COMMONWEALTH OF MASSACHUSETTS

SUFFOLK, SS.

SUPREME JUDICIAL COURT FOR
SUFFOLK COUNTY
NO. SJ-2000-003

LINDA L. RUTHARDT, as she is
COMMISSIONER OF INSURANCE of the
COMMONWEALTH OF MASSACHUSETTS, and
THOMAS F. REILLY, as he is
ATTORNEY GENERAL of the
COMMONWEALTH OF MASSACHUSETTS,

Plaintiffs,

v.

HARVARD PILGRIM HEALTH CARE, INC.,
PILGRIM HEALTH CARE, INC., and HARVARD
PILGRIM HEALTH CARE OF NEW ENGLAND,
INC.,

Defendants.

TEMPORARY RECEIVER'S SECOND STATUS REPORT

In accordance with paragraph 1 of the Order entered February 1, 2000, Linda L. Ruthardt, Commissioner of Insurance, as Temporary Receiver (the "Temporary Receiver") of Harvard Pilgrim Health Care, Inc., Pilgrim Health Care, Inc., and Harvard Pilgrim Health Care of New England, Inc. (collectively, "HPHC"), and Thomas F. Reilly, Attorney General, submit this status report, which will summarize the more significant steps taken over the past month and propose further action concerning HPHC.

Background

1. Continued stability. As noted in the Temporary Receiver's and Attorney General's First Status Report ("First Status Report"), the initial goal of the temporary receivership proceeding was to stabilize the situation and avoid disruption in health care services by providing for continued payments to hospitals, physicians and other providers. The situation is presently stable.

2. Members continue to receive health care services and supplies. With minor exceptions that either have been addressed by the Attorney General and Division of Insurance or are in the process of being addressed, hospitals, physicians and other health care providers have continued to provide services to HPHC members. The Temporary Receiver and Attorney General have not needed to seek judicial enforcement of the injunctive provisions of the Receivership Order.

3. Providers also continue to be paid in full. Hospitals, physicians and other health care providers are being paid in the normal course of business. Since January 4, 2000, HPHC has paid $338 million to providers, of which $198 million was for pre-receivership obligations, and it has also continued to pay suppliers and trade vendors in the ordinary course.

4. In order to be informed of and address concerns, the Temporary Receiver and Attorney General have continued to meet with trade organizations and other persons, including the Massachusetts Hospital Association, the Massachusetts Medical Society, the Massachusetts Psychiatric Society, the Massachusetts Council of Community Hospitals, Health Care *for* All, the Health Care Finance' Agency, and many others. The Temporary Receiver has also been in regular communication with the insurance regulators of New Hampshire and Maine to discuss matters of common interest, and she is working with the Director of the Rhode Island Department of Business Regulation to resolve issues arising from the Rhode Island proceeding *for* HPHC's Rhode Island affiliate.

5. HPHC's turnaround plan. An important aspect of the receivership has been the continued implementation of HPHC's turnaround plan ("Turnaround Plan"). Beginning in mid-1999, HPHC's new management developed and began to implement the Turnaround Plan, which included additional management changes and steps to streamline HPHC's organizational structure, substantial rate increases and enhanced rate-setting controls, renegotiation of provider contracts and enhanced medical management functions, outsourcing of information technology and claims

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processing, and ceasing the activities of Harvard Pilgrim's Rhode Island affiliate. Major elements of the Turnaround Plan, including provider recontracting, increased rates, and outsourcing of information technology, had been put in place before the receivership. Others, including streamlining HPHC's administrative structure, improving management controls, and winding down the Rhode Island affiliate, were in process.

