

**THE COMMONWEALTH OF MASSACHUSETTS
OFFICE OF CONSUMER AFFAIRS AND BUSINESS REGULATION**

DIVISION OF INSURANCE

**REPORT OF EXAMINATION OF
Harvard Pilgrim Health Care, Inc.**

Worcester, Massachusetts

As of December 31, 2010

NAIC GROUP CODE 595

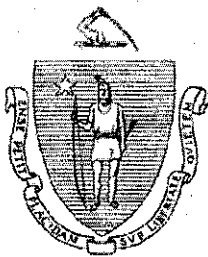
NAIC COMPANY CODE 96911

EMPLOYER'S ID NO. 04-2452600

Harvard Pilgrim Health Care, Inc.

TABLE OF CONTENTS

| | |
|--|----|
| Salutation | 1 |
| Scope of Examination | 2 |
| Status of Prior Examination Findings | 2 |
| History | |
| General | 3 |
| Growth of the Company | 4 |
| Provider Contracts | 4 |
| Reserves | 4 |
| Reinsurance | 5 |
| Income Taxes | 5 |
| Management and Control | 5 |
| Articles of Organization and By-Laws | 5 |
| Members and Membership | 5 |
| Board of Directors | 5 |
| Committees of the Board | 8 |
| Officers | 8 |
| Conflict of Interest Procedures | 9 |
| Corporate Records | 10 |
| Corporate Governance | 10 |
| Affiliated Companies | 11 |
| Organization Chart | 11 |
| Related Party Transactions | 11 |
| Fidelity Bond and Other Insurance | 12 |
| Commitments and Contingencies | 12 |
| Lease Obligations | 13 |
| Pension and Other Post Retirement Benefit Plans | 14 |
| Territory and Plan of Operations | 15 |
| Surplus Notes | 15 |
| Special Deposits | 17 |
| Legal Proceedings | 17 |
| Accounting Records | 17 |
| Financial Statements | 18 |
| Statement of Assets, Liabilities and Capital & Surplus | 19 |
| Statement of Revenue and Expenses | 20 |
| Capital & Surplus | 21 |
| Statement of Changes in Capital & Surplus | 22 |
| Acknowledgement | 23 |



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

1000 Washington Street • Suite 810 • Boston, MA 02118-6200
(617) 521-7794 • Fax (617) 521-7771
TTY/TDD (617) 521-7490
<http://www.state.ma.us/doi>

DEVAL L. PATRICK
GOVERNOR

TIMOTHY P. MURRAY
LIEUTENANT GOVERNOR

GREGORY BIALECKI
SECRETARY OF HOUSING AND
ECONOMIC DEVELOPMENT

BARBARA ANTHONY
UNDERSECRETARY OF CONSUMER AFFAIRS
AND BUSINESS REGULATION

JOSEPH G. MURPHY
COMMISSIONER OF INSURANCE

April 27, 2012

The Honorable Joseph G. Murphy
Commissioner of Insurance
Commonwealth of Massachusetts
Division of Insurance
1000 Washington Street
Suite 810
Boston, MA 02118-6200

Honorable Commissioner Murphy:

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

Harvard Pilgrim Health Care, Inc.

at its home office located at 93 Worcester Street, Wellesley, MA 02481-9181. The following report thereon is respectfully submitted.

SCOPE OF EXAMINATION

This statutory examination of Harvard Pilgrim Health Care, Inc., hereinafter referred to as "Company", "Corporation", "HPHC", "Harvard Pilgrim", "HPHC, Inc." or "Plan", is as of December 31, 2010, including any material transactions and/or events occurring subsequent to the examination date and noted during the course of this statutory examination.

The current examination was conducted at the direction of and under the overall management and control of the examination staff of the Massachusetts Division of Insurance ("Division") in accordance with standards established by the NAIC Financial Condition (E) Committee as well as with the requirements of the NAIC Financial Condition Examiners' Handbook, the examination standards of the Division and with Massachusetts General Laws ("M.G.L."). Representatives from the firm of KPMG LLP ("KPMG") were engaged by the Division to assist in the examination by performing certain examination procedures at the direction of and under the overall management of the Division's examination staff. This assistance included a review of accounting records, information systems, taxes, investments, and actuarially determined loss and loss adjustments expense reserves.

The principal focus of the examination was 2010 activity; however, transactions both prior and subsequent thereto were reviewed as deemed appropriate. The examination was conducted following the NAIC Risk Focused Examination Model.

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 work papers provided by the Company's independent auditor, Deloitte & Touche LLP ("Deloitte"). Wherever possible and wherever deemed appropriate and effective, Deloitte's independent work product was used to define, support, document and expedite the overall examination process.

Status of Prior Examination Findings

The prior report of examination did not have any findings.

HISTORY

General

Harvard Pilgrim Health Care, Inc., a Massachusetts not-for-profit corporation, operates as a health plan providing comprehensive health benefit plans, access to health care and other related services in Massachusetts and Maine to group, individual and Medicare members through contracts with physicians, established primary care and multi-specialty physician groups, hospitals, and other health care providers. HPHC, Inc. also administers comprehensive health benefit plans for certain self-insured employer groups. HPHC, Inc. terminated its Medicare private fee for service product effective December 31, 2010 and is offering a Medicare supplement product effective January 1, 2011 through an affiliated entity.

In July 2009, the Harvard Pilgrim Health Care Institute, LLC ("Institute") was formed. HPHC, Inc. is the sole corporate member of the Institute. The Institute performs research and research administration, for grants and contracts awarded to HPHC, Inc. The carrying value of the Institute of \$11.6 million is treated as a nonadmitted asset in accordance with Statement of Statutory Accounting Principles (SSAP) No. 97, *Investment in Subsidiary, Controlled and Affiliated Entities*, A replacement of SSAP No. 88.

