31, 2006, FCHP's wholly-owned subsidiary FHLAC acquired UltraBenefits, a third party administrator in Massachusetts, for cash and future cash considerations based upon certain client retention provisions and certain profitability targets. UltraBenefits provides medical, dental and disability claim processing, as well as claims management services, premium and fee-billing services and administration of Flexible Spending Accounts, Health Reimbursement Accounts and COBRA. The acquisition was accounted for under the statutory purchase method and FHLAC has recorded goodwill for the excess purchase price over the net book value of UltraBenefits.

### **MANAGEMENT CONTINUITY AND NATIONAL EMERGENCY**

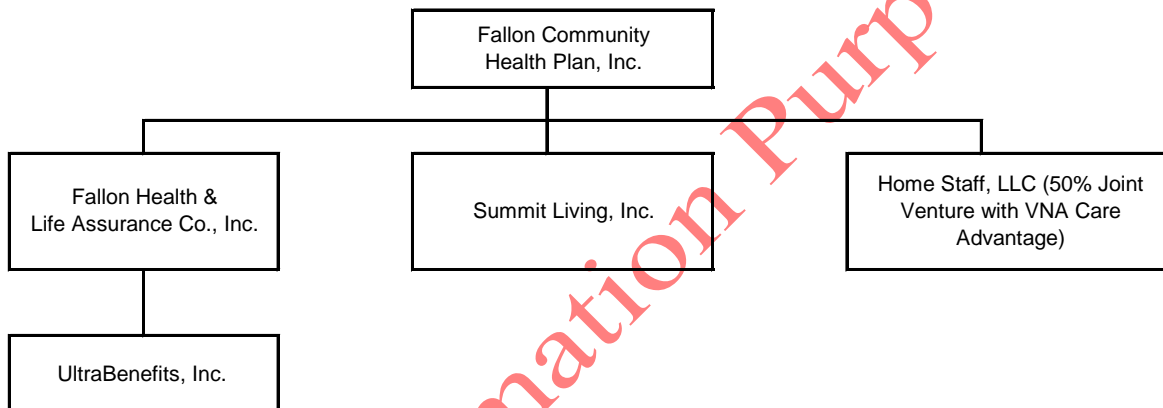
The Company provides for the continuity of management and operations in the event of a catastrophe or national emergency in accordance with Massachusetts General Laws, Chapter 175, Sections 180M-180Q.

### **AFFILIATED COMPANIES**

A summary of ownership and relationship of the Company and its operating subsidiaries and affiliated companies as of December 31, 2007 is illustrated below:



Based on events subsequent to the December 31, 2007 examination date which are discussed further in the Subsequent Events section, FCHP's current organizational structure as of December 31, 2008 is illustrated below:



### **RELATED PARTY TRANSACTIONS**

FHLAC is a wholly-owned subsidiary of FCHP. FHLAC has no employees and FCHP accordingly 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. Total management fees for the years ended December 31, 2007 and 2006 amounted to \$3.78 million and \$2.97 million, respectively. As of December 31, 2007, FCHP owed FHLAC \$1.10 million and was due \$1.02 million from FHLAC. As of December 31, 2006, FCHP owed FHLAC \$1.94 million and was due \$0.75 million from FHLAC. Settlement of intercompany balances takes place monthly.

In 2007, FCHP made capital contributions to FHLAC totaling \$3.05 million. In 2006, FCHP made capital contributions to FHLAC totaling \$6.90 million. In 2005, FCHP made capital contributions to FHLAC totaling \$1.00 million.

### **FIDELITY BOND AND OTHER INSURANCE**

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

In addition to the bond insurance, the Company has further protected its interests and properties by acquiring policies of insurance covering other insurable risks. Coverage is provided by insurers licensed in the Commonwealth of Massachusetts and was in force as of December 31, 2007.

