STATE OF CALIFORNIA -- BUSINESS, TRANSPORTATION AND HOUSING AGENCY PETE WILSON, Governor

DEPARTMENT OF CORPORATIONS
OFFICE OF THE COMMISSIONER
[illegible]
LOS ANGELES, CALIFORNIA [illegible]

IN REPLY REFER TO
FILE NO.

July 21, 1995

Board of Directors
Blue Cross of California
21555 Oxnard Street
Woodland Hills, CA 91367

Dear Board Member:

The Department of Corporations is reviewing the public benefit plan that Blue Cross of California (BCC) has submitted and the proposed transaction between BCC, WellPoint Health Networks and Health Systems International (HSI). The Department is considering the extent to which BCC's public benefit plan and the proposed BCC/WellPoint/HSI merger are consistent with BCC's responsibilities under the Nonprofit Corporation Law and the participants' respective responsibilities under the Knox-Keene Act.[1]

During this review, the Department is seeking to determine whether (i) the BCC directors have acted in good faith and in a manner in which they believe to be in the best interests of BCC and with such care, including reasonable inquiry, as an ordinarily prudent person in a like position would use under similar circumstances (Corporations Code Section 5231); (ii) the BCC/WellPoint/HSI transaction is fair and reasonable to BCC (Corporations Code Section 5233(d)(2)(B)); (iii) prior to authorizing the transaction the BCC directors considered and in good faith determined after reasonable investigation under the circumstances that BCC could not have obtained a more advantageous arrangement with reasonable effort under the circumstances (Corporations Code Section 5233(d)(2)(D)(i)) and (iv) the proposed transaction is consistent with the public trusts that BCC has assumed (Corporations Code Section 5250). This review is being undertaken pursuant to the authority granted to the Commissioner of Corporations under Sections 5250 and 10821 of the Corporations Code.

Uncompensated Loss of BCC's Control Premium. BCC currently owns 80% of the equity interest in WellPoint and more than 97% of the voting power of WellPoint. This controlling interest is a valuable asset of BCC. In connection with the proposed transaction, however, BCC will give up this asset without any compensation. The Department has serious concerns with respect to the fairness and reasonableness to BCC of this aspect of proposed transaction and believes that a more advantageous arrangement in this regard should be available to BCC with reasonable effort under the circumstances. Furthermore, the surrender of control

[1] This letter does not address the Knox-Keene Act issues that may be raised in connection with the Department's review of the notices of material modification submitted by BCC and WellPoint.

without compensation would appear to be a departure from the public trusts assumed by BCC. The following terms of the proposed transaction raise these concerns:

(1) Pursuant to the proposal, BCC/Foundation will initially own in excess of 56% of the voting power of Newco. BCC's right to elect directors and exercise other shareholder rights should reflect the approximate 56% voting power that it will hold. BCC's statement that it is fair that it only have the right to designate three of 12 members[2] of the Newco's Board because these inadequate Board rights are an improvement over the even more inadequate Board rights that BCC previously enjoyed strongly suggests that no reasonable effort was made to protect BCC's control premium or controlling interest in Newco.

(2) The proposed terms of the Voting Agreement and Bylaws relating to the election of directors of Newco do not appear to be fair and reasonable to BCC in light of its controlling ownership position in Newco. The Voting Agreement requires BCC/Foundation to vote its shares in favor of each person nominated by the Newco Nominating Committee. The Nominating Committee to be established by Newco's bylaws will continue in existence only until such time as BCC/Foundation has reduced its ownership level to less than 5% of the voting power or the expiration of seven years (whichever is earlier). Because the Bylaws provide for a Nominating Committee only so long as BCC/Foundation is in control, it is apparent that the purpose of the committee is to deprive BCC/Foundation of its ability to exercise meaningful oversight of the Newco board or voting power commensurate with its economic stake in the enterprise. The Bylaws further provide that Dr. Hasan and Mr. Schaeffer will be two of the initial three members.[3] Generally, Nominating Committees should consist entirely of non-management, non-employee directors. The proposal appears at odds with accepted practices of corporate governance and may be

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[2] Please provide the Department with written background information concerning BCC's initial proposal that Newco would choose the three BCC/Foundation directors from six designees proposed by BCC/Foundation and a statement of the procedure that is now proposed to be followed with respect to the BCC/Foundation nominees to Newco's Board.