Other not-for-profit affiliates not included in these statutory financial statements include the Harvard Pilgrim Health Care Foundation, Inc. ("Foundation"), a Massachusetts corporation, and Harvard Pilgrim Health Care of New England, Inc. ("New England"), a Massachusetts corporation.

The 2010 healthcare reforms contemplated in the Patient Protection and Affordability Act did not have a material impact on the financial statements of HPHC, Inc. HPHC, Inc. is continuing to assess the potential impact of reforms contemplated for 2014.

Harvard Pilgrim Health Care, Inc.

Growth of the Company

Capital and Surplus consists of capital contributed to the Company, surplus notes 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 2008 through 2010 are shown in the following schedule:

| <u>Year</u> | <u>Admitted Assets</u> | <u>Liabilities</u> | <u>Capital and Surplus</u> |
|-------------|------------------------|--------------------|----------------------------|
| 2008 | \$748,226,342 | \$361,493,558 | \$386,732,784 |
| 2009 | 801,143,505 | 419,187,833 | 381,955,672 |
| 2010 | 793,887,838 | 381,163,507 | 412,724,331 |

PROVIDER CONTRACTS

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

The Company enters into contractual agreements with various health care providers to provide certain medical services to its members. Compensation arrangements vary by provider. Certain providers have entered into risk-sharing arrangements with the Company, whereby a settlement is calculated by comparing actual medical claims experience to a pre-approved and predetermined budgeted amount. These settlements are accrued on an estimated basis in the period the related services are rendered, and adjusted in future periods as final settlements are determined. The agreements are in compliance with Massachusetts statutes and regulation 211 CMR § 52.

RESERVES

The Company uses estimates for determining its claims incurred but not yet reported, which are based on historical claim payment patterns, healthcare trends and membership and includes a provision for adverse changes in claim frequency and severity. Amounts incurred related to prior years may vary from previously estimated liabilities as the claims are ultimately settled.

KPMG Health Actuaries prepared independent estimates of the Unpaid Claim Liabilities ("UCL") as of December 31, 2010 and prior periods. For December 31, 2010, 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. The actuarial estimates, as determined by the KPMG Health actuaries, indicate that HPHC's UCL are reasonable as of December 31, 2010.

Harvard Pilgrim Health Care, Inc.

The Company's premium deficiency reserve calculation was reviewed and found to be reasonable. The calculation indicated that no premium deficiency reserves were required as of December 31, 2010. Based on KPMG's review, the UCL as of December 31, 2010 appears to be fairly stated.

REINSURANCE

HPHC, Inc. carries reinsurance against unexpectedly high medical expenses incurred on a per-member basis. Under a reinsurance agreement that is currently in place, HPHC, Inc. is reimbursed 80% of certain hospital inpatient, outpatient and pharmacy claims in excess of the policy deductibles which range from \$500,000 to \$1,000,000. Inpatient hospital, outpatient hospital, and pharmacy claims are subject to additional policy sub limits. The maximum recoverable under the reinsurance agreement is \$2,000,000 per member per lifetime. The impact of reinsurance recoveries on the statutory financial statements was immaterial for 2010, 2009 and 2008.

INCOME TAXES

HPHC, Inc. is a tax-exempt organization under Section 501(c)(3) of the Internal Revenue Code and therefore not subject to income tax. HPHC, Inc. has evaluated and ascertained tax positions and determined that HPHC, Inc. did not have any unrecognized tax benefits as of December 31, 2010 and 2009.

MANAGEMENT AND CONTROL

Articles of Organization and By-Laws

The Company's by-laws may be altered, amended or repealed at any annual or special meeting of the directors, notice of which shall specify the subject matter of the proposed alteration, amendment or repeal of the sections to be affected thereby, by vote of a majority of the directors then in office. Our review of the by-laws indicated that they were amended effective May 11, 2011; however, they contained no significant changes.

Members and Membership

The Company's by-laws indicate that the Corporation shall have no members. Any action or vote required or permitted to be taken by the members under applicable law shall be taken by action or vote of the same percentage of directors of the Corporation.

Board of Directors

The Company's by-laws indicate the following regarding its board of directors ("Board"):

- Powers: The affairs of the Corporation shall be managed by the directors who shall have and may exercise all the powers of the Corporation.

Harvard Pilgrim Health Care, Inc.

- **Number and Election:** The board of directors of the Corporation shall be comprised of between seven (7) and seventeen (17) individuals. Such persons elected as directors by the Corporation's board of directors shall serve for staggered terms. At each annual meeting of the directors, the directors shall elect the appropriate number of successors to the directors whose terms are then expiring. At any special or regular meeting, the directors may increase their number to not more than seventeen (17) and elect new directors to complete the number so fixed by a vote of a majority of the directors then in office, or they may decrease the number of directors to not less than seven (7), but only to eliminate vacancies existing by reason of the death, resignation, removal or disqualification of one or more directors.

- **Term of Office:** The terms of office of the directors of the Corporation shall be staggered, and no director shall hold office for a term not to exceed three (3) years and until his successor is elected and qualified, or until he sooner dies, resigns, is removed or becomes disqualified. A director may serve more than one term, but not more than three (3) consecutive terms. Notwithstanding the foregoing, if the board of directors elects a new director at any time other than during an annual meeting, the director shall hold office for the remainder of the then current term year and at the next annual meeting of the board such new director may be elected to begin serving his or her first full 3-year term.

- **Regular Meetings:** Regular meetings of the directors may be held at such places and at such times as the directors may determine.

- **Special Meetings:** Special meetings of the directors may be held at any time and at any place when called by the Chairman of the board of directors, the President or by two or more directors.

- **Annual Meetings:** The annual meeting of the directors shall be held on the third Thursday in January in each year (unless that day be a legal holiday at the place where the meeting is to be held, in which case the meeting shall be held at the same hour on the next succeeding day not a legal holiday) or at such other earlier or later date and time as shall be determined from time to time by the directors or by the President.