### **PENSION AND INSURANCE PLANS**

Effective December 31, 2006, FCHP amended its defined benefit pension plan to freeze the plan for current participants and close the plan for new entrants as of December 31, 2006. Current participants who are employed on December 31, 2006 and have earned at least one year of credited service as of that date will have their accrued December 31, 2006 benefits enhanced by the addition of one to five years, depending on their years of service at December 31, 2006, to their actual credited service for purposes of determining their frozen accrued benefits as of December 31, 2006. No new pension plan benefits will be accrued after December 31, 2006. At December 31 2007, the defined benefit pension plan was under-funded, as the actuarial present value of the accumulated benefit obligations exceeded the fair value of plan assets. Total net periodic benefit costs were \$0.4 million and \$3.7 million for the years ended December 31, 2007 and 2006, respectively. The vested accumulated benefit obligation was \$21.2 million and \$22.5 million at December 31, 2007 and 2006, respectively. To determine benefit obligations, the Company used a discount rate of 6.5% and 6.0% at December 31, 2007 and 2006, respectively. The fair value of plan assets was \$17.7 million and \$15.0 million at December 31, 2007 and 2006, respectively.

FCHP has a 401(k) savings plan for eligible employees. In 2006, FCHP contributed an amount equal to 50% of employee contributions, up to a maximum of 3% of each employee's compensation subject to a pretax Internal Revenue Service (IRS) limit of \$15,000. Effective January 1, 2007, FCHP amended its 401(k) savings plan for eligible employees. In 2007, eligible employees received an automatic fixed employer contribution of 3% of compensation, regardless of whether or not the employees were contributing to the 401(k) savings plan. In addition, FCHP contributed 100% of the first 3% that the employee contributed, and 66.67% of the next 3% of compensation that the employee contributed. The total match is equivalent to 5% of the first 6% of compensation that the employee contributed, subject to a pretax IRS limit of \$15,500 in 2007. Contributions are maintained in investment funds established under the employee savings plan. Total Company contributions charged to operations amounted to \$2.65 million in 2007 and \$0.62 million in 2006.

### **SPECIAL DEPOSITS**

The special deposits of the Company at December 31, 2007 were as follows:

<b>Description of Deposit</b>	<b>Purpose of Deposit</b>	<b>Book Value</b>	<b>Fair Value</b>
U.S. Treasury Note, 4.625%, 8/13/2011 Maturity	Massachusetts – Protection for All Policyholders	\$ 1,001,410	\$ 1,046,880
		<u>\$ 1,001,410</u>	<u>\$ 1,046,880</u>

## **TERRITORY AND PLAN OF OPERATION**

### **Territory**

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

### **Plan of Operation**

Fallon Community Health Plan, Inc. is headquartered in Worcester, MA. FCHP historically focused on Worcester County, MA, but has since expanded its service area to most of Massachusetts. FCHP's Direct Care service area includes communities primarily in Central Massachusetts and suburban Boston. FCHP's Select Care service area encompasses communities statewide, excluding portions of Southeastern Massachusetts, Cape Cod, Martha's Vineyard and Nantucket.

## **PRODUCTS**

The Company offers the following insured products:

**FCHP Direct Care** – This plan is a concentrated HMO network which offers access to over 1,000 in-network physicians in ten physician practice groups within FCHP's Direct Care service area. Because the Direct Care network offers members more coordinated, cost-efficient care, Direct Care plans are available at a lower premium than Select Care plans. FCHP administers the Direct Care HMO product.

**FCHP Select Care** – The Select Care network is an extensive HMO network of over 10,000 physicians and facilities located throughout Massachusetts. The Select Care network includes all physicians and facilities available through the more concentrated Direct Care network. FCHP administers the Select Care HMO product.

**FCHP Preferred Care** – This PPO product offers access to a nationwide network of over 500,000 health care providers and has no referral requirements. Members may choose a higher percentage of plan coverage by visiting providers in the FCHP Preferred Care network or pay a higher percentage of the cost themselves by visiting a provider who is not a FCHP Preferred Care provider. FCHP administers the Preferred Care PPO product.

**FCHP MassHealth** – This plan is available to Medicaid recipients and provides access to physicians and interpreters in numerous languages as well as worldwide emergency coverage. FCHP administers the MassHealth product.