6. The Temporary Receiver has continued to implement the essential elements of the Turnaround Plan. Some of the more significant operational decisions of the past month include:

a. Consolidation of HPHC's administration. HPHC's administration had been spread in six separate locations. The Temporary Receiver approved HPHC's plan to consolidate its administration in a new, smaller headquarters in Wellesley. This not only will improve communication and operations, but it will also save approximately $8 million per year compared to the existing locations renewed at market rents.

b. Reductions in force. The Temporary Receiver has implemented previously planned reductions in force involving 111 people. These layoffs will save HPHC approximately $4.25 million in 2000, after taking severance costs into account.

c. Resolution of hospital issues. HPHC has settled payables and receivables balances for 1998 and prior years with fifteen hospitals..

d. Resolution of practice group issues. HPHC has settled ownership, balances and other issues concerning a large physician group practice.

e. Resolution of access to bond proceeds. The insurer of the 1998 HEFA Bonds, Financial Security Assurance, Inc. ("FSA") , asserted that it had a security interest in the remaining proceeds from the 1998 bonds held by HEFA. Those proceeds were dedicated to payment of HPHC's construction expenses for the Crown Colony II project in Quincy and other sites. To ensure continuing access to the funds while deferring this dispute, the Temporary Receiver and FSA entered into a conditional security agreement under which FSA agreed to the release of certain funds for the Crown Colony II project in exchange for a mortgage in the amount of the released funds in the project. The conditional security agreement will be presented to the Court for approval shortly.

f. Cash management pledge agreement. BankBoston provides cash management services to HPHC, including automatic clearinghouse and payroll direct deposit, which exposes BankBoston to credit risk. To ensure that this service continues, the Temporary Receiver is entering into a pledge agreement with BankBoston. That agreement will be presented to the Court for approval shortly.

7. The various changes contemplated by HPHC's Turnaround Plan are intended to reduce the operating losses that HPHC has previously incurred and ultimately to produce operating gains. The results of the Turnaround Plan, in particular the new provider. contracts and increased rates, are expected to substantially benefit HPHC in 2000.

8. HPHC has incorporated the expected results of the Turnaround Plan into its year 2000 business plan (the "2000 Business Plan"). The 2000 Business Plan projects the financial results for HPHC during 2000 based on various assumptions that reflect the expected impact of the changes under the Turnaround Plan. The 2000 Business Plan does not rely on any new infusions of capital into HPHC. It projects that HPHC will have an operating loss in 2000, but significantly smaller than in 1999. The full benefits of the Turnaround Plan are expected to be reflected in HPHC's profitable operating results for 2001.

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9. The 2000 Business Plan is significant because it indicates that the continued operation of HPHC will ultimately produce operating gains and thus begin to restore HPHC's capital. The Temporary Receiver and the Attorney General accordingly requested that the consultants retained by the Division of Insurance, the accounting firm of KPMG Peat Marwick (UKPMG"), review the 2000 Business Plan. KPMG has reviewed the 2000 Business Plan by evaluating the methodologies and assumptions used to develop the plan. KPMG concluded that the 2000 Business Plan is a reasonable base case.

10. Since KPMG's initial review, HPHC's preliminary operating results for January 2000 have become available. The January operating numbers support the reasonableness of the 2000 Business Plan. HPHC's January administrative expenses were less than projected in the plan; its medical costs were consistent with the plan and less than the November costs on which the plan was based; HPHC's January membership was slightly higher than anticipated in the plan; and its premium on a per member per month basis was higher than the plan projected.

11. HPHC's cash position has improved from February 1 to March 1, 2000, even though there were five weekly claims

payments during the month of February instead of the usual four.

12. The Temporary Receiver and the Attorney General are accordingly of the view that the 2000 Business Plan provides a reasonable basis to conclude that HPHC can be a viable business going forward. HPHC's operational difficulties are being addressed through the implementation of the Turnaround Plan. HPHC's primary problem is a lack of statutory capital (but not of cash) to support its business while the Turnaround Plan takes effect.

13. <u>Identification and Evaluation of Options.</u> The Temporary Receiver and Attorney General have sought to identify all possible options to recapitalize HPHC so that public officials could determine which options were available, in the public interest and should be presented to the Court. Over the past month, Salomon Smith Barney ("SSB") , the investment banker engaged by the Temporary Receiver, and other representatives of the Temporary Receiver have conducted extensive discussions with interested for profit and non-profit corporations to determine what options are available to recapitalize HPHC. The following is a brief summary of the most significant of those discussions.