- **Notice of Meetings:** Notice of the time and place of each meeting of the directors shall be given to each director by mail, addressed to him at his usual or last known business residence address at least seven days before the meeting, or in person or by telephone at least forty-eight hours before the meeting. Whenever notice of a meeting is required, such notice need not be given to any director if a written waiver of notice, executed by him (or his attorney thereunto authorized) before or after the meeting, is filed with records of the meeting, or to any director who attends the meeting without protesting prior thereto or at its commencement the lack of notice to him. Neither such notice nor waiver of notice need specify the purposes of the meeting, unless otherwise required by law, the restated articles of organization or the restated by-laws.

- **Quorum:** At any meeting of the directors, a majority of the directors then in office shall constitute a quorum. Any meeting may be adjourned by a majority of the votes cast upon the question, whether or not a quorum is present, and the meeting may be held as adjourned without further notice.

- **Action by Vote:** When a quorum is present at any meeting, a majority of the directors present and voting shall decide any question, including election of directors and officers, unless otherwise provided by law, the restated articles of organization, or the restated by-laws.

Harvard Pilgrim Health Care, Inc.

• **Action by Writing:** Any action required or permitted to be taken at any meeting of the directors may be taken without a meeting if all the directors consent to the action in writing and the written consents are filed with the records of the meetings of the directors. Such consents shall be treated for all purposes as a vote at a meeting.

• **Presence through Communications Equipment:** Unless otherwise provided by law or the restated articles of organization, members of the board of directors may participate in a meeting of the board by means of a conference telephone or similar communications equipment by means of which all persons participating in the meeting can hear each other at the same time. Participation by such means shall constitute presence in person at a meeting.

At December 31, 2010, the Board was comprised of thirteen (13) directors, which is in compliance with the Company's by-laws. Directors duly elected and serving at December 31, 2010, with business affiliations, were as follows:

| <u>Director</u> | <u>Class of Director</u> | <u>Principal Occupation</u> |
|--------------------------|-----------------------------|---|
| Eric H. Schultz | Management Director | President and Chief Executive Officer, HPHC, Inc. |
| Connie Smith Barr, M.D. | Independent Director | Internist, Dedham Medical Associates |
| Earl W. Baucom | Independent Director | Senior Vice President and Chief Accounting Officer, Federal Home Loan Bank of Boston |
| John H. Budd | Independent Director | Of Counsel, Mirick, O'Connell, DeMallie & Lougee, LLP |
| Susan V. Duprey | Independent Director | Attorney, Divine Millimet |
| Katherine A. Hesse | Independent Director | Partner, Murphy, Hesse, Toomey & Lehane, LLP |
| Deborah C. Jackson | Independent Director | Chief Executive Officer, American Red Cross of Massachusetts Bay |
| Herman B. Leonard, Ph.D. | Independent Director | Professor, Harvard University, John F. Kennedy School of Gov't |
| Edward F. McCauley | Independent Director | Retired Partner, Deloitte & Touche LLP |
| Joseph A. Murphy | Independent Director | Vice Chancellor and Chief Operating Officer, University of Massachusetts Medical School |
| Joseph O'Donnell | Independent Director | Professor, Dartmouth Medical School |
| Barry L. Shemin | Independent Director, Chair | Consulting Actuary, John Hancock Financial Services, Inc. |
| Mary Ann Tocio | Independent Director | President, Bright Horizons, Family Solutions |

Harvard Pilgrim Health Care, Inc.

Committees of the Board

The Board may, by vote of a majority of the directors then in office, elect or appoint one or more committees and delegate to any such committee or committees any or all of the powers of the directors, except those which by law, by the restated articles of organization or by the restated by-laws they are prohibited from delegating. Unless the directors otherwise determine, there shall be an Executive Committee which shall have all of the powers specified in Massachusetts General Laws, Chapter 156B, Section 55. Unless the directors otherwise designate, committees shall conduct their affairs as nearly as may be in the same manner as is provided in the restated by-laws for the directors. The members of any committee shall remain in office at the pleasure of the directors. All committees of the board, except the Executive Committee, may include members from within or without the membership of the Board of directors. By virtue of his office, the President shall be a member of the Executive Committee.

In addition, other committees may be appointed by the board of directors, which shall include standing Audit, Finance, Human Resources and Nominating and Governance committees with a board member as chairperson.

The current standing committees of the Board as of December 31, 2010 were as follows:

Audit Committee - The Audit Committee oversees the Company's financial reporting processes and its systems of internal controls and compliance to ensure their integrity and effectiveness.

Finance Committee - The Finance Committee oversees the financial condition of the Company to ensure the Company's financial strength and integrity.

Human Resources Committee - The Human Resources Committee ensures implementation of policies and procedures which enable the Company to attract, retain and develop the most talented staff available; to evaluate the performance of the President and Chief Executive Officer.

Nominating and Governance Committee - The Nominating and Governance Committee oversees the Board's organizational structure, composition and focus of activities to ensure the Board's effectiveness in supporting achievement of the Company's mission.

Patient Care Assessment Committee - The Patient Care Assessment Committee develops, recommends for approval by the board of directors and implements the Patient Care Assessment Plan of the corporation and its affiliates approved from time to time by the board of directors pursuant to Massachusetts General Laws, Chapter 111, Section 203 and the Qualified Patient Care Assessment Coordinator for the corporation and its affiliates pursuant to the foregoing regulations.

Officers

The Company's officers consist of a Chairman of the Board, President, Treasurer, Clerk and such other officers, if any, as the directors or the President may determine. The Clerk shall be a resident of the Commonwealth of Massachusetts unless the Corporation has appointed a resident agent to receive service of process. A person may hold more than one office at the same time.

Harvard Pilgrim Health Care, Inc.

The officers of the Corporation shall be elected by the Board at its annual meeting. Each officer shall hold office until the annual meeting of the Board next following his election and until his successor is chosen and qualified, or until he sooner dies, resigns, is removed or becomes disqualified.