**Commonwealth Care FCHP Direct Care** – Commonwealth Care is a program run by the Commonwealth Health Insurance Connector Authority. This program connects qualified Massachusetts residents with affordable health insurance if they do not otherwise have health insurance coverage. Commonwealth Care FCHP Direct Care is one of the private health insurance plans available through the Commonwealth Care Health Insurance Program (CCHIP). Commonwealth Care FCHP Direct Care offers members coverage for office visits, prescriptions, emergency care, hospital services and mental health/substance abuse counseling. FCHP administers the Commonwealth Care FCHP Direct Care product.

**Fallon Senior Plan** – The Fallon Senior Plan is available to members who are enrolled in both Medicare Parts A and B. This plan is available in a variety of options with or without prescription coverage. Comprehensive benefits and services include routine annual physical examinations, dental care benefits, vision care, worldwide emergency coverage and fitness / weight management programs. Medicare Advantage contracts between the federal government and managed care organizations are valid for one calendar year; therefore benefits, premiums, co-payments and service areas are subject to change on an annual basis. FCHP administers the Fallon Senior Plan.

**Summit ElderCare** – This is a Program of All-inclusive Care for the Elderly (PACE) available to eligible senior citizens in the Worcester, MA area who are able to live independently and are certified by MassHealth as eligible under Medicaid nursing facility clinical criteria. The Summit ElderCare PACE gives participants primary and specialty care, full prescription drug and hospitalization coverage, an adult day health program, family caregiver support and specialized geriatric care. FCHP administers the Summit ElderCare product.

**Care Choice High Deductible Plans** – Care Choice plans are high-deductible product choices that are compatible with the savings of tax-advantaged accounts, such as Health Savings Accounts (HSA). FCHP has partnered with Sovereign Bank as the HSA custodian for the Company's Care Choice plans. Care Choice plans are available for the Direct Care HMO, Select Care HMO and Preferred Care PPO products. FCHP administers the Care Choice HMO plans, while FHLAC administers the Care Choice PPO plans.

### **PROVIDER CONTRACTS**

The Company arranges for the provision of health care services to its subscribers and eligible dependents thereof through contracts with physician providers and other health care providers. For all purposes, physician providers and such other organizations or individuals are and shall be deemed to be independent contractors with the Company, and shall not be characterized as officers, employees or agents of the Company.

The agreements are in compliance with Massachusetts statutes and regulation 211 CMR 52.00.

### **UNPAID CLAIMS**

KPMG Health Actuaries prepared independent estimates of the Unpaid Claim Liabilities (UCL) as of December 31, 2007 and prior periods. For December 31, 2007, completion factors for the projection of ultimate claims were developed using historical payment patterns and actuarial judgment. "Low" and "High" estimates were developed by subtracting the claims paid-to-date from the actuarial range of incurred estimates. As the FCHP business pays fairly quickly, the range of estimates for the December 31, 2007 UCL is narrow and the actuarial estimates are similar to FCHP's estimates with hindsight through September 30, 2008.

FCHP made a separate provision for Loss Adjustment Expenses / Claim Adjustment Expenses (LAE/CAE) in 2007 and the resulting expense percentage levels used are within industry norms.

Based upon KPMG's review, the UCL as of December 31, 2007 appears to be fairly stated but conservative. While some conservatism is not unreasonable given the exposure to factors that impact the reserves and cause uncertainty when developing reserve estimates, the amount of conservatism in the December 31, 2007 reserves appears to be somewhat above current industry results.

The Company's premium deficiency reserve calculation was reviewed and found to be reasonable. The Company has calculated the reserve by looking at projected deficiency separately for each large group. The projected deficiency is defined as the difference between the premium sold on the contract and the premium (claims and expenses) required by the underwriting department for the months remaining in the rating period. The calculation indicated that a premium deficiency reserve of \$3.3 million was required as of December 31, 2007.

### **REINSURANCE**

FCHP carries reinsurance against excessive claims utilization. Under its reinsurance policy, the Company is reimbursed for 90% of all claims over the policy deductible, which is \$800,000. The per member per year limit is \$2,000,000. Total premiums of \$607,000 and \$678,000 were ceded relating to reinsurance for the years ended December 31, 2007 and 2006, respectively. Recoveries realized under the applicable reinsurance contract for the years



ended December 31, 2007 and 2006 were \$1,202,000 and \$740,000, respectively. Reinsurance recoverable at December 31, 2007 and 2006 was \$847,000 and \$0, respectively.