14. Sale options. The sale options that have been pursued are of two types. The first is an acquisition by a for-profit company. A for-profit transaction of some sort may be available. However, as discussed below, there are several drawbacks to pursuing this option. Several prominent for-profit health care organizations have conducted extensive due diligence pursuant to confidentiality agreements and engaged in ongoing discussions with SSB. While some potential for-profit acquirers continue to express interest, and the others may still be active, they have pot made definitive proposals. The transactions in which they appear to be interested are asset acquisitions, not purchases of HPHC as an entity that would include assumption of its past liabilities.

15. While it is SSB's view that such a sale transaction is a possible option, there are several concerns that weigh against pursuing this course further. First, the most likely for-profit option would be a transaction which would leave some HPHC obligations unpaid. Second, as no for-profit has made a definitive proposal, any resolution is ,likely several weeks away and of uncertain value. Third, depending on the specific form of a transaction, there may be issues associated with conversion of public charities like those now in

receivership to a for-profit entity. Fourth, a for-profit transaction would probably cause the 1998 HEFA bonds to lose their tax-exempt status.

16. SSB also explored the potential for not-for profit acquisitions. However, no not-for-profit has made a proposal to acquire HPHC. One large not-for-profit has conducted due diligence pursuant to a confidentiality agreement and discussed a potential acquisition. This company ultimately presented another type of proposal to purchase surplus notes that required that the Commonwealth offer substantial inducements. The Temporary Receiver and Attorney General declined that proposal.

17. <u>Recapitalization by surplus notes.</u> The Temporary Receiver also sought to determine interest in recapitalizing HPHC through the sale of "surplus notes." Surplus notes are a tool used by insurance companies, especially mutual insurance companies, to raise capital. Such notes have two distinctive features: (1) payment of principal and interest on the notes are subject to the prior approval of the insurance regulator of the insurer's domiciliary state, and (2) the obligations represented by the notes are subordinated to all other claims against the insurer. Because of these features, surplus notes are not

treated as liabilities but as contributions to the insurer's capital under statutory accounting principles.

18. In early February, a confidential preliminary private placement memorandum concerning the potential issuance of surplus notes by HPHC was provided to approximately twenty potential investors pursuant to confidentiality agreements. SSB then had extensive discussions with the potential investors concerning surplus notes, and many of those entities conducted due diligence either directly or through their consultants.

19. After discussions. over a two week period, the potential investors ultimately advised they were not interested in the surplus notes as proposed. A large group of potential not-for-profit investors responded by conditioning a potential purchase on a full guaranty of the surplus notes by the Commonwealth, and a number of other governmental inducements. As noted above, one not-for-profit ultimately offered to purchase surplus notes on conditions that were deemed unacceptable. One possible for-profit investor expressed interest but only if it were offered. other significant commercial benefits. Several of the potential not-for-profit and for-profit investors expressed interest in purchasing limited amounts of surplus notes, but only if other investors would purchase large

amounts. No potential investor was willing to commit to take a leading position and purchase a significant amount of the surplus note offering.

20. As there was interest in HPHC surplus notes enhanced by some form of guaranty, the Temporary Receiver sought to obtain a partial guaranty of the surplus notes from private sources. SSB and other representatives held lengthy discussions with one potential guarantor over another two week period. It likely would be possible to obtain a guaranty of $75 million of the surplus notes from that source. However, the guaranty would be subject to numerous conditions, including rights to assert significant control over HPHC in the event HPHC were not to meet certain financial targets and potential extension of an unrelated contract. SSB also negotiated with a large reinsurer and obtained a preliminary proposal under which the reinsurer would partially guaranty the surplus notes. That proposal is expensive. In any event, given the reaction of the potential investors to the original surplus note proposal, it remains unclear whether partially guaranteed surplus notes could be sold.