The elected officers and their respective titles at December 31, 2010 were as follows:

| <u>Officer</u> | <u>Elected Title</u> |
|--------------------------------|---------------------------------------|
| Barry L. Shemin | Chairman of the Board |
| Mary Ann Tocio | Vice Chairman of the Board |
| Eric H. Schultz | President and Chief Executive Officer |
| Roberta Herman, MD | Chief Operating Officer |
| James W. DuCharme ¹ | Chief Financial Officer and Treasurer |
| Laura S. Peabody | Secretary and Clerk |
| Gary H. Lin ² | Chief Actuary |

¹- James DuCharme was CFO and Treasurer until departing in January, 2012. Mr. DuCharme served as CFO and Treasurer from June 2008 – January 2012. As of the date of this examination report, Harvard Pilgrim continues its search for a replacement.

²- Gary Lin left Harvard Pilgrim in August, 2011. Interim Actuary, Linda A. Areae started in September, 2011. In January 2012, Scott Allen became Senior Vice President and Chief Actuary.

Conflict of Interest Procedures

The Company has adopted a conflict of interest policy statement. The Company has an established procedure for the disclosure to the Board of any material interest or affiliation on the part of any officer or director which is in or is likely to conflict with his/her official duties.

Each director of the Board shall annually deliver to the Board, at or about the time of the Annual Meeting, a true and complete conflicts of interest statement (a "Conflicts Statement") in the form approved by the Board; provided that each person described above shall deliver only one Conflicts Statement regardless of the number of positions listed above that he or she holds. Each director shall promptly update his or her most recent Conflicts Statement upon the occurrence of any event that makes the information contained in such Conflicts Statement no longer true or that would be required to be reported in such Conflicts Statement at the time it is delivered to the Board.

The completed Conflict of Interest Disclosure Statements for Directors, Officers and Senior Managers for 2008, 2009 and 2010 were reviewed. No discrepancies were noted in the response to the General Interrogatories regarding conflicts of interest as reflected in the Company's December 31, 2010 Annual Statement.

Corporate Records

Board of Directors Minutes

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

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.

Corporate Governance

The Company's board of directors has significant influence on the entity's control consciousness. The Board, through its own activities and supported by its audit committee, is responsible for overseeing all financial reporting policies and procedures. The Board appears appropriately experienced and qualified.

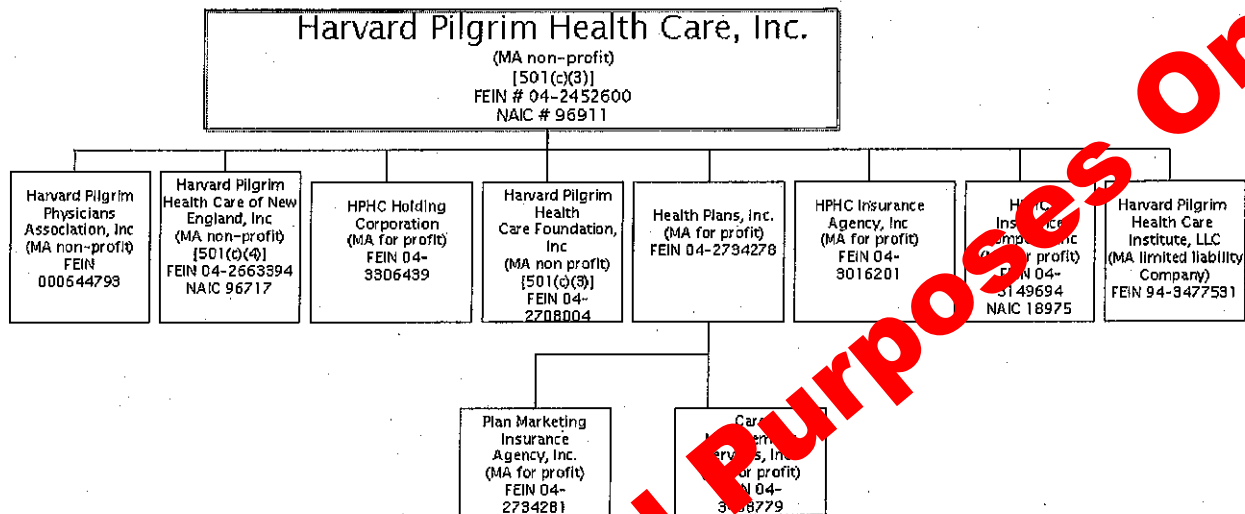
During the period under examination and through completion of examination fieldwork, it appears that the Company's internal audit department objectives and strategies are clear and well-documented. Audits were performed on a regular basis with results communicated to senior management, the respective department heads and external auditors. The Company's external auditors did not identify any deficiencies in internal controls that were considered to be material.

Harvard Pilgrim Health Care, Inc.

AFFILIATED COMPANIES

Organization Chart

A summary of ownership and relationship of the Company and its operating subsidiaries and affiliated companies as of December 31, 2010 is illustrated below:



Related Party Transactions

Harvard Pilgrim Health Care, Inc. provides all administrative and operational management services to HPHC Insurance Company, Inc. ("Insurance Company"). Administrative services are charged to the Insurance Company based on Harvard Pilgrim's departmental cost allocation methodology. For the years ended December 31, 2010 and 2009, total administrative expenses and claims adjustment expenses allocated to the Insurance Company were \$33.5 and \$25.7 million, respectively. As of December 31, 2010, Harvard Pilgrim had a receivable of \$5.1 million from the Insurance Company, and owed the Insurance Company \$10.2 million in 2009.

The Company also provides all administrative and operational management services to Harvard Pilgrim Health Care of New England, Inc. ("New England"). The Company has a management and medical services agreement with New England, which provides for an allocation of hospital and medical costs, including claims adjustment expenses from HPHC, Inc. to New England. Administrative expenses are allocated to New England based on Harvard Pilgrim's departmental cost allocation methodology.