### **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 23.00. The CPA Firm issued an unqualified opinion on the December 31, 2007 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 Information Technology (IT) environment. The questionnaire was completed by the Company and reviewed by KPMG's Information Technology Advisory Services (ITAS) team, which evaluated the adequacy of the IT 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 2007 Annual Statement. No material exceptions were noted.

### **SUBSEQUENT EVENTS**

Effective January 23, 2008, Summit Living, Inc. (Summit Living) filed Articles of Organization with the Commonwealth of Massachusetts as a not-for-profit charitable organization pursuant to Internal Revenue Code Sections 170(c)(2)(B) and 501(c)(3). FCHP is the sole corporate member of Summit Living, which was organized to develop an independent living / assisted living facility. During the third quarter 2008, Summit Living received approval of its not-for-profit status. As of December 2008, Summit Living had placed a deposit on a facility site and was conducting pre-purchase due diligence. Estimated costs for the project were approximately \$20 million as of December 2008. As of December 31, 2008, FCHP was due \$463,000 from Summit Living, which represented a \$65,000 deposit on land and \$398,000 in capital costs related to the facility development; the entire amount of this receivable was recorded as a non-admitted asset.

On April 2, 2008, FCHP partnered with VNA Care Network & Hospice to jointly acquire Home Staff, LLC (Home Staff), a home supportive services agency. Home Staff, which is based in Worcester and has three other offices in Massachusetts, specializes in providing a variety of in-home services to individuals who are facing illness or injury. Home Staff is organized as a joint venture, with FCHP and VNA Care Network & Hospice each owning a 50% stake. The actual cost to FCHP at the time of acquisition was approximately \$2.05 million.

During 2008, FCHP made capital contributions to FHLAC totaling \$4.45 million. In turn, FHLAC made capital contributions during 2008 to its wholly-owned subsidiary, UltraBenefits totaling \$75,000.



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On March 18, 2008, FCHP borrowed \$15 million through a tax-exempt bond financed through the Massachusetts Health and Education Facilities Authority (MHEFA) to assist in financing the development and installation of a healthcare payer system (i.e., the Core Business Application Modernization (CBAM) project). FCHP has contracted with the TriZetto Group, Inc. to implement the new system, provide FCHP with a perpetual software license and provide hosting applications for five years. Principal payments will be made over six years beginning February 1, 2009 and annually on February 1 thereafter. Final payment will be made on February 1, 2014. The MHEFA bond is backed by a Letter of Credit with TD Banknorth, N.A.

At December 31, 2008, the Company was in violation of a financial covenant contained in the Letter of Credit with TD Banknorth to maintain a minimum risk based capital ratio of 400%. Subsequently, TD Banknorth modified the agreement to change the covenant to a minimum risk based capital ratio of 300% for all dates required to be in compliance from February 24, 2009 going forward. FCHP did not incur any penalties or payments as a result of the covenant violation.

### **COMMITMENTS AND CONTINGENCIES**

#### **Lease Obligations**

FCHP leases administrative facilities under operating leases with various lease terms expiring through January 2022. The leases provide for base monthly rent, plus proportionate shares of real estate taxes and certain operating expenses, and include various options to extend the lease terms. In 2007 and 2006 total lease expense was approximately \$2.5 million and \$2.2 million, respectively.

The following is a schedule, by year, of future minimum rental payments required by the non-cancelable operating leases as of December 31, 2007 (000's):

<b>Year ending December 31</b>	<b>Operating Lease</b>
2008	\$ 2,897
2009	2,970
2010	2,773
2011	2,772
2012	2,599
Thereafter	<u>21,293</u>
Total	<u>\$35,304</u>

#### **Letter of Credit**

In 2007, the Company established a Letter of Credit available in the amount of \$15,000,000 with TD Banknorth, N.A. This Letter of Credit was obtained to protect holders of the tax-exempt MHEFA bonds in the event FCHP is unable to meet payments due. As of December 31, 2007, the Company did not have an outstanding balance under the Letter of Credit.