21. In sum, further efforts to pursue the surplus notes option are possible, but the conditions that have been expressed by significant potential investors and

guarantors are onerous. The Temporary Receiver and the Attorney General are of the view that those conditions are not in the best interest of HPHC, its members, creditors or the public.

22. Plan of rehabilitation. In these circumstances, the Temporary Receiver and Attorney General have considered potential avenues to increase HPHC's capital through a plan of rehabilitation. As noted above in connection with the discussion of HPHC's Turnaround Plan and the 2000 Business Plan, HPHC's present problem is its negative statutory net worth and consequent lack of capital to support its business until it begins to realize operational gains. HPHC's unaudited operating losses for 1999 are approximately $200 million. HPHC's unaudited statutory net worth (the amount remaining after all liabilities, including loss reserves, are subtracted from admitted assets) as of December 31, 1999, was approximately negative $90 million. Further, although the Turnaround Plan is taking effect, HPHC anticipates incurring operating losses during the first half of 2000. A plan of rehabilitation would need to return HPHC to a position where it has sufficient capital to operate outside of receivership, although under continuing oversight.

23. The alternative to a reorganization plan is liquidation. If HPHC were liquidated, it would likely result in a loss to creditors significantly in excess of the $90 million plus recent operating losses for two principle reasons. First, HPHC's assets would lose the value associated with HPHC's ongoing business. For example, much of HPHC's real estate consists of buildings whose value reflects their continued use by Harvard Vanguard Medical Associates ("HVMA"). If HPHC ceased doing business, HVMA would also be placed at risk. Without a tenant, the HPHC real estate and buildings would lose value. Second, if HPHC stopped operations, it would have a much more difficult time collecting receivables.

24. Liquidation is also undesirable because it would significantly disrupt the provision of health care service and coverage in the Commonwealth and neighboring states. HPHC's million members in Massachusetts and 100,000 members in New Hampshire and Maine would have to find other coverage *or* be allocated to other health maintenance organizations and plans. The provider network in place to serve HPHC members would have to be reconstituted.

25. The Temporary Receiver and Attorney General accordingly plan to present a plan of rehabilitation that recognizes the progress of HPHC's Turnaround Plan to date,

does not require infusion of additional cash and minimizes other effects on HPHC's creditors. The plan presently contemplates three steps. First, payment of HPHC's pre receivership obligations to those creditors in the lowest statutory priority class under G.L. c. 176G, § 20, and G.L. c. 175, § 180F, will only be made subject to pre-approval by the Commissioner, made payable on or after July 1, 2000, and subordinated in accordance with the statutory priorities. While this will affect general unsecured creditors, the vast bulk of the affected obligations are not scheduled to be paid for many years and the 2000 Business Plan anticipates that these payments scheduled for 2000 will be made in accordance with the existing schedule beginning on July 1, 2000. In any event, the general unsecured creditors will be better off than in a liquidation, where they would not be paid. Second, the Commissioner will permit HPHC to carry its owned real estate at market value for statutory accounting purposes. These two steps will increase HPHC's statutory net worth. SSB is continuing to develop reinsurance proposals that may provide reductions in certain of the risks associated with HPHC's business.

26. Third, HPHC will be released from temporary receivership subject to an administrative supervision order

and operating agreements which will address continuing operational issues and other matters. For example, before the administrative supervision order will be removed, HPHC will be required to show that it has reduced its hospital and other medical provider claims inventory, completed its reconciliation of accounts with providers for 1999, and implemented Board of Directors governance reforms. A number of operational restrictions and reporting requirements will apply during the period of administrative supervision.

27. The Temporary Receiver and Attorney General will file the plan of rehabilitation, motion for approval of the plan of rehabilitation and supporting papers within the next week.

Respectfully submitted,

LINDA L. RUTHARDT COMMISSIONER
OF INSURANCE AS TEMPORARY
RECEIVER

and

THOMAS F. REILLY
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BY:______________________________

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