For the year ended December 31, 2010 and 2009, total gross administrative expenses and claims adjustment expenses allocated to New England were \$27.7 million and \$27.4 million, respectively. New England had a receivable of \$2.4 million from the Company in 2010 and owed the Company \$0.2 million in 2009. In addition, HPHC, Inc.'s board of directors approved and paid a \$15 million capital contribution to New England in 2009. HPHC, Inc. did not make any capital contributions to New England in 2010.

Harvard Pilgrim Health Care, Inc.

There are certain operating expenses incurred by HPI, which are initially paid by HPHC, Inc. In addition, administrative expenses are allocated to HPI based on Harvard Pilgrim's departmental cost allocation methodology. For the year ended December 31, 2010 and 2009, total gross administrative expenses and claims adjustment expenses allocated to HPI were \$1.8 million and \$1.6 million, respectively. As of December 31, 2010 and 2009, HPI owed HPHC, Inc. \$0.7 million and \$2 million for the operating and administrative expenses incurred.

HPHC, Inc. makes contributions to the Foundation to support its ongoing operations. In addition, the Foundation reimburses HPHC, Inc. for expenses paid on its behalf. The Foundation owed HPHC, Inc. \$0.6 million and \$0.4 million in 2010 and 2009, respectively.

HPHC, Inc. makes contributions to the Institute to support its ongoing operations. In addition, the Institute initially funds payroll and related expenses for personnel working on projects funded by federal and other grants, which is ultimately reimbursed to HPHC, Inc. as grantee, by granting organizations. These costs are then reimbursed by HPHC, Inc. to the Institute. As of December 31, 2010 and 2009, HPHC, Inc. owed the Institute \$2 million and \$1.2 million, respectively.

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 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, 2010.

COMMITMENTS AND CONTINGENCIES

Related-Party Guarantees — HPHC, Inc. and its insurance affiliates the Insurance Company and New England participate in a Guaranty and Indemnity Agreement ("G&I Agreement"). Under the terms of the G&I Agreement, each entity guarantees the payment and performance of the others. In addition, each entity is jointly and severally liable for all obligations that may arise out of this G&I Agreement.

Long-Term Service Contract with Dell Perot Systems Healthcare Services Corporation ("DPSHS") — HPHC, Inc. has a long-term agreement with DPSHS whereby DPSHS provides information technology operations, development and claims processing services at HPHC, Inc. facilities under the direction of DPSHS staff. Services include operational services for technology and claims operations and business project services. The agreement calls for an annual minimum commitment of \$60 million, and is subject to adjustment for changes in service levels, cost management by HPHC, Inc. and performance incentives for DPSHS. The agreement runs through 2024.

Service Agreement with United Healthcare Services, Inc. — In 2006, HPHC, Inc. entered into a service agreement whereby United Healthcare Services, Inc. ("United") administers a national preferred provider organization ("PPO") product on behalf of the Insurance Company. The national PPO product is a joint product offering between the Insurance Company and United. As part of the service agreement, United performs administrative functions associated with the product, including

Harvard Pilgrim Health Care, Inc.

premium billing and claims adjudication. The Insurance Company pays a per member, per month fee to United for the services performed. The agreement is effective through December 31, 2016.

Minimum Net Worth— The Commonwealth of Massachusetts, under the Acts of 2003, Chapter 141, Sections 46 and 83, amended the General Laws of Massachusetts, Chapter 176G Health Maintenance Organizations by adding Section 25 Net Worth of Health Maintenance Organizations which took effect on January 1, 2004. Section 25 sets forth minimum adjusted net worth requirements for health maintenance organizations to be phased in over a seven-year period beginning December 31, 2004. In addition, Health Maintenance Organizations (“HMO”) must maintain a minimum deposit of at least \$1 million with a trustee acceptable to the Division. As of December 31, 2010 and 2009, the minimum net worth requirement for HPHC, Inc. was \$122.1 million and \$94.5 million, respectively. As of December 31, 2010 and 2009, the minimum net worth requirement had been satisfied.

LEASE OBLIGATIONS

HPHC, Inc. has entered into several long-term non-cancelable operating leases for buildings and equipment. The terms of the leases vary through the year 2015 with an option to renew through the year 2025. The following is a schedule, by year, of future minimum rental payments required under all operating leases for buildings and equipment that have entered into or remaining non-cancelable lease terms of one year or more as of December 31, 2010 (amounts in thousands):

| <u>Years Ending December 31</u> | <u>Amount</u> |
|-------------------------------------|------------------|
| 2011 | \$ 10,685 |
| 2012 | 10,441 |
| 2013 | 10,230 |
| 2014 | 10,221 |
| 2015 | 3,742 |
| Thereafter | <u>95</u> |
| Total | <u>\$ 45,414</u> |

Total rent expense on all leases was \$19.6 million and \$19.4 million in 2010 and 2009, respectively.

Harvard Pilgrim Health Care, Inc.

HPHC, Inc. leases, as lessor, certain properties. The amounts due to HPHC, Inc. as of December 31, 2010, are as follows (amounts in thousands):

| <u>Years Ending December 31</u> | <u>Amount</u> |
|-------------------------------------|------------------|
| 2011 | \$ 2,636 |
| 2012 | 2,661 |
| 2013 | 2,938 |
| 2014 | 2,963 |
| 2015 | 368 |
| Thereafter | 0 |
| Total | <u>\$ 11,566</u> |

HPHC, Inc. recorded net sublease income related to the above properties of \$3.5 million and \$3.7 million in 2010 and 2009, respectively in miscellaneous (expense) income in the statutory statements of income.

PENSION AND OTHER POST RETIREMENT BENEFIT PLANS

Defined Contribution Plan — HPHC, Inc. employees participate in a defined contribution plan covering all employees. Participants can make salary deferral contributions up to 50% of their pay, subject to the legally permitted maximum, after one year of service. HPHC, Inc. will make matching contributions equal to 100% of the first 4% of salary deferrals, subject to the legally permitted maximum. HPHC, Inc. also makes an annual contribution of 4% of pay to each participant's account regardless of whether the employee makes salary deferral contributions or not. HPHC, Inc.'s contributions amounted to approximately \$6.6 million and \$6.9 million for the years ended December 31, 2010 and 2009, respectively.