#### **Line of Credit**

During 2006, the Company obtained a \$5 million Line of Credit with TD Banknorth, N.A. This Line of Credit was renewed during 2008 and is valid through June 30, 2010. As of December 31, 2007, the Company did not have an outstanding balance under the Line of Credit. The Company borrowed \$5 million through this Line of Credit during the second quarter of 2008 and this amount was fully repaid during the third quarter of 2008.

**Information Technology Modernization Project**

The Company commenced the Core Business Application Modernization (CBAM) project in 2006. This initiative will replace the current IDX core application and replace the current data warehouse with a new enterprise data warehouse. The Company expects to complete the CBAM project in 2009. Total budgeted spending commitments under the project are \$34 million, the majority of which will be incurred after December 31, 2007.

**Legal Proceedings**

FCHP is involved in legal actions in the ordinary course of business. In the opinion of management, there are no legal proceedings pending against or involving FCHP, the outcome of which is likely to have a material adverse effect upon the statutory financial statements.

For Information Purposes Only

**FINANCIAL STATEMENTS**

The Financial Statements section includes the following:

	<u>Page</u>
Statutory Statement of Assets, Liabilities and Capital & Surplus as of December 31, 2007	17
Statement of Revenue and Expenses for the Year Ended December 31, 2007	18
Capital & Surplus for the Year Ended December 31, 2007	19
Reconciliation of Capital & Surplus for the Three Year Period Ended December 31, 2007	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, 2007.

For Information Purposes Only

Commonwealth of Massachusetts Division of Insurance  
Report on the Statutory Examination of  
FALLON COMMUNITY HEALTH PLAN, INC.

Fallon Community Health Plan, Inc.  
Statutory Statement of Assets, Liabilities and Capital & Surplus  
As of December 31, 2007

	<u>Annual Statement</u>	<u>Statutory Examination Adjustment</u>	<u>Per Statutory Examination</u>
<b><u>ASSETS</u></b>			
Bonds	\$ 128,479,986	\$ -	\$ 128,479,986
Stocks:			
Common stocks	109,327,725	-	109,327,725
Cash, cash equivalents and short-term investments	5,522,931	-	5,522,931
Other invested assets	32,864,022	-	32,864,022
Subtotals, cash and invested assets	276,194,664	-	276,194,664
Investment income due and accrued	1,352,616	-	1,352,616
Uncollected premiums and agents' balances in the course of collection	9,894,102	-	9,894,102
Reinsurance:			
Amounts recoverable from reinsurers	846,763	-	846,763
Receivables from parent, subsidiaries and affiliates	1,019,192	-	1,019,192
Health care and other amounts receivable	10,738,956	-	10,738,956
<b>Total Assets</b>	<b>\$ 300,046,293</b>	<b>\$ -</b>	<b>\$ 300,046,293</b>
<b><u>LIABILITIES</u></b>			
Claims unpaid	\$ 66,108,951	\$ -	\$ 66,108,951
Accrued medical incentive pool and bonus amounts	11,881,892	-	11,881,892
Unpaid claims adjustment expenses	1,026,785	-	1,026,785
Aggregate health policy reserves	5,398,902	-	5,398,902
Premiums received in advance	9,407,721	-	9,407,721
General expenses due or accrued	5,961,060	-	5,961,060
Amounts due to parent, subsidiaries and affiliates	1,101,249	-	1,101,249
Other liabilities	27,689,783	-	27,689,783
<b>Total Liabilities</b>	<b>\$ 128,576,343</b>	<b>\$ -</b>	<b>\$ 128,576,343</b>
<b><u>CAPITAL AND SURPLUS</u></b>			
Unassigned funds (surplus)	171,469,950	-	171,469,950
<b>Total Capital and Surplus</b>	<b>\$ 171,469,950</b>	<b>\$ -</b>	<b>\$ 171,469,950</b>
<b>Total Liabilities, Capital and Surplus</b>	<b>\$ 300,046,293</b>	<b>\$ -</b>	<b>\$ 300,046,293</b>