Deferred Compensation Plan — HPHC, Inc. established a nonqualified deferred compensation plan, effective July 1, 2005, which allows certain highly compensated employees the option to defer specified amounts of their annual compensation on a pretax basis and also allows HPHC, Inc., at its discretion, the option to provide deferred compensation to key employees. A participant in the plan is notified if a voluntary contribution is made by HPHC, Inc. to that participant's account. In addition, the participant's account is credited to reflect investment returns based on measuring investments selected by either the participant or the plan administrator in accordance with the plan document. The participant has the option to take a distribution of their account, in its entirety, upon severance from employment with HPHC, Inc. HPHC, Inc. has recorded a liability of \$1.1 million and \$0.7 million as of December 31, 2010 and 2009, respectively, which represents its obligation for benefits payable under the plan. All amounts of compensation deferred under the plan remain the assets of HPHC, Inc. until paid out to a participant or his or her beneficiary. HPHC, Inc. is not required to segregate or set aside any assets to meet its obligation under the plan.

Postretirement Medical Plan — HPHC, Inc.'s postretirement medical plan allows employees who have attained age 60 and completed 10 years of continuous service to remain in HPHC, Inc.'s group health care coverage upon retirement and until they qualify for Medicare coverage. In accordance

Harvard Pilgrim Health Care, Inc.

with the provisions of the postretirement medical plan, the employee will pay 100% of the monthly premium until they reach age 65. Once they reach age 65 and enroll in both Medicare A and B, HPHC, Inc. will provide a maximum monthly contribution of \$150 to each retiree (and spouse, if applicable), provided the employee is transitioning from an active HPHC, Inc. employee medical plan. The plan is not currently funded.

The Medicare Prescription Drug, Improvement and Modernization Act of 2003 ("Act") was signed into law in December 2003. The Act provides a Medicare prescription drug benefit which began in 2006 and federal subsidies to employers who provide drug coverage to retirees. This legislation did not materially impact plan obligations, and accordingly, HPHC, Inc. has not reflected any impact from the legislation.

TERRITORY AND PLAN OF OPERATION

The Corporation is licensed to transact business in the Commonwealth of Massachusetts and the state of Maine. Harvard Pilgrim Health Care, Inc. is headquartered in Weymouth, MA. As of December 31, 2010, HPHC's service area included all of Massachusetts with a focus on the greater metropolitan Boston area.

SURPLUS NOTES

In connection with a plan of rehabilitation issued in fiscal year 2000, when Harvard Pilgrim was released from temporary receivership and placed under administrative supervision, Harvard Pilgrim issued surplus notes for substantially all of the pre-receivership general unsecured obligations ("Surplus Notes"). Payments of principal and interest on the Surplus Notes and the Massachusetts Health and Education Facilities Revenue Bonds Issue 1998 Series A ("Bonds") were made subject to the approval of the Commissioner of Insurance of the Commonwealth of Massachusetts ("Commissioner"). As such, the outstanding amount of the Bonds, reduced by the \$29 million mortgage, qualify to be treated as surplus notes under NAIC Statutory Accounting Principles ("SAP") and are included as a component of statutory net worth. The amounts outstanding for surplus notes are as follows (amounts in thousands):

| | <u>2010</u> | <u>2009</u> |
|---|------------------|------------------|
| Massachusetts Health and Educational Facilities Authority Revenue Bonds, Harvard Pilgrim Health Care Issue 1998 Series A, payable through 2028 — net of \$1,503 and \$1,589 discount, respectively | \$ 106,912 | \$ 116,626 |
| Mortgage | <u>(29,000)</u> | <u>(29,000)</u> |
| Total surplus notes | <u>\$ 77,912</u> | <u>\$ 87,626</u> |

In both 2010 and 2009, principal payments on the Bonds were \$9.8 million. Interest expense amounted to \$5.8 million and \$6.3 million in 2010 and 2009, respectively. Related interest paid amounted to \$5.9 million and \$6.4 million in 2010 and 2009, respectively. The payment of scheduled installments of principal and interest on the Bonds is fully insured.

Harvard Pilgrim Health Care, Inc.

In 2004, Harvard Pilgrim and Assured Guarantee Corp. ("AGC"), formerly Financial Security Assurance Inc., the Bonds' insurer, entered into an agreement which provides that the requirement that the Commissioner give prior approval to the payment of principal and interest on the Bonds ("Condition") remain in effect for the life of the Bonds after Harvard Pilgrim was released from Administrative Supervision by the Commissioner. As a result of this agreement, the Bonds will continue to be treated as surplus notes for the life of the Bonds. In consideration for AGC's agreement to the continuing application of the pre-approval Condition, Harvard Pilgrim agreed to increase the annual principal payment it makes with respect to the obligations to the greater of \$9.8 million or the original principal requirement as outlined in the Loan and Trust agreement. Supplemental payments of additional principal up to a maximum of \$10 million per year and \$46 million in the aggregate would be required if certain profitability and financial conditions are met.

On June 15, 2006, Harvard Pilgrim was released from Administrative Supervision by the Commissioner. As a result, Harvard Pilgrim increased the principal payment due on July 1 each year thereafter to \$9.8 million ("Additional Principal Payment") in accordance with the agreement. In addition, Harvard Pilgrim agreed to pay AGC an annual fee, commencing on January 1, following the release from Administrative Supervision by the Commissioner equal to the principal amount of the Bonds outstanding on the previous December 31 multiplied by 50 basis points per year or 15 basis points per year if the Bonds carry an investment grade rating by Moody's or Standard & Poor's on the date such payment is due. At December 31, 2010, the Bonds carried an investment grade rating by Moody's.

At December 31, 2010 and 2009, the estimated fair market value of the Bonds was approximately \$107.7 million and \$118.5 million, respectively. The fair market value is estimated based on the quoted market prices for the same or similar issues.

Special deposits include a debt service fund that was established with the bond trustee for the payment of principal and interest. The debt service fund amounted to \$2.7 million and \$3 million at December 31, 2010 and 2009, respectively. These funds are invested in U.S. government securities and are carried at amortized cost, which approximates estimated fair value.

The aggregate amount of maturities and sinking fund requirements of the Bonds after consideration of the aforementioned amendment, as of December 31, 2010, is as follows (amounts in thousands):

| <u>Years Ending</u> <u>December 31</u> | <u>Amount</u> |
|---|-------------------|
| 2011 | \$ 9,800 |
| 2012 | 9,800 |
| 2013 | 9,800 |
| 2014 | 9,800 |
| Thereafter | <u>69,215</u> |
| | <u>\$ 108,415</u> |

Harvard Pilgrim Health Care, Inc.

Other conditions of the Bonds require Harvard Pilgrim to comply with certain covenants, the most restrictive of which is the requirement that Harvard Pilgrim maintain a GAAP debt service coverage ratio of 1.1. For the years ended December 31, 2010 and 2009, all debt covenant requirements were satisfied.

For Informational Purposes Only

Harvard Pilgrim Health Care, Inc.

SPECIAL DEPOSITS

The special deposits of the Company at December 31, 2010 are as follows:

| Description | On Deposit | Par or Book Value | Statement Value | Market Value |
|--------------------------------------|---|-------------------|-----------------|--------------|
| US Treasury Stripped, 8/15/11 | KeyBanc Capital Markets, Augusta, ME – State of Maine Reserve | \$1,900,000 | \$1,897,507 | \$1,897,397 |
| US Treasury Notes, 6.375%, 6/15/2027 | CitiBank, New York, NY- Custodian for Commonwealth of Massachusetts Division of Insurance | 1,000,000 | 1,286,880 | 1,287,040 |
| Total | | \$2,900,000 | \$3,184,387 | \$3,184,437 |

LEGAL PROCEEDINGS

HPHC, Inc. 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 HPHC, Inc., the outcome of which is likely to have a material adverse effect upon the statutory financial statements.

ACCOUNTS AND RECORDS

The books and records of the Company are audited annually by the independent certified public accounting (“CPA”) firm of Dwyer & Touche, LLP in accordance with 211 CMR 23.00. The CPA firm issued an unqualified opinion for all 3 years ended December 31, 2010. The Company is also subject to review by an internal audit department.

As part of its engagement for the Division, KPMG performed a review and evaluation of the control environment of the Company’s IT systems. The NAIC’s Information Systems Questionnaire completed by the Company was reviewed and interviews with Company management and IT staff were conducted to gather supplemental information and corroborate the Company’s responses to the questionnaire. Included was a review of the documentation supporting management and organization controls, application systems development and maintenance controls, operating and processing controls, logical and physical security controls, contingency planning controls, personal computers, local area network (“LAN”), wide area network (“WAN”) and internet controls.

The control environment of the Company’s information systems was found to have in place sufficient internal controls. There were no material internal control weaknesses noted in connection with the examination, nor were any such matters reported in the CPA firm’s filings with the Division. The Company uses an automated general ledger system. Trial balances were traced from the general ledger and supporting documents to the 2010 Annual Statement. No material exceptions were noted.

FINANCIAL STATEMENTS

| The Financial Statement section includes the following: | <u>Page</u> |
|---|-------------|
| Statement of Assets, Liabilities and Capital & Surplus as of December 31, 2010 | 19 |
| Statement of Revenue and Expenses for the Year Ended December 31, 2010 | 20 |
| Capital & Surplus for the Year Ended December 31, 2010 | 21 |
| Statement of Changes in Capital & Surplus for Three Years Ended December 31, 2010 | 2 |

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, 2010.

For Informational Purposes Only

Harvard Pilgrim Health Care, Inc.

Harvard Pilgrim Health Care, Inc.
Statement of Assets, Liabilities and Capital & Surplus
As of December 31, 2010

| | Per Company | Examination Changes | Per Statutory Examination |
|---|----------------|------------------------|---------------------------------|
| Assets | | | |
| Bonds | \$ 500,670,903 | \$ 0 | \$ 500,670,903 |
| Stocks | | | |
| Common Stocks | 147,948,424 | | 147,948,424 |
| Real Estate: | | | |
| Properties occupied by the company | 28,780,000 | | 28,780,000 |
| Properties held for the production of income | 4,683,798 | | 4,683,798 |
| Cash, cash equivalents and short-term investments | 35,111,994 | | 35,111,994 |
| Aggregate write-ins for invested assets | 2,843,524 | | 2,843,524 |
| Subtotals, cash and invested assets | \$ 720,038,643 | \$ 0 | \$ 720,038,643 |
| Investment income due and accrued | 3,734,191 | | 3,734,191 |
| Premiums and considerations: | | | |
| Uncollected premiums and agents' balances in the course of collection | 9,621,050 | | 9,621,050 |
| Amounts receivable relating to uninsured plans | 28,635,534 | | 28,635,534 |
| Electronic data processing equipment and software | 7,800,485 | | 7,800,485 |
| Furniture and equipment including health care delivery assets | 255 | | 255 |
| Receivables from parent, subsidiaries and affiliates | 6,479,296 | | 6,479,296 |
| Health care and other amounts receivable | 16,440,892 | | 16,440,892 |
| Aggregate write-ins for other than invested assets | 1,137,492 | | 1,137,492 |
| Total Assets | \$ 793,887,838 | \$ 0 | \$ 793,887,838 |
| Liabilities | | | |
| Claims unpaid | 178,104,112 | | 178,104,112 |
| Accrued medical incentive pool and bonus amounts | 26,353,581 | | 26,353,581 |
| Unpaid claims adjustment expenses | 2,748,851 | | 2,748,851 |
| Premiums received in advance | 39,337,432 | | 39,337,432 |
| General expenses due or accrued | 64,595,425 | | 64,595,425 |
| Amounts withheld or retained for the account of others | 1,018,051 | | 1,018,051 |
| Amounts due to parent, subsidiaries and affiliates | 4,351,062 | | 4,351,062 |
| Liability for amounts held under uninsured plans | 28,520,720 | | 28,520,720 |
| Aggregate write-ins for other liabilities | 36,134,273 | | 36,134,273 |
| Total Liabilities | \$ 381,163,507 | \$ 0 | \$ 381,163,507 |
| Capital and Surplus | | | |
| Surplus notes | 77,911,506 | | 77,911,506 |
| Unassigned funds (surplus) | 334,812,825 | | 334,812,825 |
| Total Capital and Surplus | \$ 412,724,331 | \$ 0 | \$ 412,724,331 |
| Total Liabilities, Capital and Surplus | \$ 793,887,838 | \$ 0 | \$ 793,887,838 |