**Commonwealth of Massachusetts Division of Insurance**  
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**Fallon Community Health Plan, Inc.**  
**Statement of Revenue and Expenses**  
**For the Year Ended December 31, 2007**

	<u>Annual Statement</u>	<u>Statutory Examination Adjustment</u>	<u>Per Statutory Examination</u>
Member months	1,894,286	-	1,894,286
Net premium income	\$ 889,782,630	\$ -	\$ 889,782,630
Total revenues	889,782,630	-	889,782,630
Hospital and medical:			
Hospital/medical benefits	681,327,406	-	681,327,406
Other professional services	26,048,266	-	26,048,266
Outside referrals	1,475,912	-	1,475,912
Emergency room and out-of-area	1,286,228	-	1,286,228
Prescription drugs	91,734,281	-	91,734,281
Other hospital and medical	3,260,195	-	3,260,195
Incentive pool, withhold adjustments and bonus amounts	2,181,101	-	2,181,101
Subtotal	807,313,389	-	807,313,389
Less:			-
Net reinsurance recoveries	1,201,815	-	1,201,815
Total hospital and medical	806,111,574	-	806,111,574
Claims adjustment expenses	11,476,190	-	11,476,190
General administrative expenses	64,239,335	-	64,239,335
Total underwriting deductions	882,948,310	-	882,948,310
Net underwriting gain	6,834,320	-	6,834,320
Net investment income earned	11,210,481	-	11,210,481
Net realized capital gains (losses)	(362,202)	-	(362,202)
Net investment gains	10,848,279	-	10,848,279
Other income	59,194	-	59,194
Net income	\$ 17,741,793	\$ -	\$ 17,741,793

Commonwealth of Massachusetts Division of Insurance  
Report on the Statutory Examination of  
**FALLON COMMUNITY HEALTH PLAN, INC.**

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**Fallon Community Health Plan, Inc.**  
**Capital & Surplus**  
**For the Year Ended December 31, 2007**

	<u>Annual Statement</u>	<u>Statutory Examination Adjustment</u>	<u>Per Statutory Examination</u>
Capital and Surplus, December 31, 2006	\$ 153,648,895	\$ -	\$153,648,895
Net income or (loss)	17,741,793	-	17,741,793
Change in net unrealized capital gains and losses less capital gains tax	1,846,424	-	1,846,424
Change in nonadmitted assets	1,559,309		1,559,309
Change in minimum pension liability	(3,326,471)		(3,326,471)
Net change in capital and surplus	<u>17,821,055</u>	<u>-</u>	<u>17,821,055</u>
Capital and Surplus, December 31, 2007	<u>\$ 171,469,950</u>	<u>\$ -</u>	<u>\$171,469,950</u>

For Information Purposes Only

**Fallon Community Health Plan, Inc.**  
**Reconciliation of Capital & Surplus**  
**For the Three Year Period Ended December 31, 2007**

	<u>2007</u>	<u>2006</u>	<u>2005</u>
Capital and Surplus, December 31, prior year	\$ 153,648,895	\$ 134,335,620	\$105,899,263
Net income or (loss)	17,741,793	21,976,450	24,611,190
Change in net unrealized capital gains and losses less capital gains tax	1,846,424	393,544	4,306,269
Change in nonadmitted assets	1,559,309	(6,195,210)	768,814
Change in minimum pension liability	(3,326,471)	3,138,491	(1,249,916)
Net change in capital and surplus	<u>17,821,055</u>	<u>19,313,275</u>	<u>28,436,357</u>
Capital and Surplus, December 31, current year	<u><u>\$ 171,469,950</u></u>	<u><u>\$ 153,648,895</u></u>	<u><u>\$134,335,620</u></u>



**ACKNOWLEDGMENT**

This is to certify that the undersigned is a duly qualified Certified Financial Examiner (CFE) and that, in conjunction with KPMG LLP, the undersigned applied certain agreed-upon procedures to the accounting and corporate records of 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 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.

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John M. Curran, CFE  
Supervising Examiner & Examiner-in-Charge (EIC)  
Commonwealth of Massachusetts  
Division of Insurance  
Boston, MA