Harvard Pilgrim Health Care, Inc.

Harvard Pilgrim Health Care, Inc.
Statement of Revenue and Expenses
For the Year Ended December 31, 2010

| | Per Company | Examination Changes | Per Statutory Examination |
|--|------------------|------------------------|---------------------------------|
| Member Months | 5,050,247 | - | 5,050,247 |
| Net premium income | \$ 2,301,976,475 | \$ 0 | \$ 2,301,976,475 |
| Total revenues | \$ 2,301,976,475 | \$ 0 | \$ 2,301,976,475 |
| Hospital and Medical: | | | |
| Hospital/medical benefits | 1,573,096,165 | | 1,573,096,165 |
| Other professional services | 104,032,906 | | 104,032,906 |
| Outside referrals | 35,340,596 | | 35,340,596 |
| Emergency room and out-of-area | 45,717,395 | | 45,717,395 |
| Prescription drugs | 250,807,012 | | 250,807,012 |
| Incentive pool, withhold adjustments and bonus amounts | 32,926,548 | | 32,926,548 |
| Subtotal | \$ 2,041,920,622 | \$ 0 | \$ 2,041,920,622 |
| Less | | | |
| Net reinsurance recoveries | 857,572 | | 857,572 |
| Total medical and hospital | 2,041,920,622 | \$ 0 | \$ 2,041,920,622 |
| Claims adjustment expenses | 43,889,897 | | 43,889,897 |
| General administrative expenses | 178,336,867 | | 178,336,867 |
| Total underwriting deductions | \$ 2,263,289,814 | \$ 0 | \$ 2,263,289,814 |
| Net underwriting gain | \$ 38,686,661 | \$ 0 | \$ 38,686,661 |
| Net investment income earned | 19,685,837 | | 19,685,837 |
| Net realized capital losses | (7,548,543) | | (7,548,543) |
| Net investment gains | \$ 12,137,294 | \$ 0 | \$ 12,137,294 |
| Aggregate write-down for other income or expenses | (6,575,825) | | (6,575,825) |
| Net income before taxes | \$ 44,248,130 | \$ 0 | \$ 44,248,130 |
| Federal and foreign income taxes incurred | 0 | | 0 |
| Net income | \$ 44,248,130 | \$ 0 | \$ 44,248,130 |

Harvard Pilgrim Health Care, Inc.

Harvard Pilgrim Health Care, Inc.
Capital & Surplus
For the Year Ended December 31, 2010

| | Per Company | Examination Changes | Per statutory Examination |
|--|-----------------------|------------------------|---------------------------------|
| Statutory net worth, December 31, 2009 | \$ 381,955,672 | \$ 0 | \$ 381,955,672 |
| Net Income | 44,248,130 | | 44,248,130 |
| Change in net unrealized gain | 34,808,925 | | 34,808,925 |
| Increase in nonadmitted assets | (38,573,500) | | (38,573,500) |
| Change in surplus notes | (9,714,896) | | (9,714,896) |
| Statutory net worth, December 31, 2010 | <u>\$ 412,724,331</u> | <u>\$ 0</u> | <u>\$ 412,724,331</u> |

For Informational Purposes Only

Harvard Pilgrim Health Care, Inc.

Harvard Pilgrim Health Care, Inc.
Statement of Changes in Capital & Surplus
For Three Year Period Ended December 31, 2010

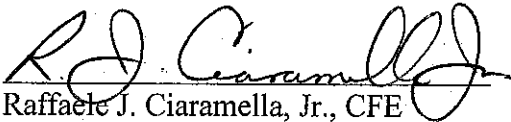
| | 2010 | 2009 | 2008 |
|---|----------------|----------------|----------------|
| Statutory net worth, prior year | \$ 381,955,672 | \$ 386,732,784 | \$ 373,472,617 |
| Net Income | 44,248,130 | 23,964,355 | 52,292,074 |
| Change in net unrealized capital gains (losses) | 34,808,925 | 23,500,158 | (13,492,743) |
| Change in nonadmitted assets | (38,573,500) | (27,526,729) | (2,679,267) |
| Change in surplus notes | (9,714,896) | (9,714,896) | (12,859,896) |
| Aggregate write-ins for losses in surplus | - | (15,000,000) | (10,000,000) |
| Net change in capital and surplus | 30,768,659 | (4,777,112) | 13,660,167 |
| Statutory net worth, December 31, current year | \$ 412,724,331 | \$ 381,955,672 | \$ 386,732,784 |

ACKNOWLEDGEMENT

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 Harvard Pilgrim Health Care, Inc. in order for the Division to fulfill the Commonwealth of Massachusetts' 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 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 Harvard Pilgrim Health Care, Inc. extended to all examiners during the course of the examination is hereby acknowledged.



Raffaele J. Ciaramella, Jr., CFE
Supervising Examiner and Examiner-in-Charge
Commonwealth of Massachusetts
Division of Insurance