[3] The maximum term on the Nominating Committee of seven years is more than twice the proposed term of directors (three years). In addition, please indicate whether purchasers of BCC/Foundation's Newco stock are intended to be bound by the unfavorable voting arrangements set forth in the Voting Agreement.

inconsistent with the New York Stock Exchange listing guidelines.[4] The Bylaws and the Voting Agreement significantly dilute BCC/Foundation's ability to exercise meaningful control, and the Department does not anticipate that these agreements are fair and reasonable to BCC or that BCC was compensated for entering into these arrangements. They should be eliminated or substantially modified to reflect the interest in Newco that BCC/Foundation will hold on behalf of the people of the State of California.

(3) There are a number of other proposed provisions in Newco's proposed charter documents which do not appear to be fair and reasonable to BCC in light of its ownership interest in Newco. These include (a) the proposed prohibition against shareholder action taken by written consent, (b) the apparent elimination[5] of the right that BCC/Foundation would have under California law to call a special meeting of shareholders and (c) the supermajority requirement to remove Dr. Hamm or Mr. Schaeffer from their respective officer positions for one years, to change provisions relating to the nominating committee present or to fill vacancies on the Newco Board. BCC should explain how these provisions serve BCC/Foundation's interest.

BlueCross BlueShield Association. The positions taken by the BlueCross BlueShield

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[4] According to the American Law Institute, for example, "as a matter of corporate practice . . . publicly held corporations should establish a nominating committee composed exclusively of directors who are not officers or employees of the corporation, including at least a majority of members who have no significant relationship with the corporation's senior executives . . . ." American Law Institute, Principles of Corporate Governance: Analysis and Recommendations 122 (1994). Rule 303.00(A) of the NYSE Listing Manual provides that "the Exchange would object to . . . [t]he imposition of any ongoing obligation to cause the nomination of and election of a person or persons who represents a specific individual or corporate shareholder on the company's Board of Directors."

[5] It is unclear whether or not this right is intended to be eliminated. Article V, Section 9 of the proposed Articles states that except as contemplated in Article VI, Section 2(D)(3)(i) of the Articles, only the Chairman, President or majority of the Board can call a special meeting of shareholders. The proposed form of Articles contains no such Section 2(D)(3)(i). In addition, it is unclear whether the elimination of this right would be valid under California law. The proposed range of directors of nine to 30 persons set forth in the Articles may also be inconsistent with California law. Under Section 212(a) of the California Corporations Code, the maximum number of authorized directors can be no more than two times the minimum number. BCC should consider the validity of these Articles provisions under California law.

Association with respect to licensing of the Blue Cross mark could significantly and adversely impact the interests of the people of the State of California. BCC has not demonstrated that more favorable arrangements in this regard were not available to BCC with reasonable effort. Further, the proposed terms do not appear to be fair and reasonable to BCC. The Department has the following particular concerns and questions:

(1) The Department questions whether BCC was directly or indirectly the source of certain conditions to the Association's approval of Newco's use of the Mark. At its September 9, 1994 meeting, the BCC Board designated both of the following two conditions as "anchor points": (a) the BCC/Foundation Board be comprised of a majority of former members of the BCC Board and (b) the BCC/Foundation remain independent of any governmental authority, other than the Attorney General. Please clarify whether these conditions were initially suggested by the Association or by BCC. BCC's Board should demonstrate why these two conditions are fair and reasonable to BCC. In addition, BCC should provide a chronological summary of all verbal communications between any Association representative and any BCC representative dealing directly or indirectly with the proposed monetization of BCC's assets.

(2) The Association has apparently insisted that BCC/Foundation reduce its interest in Newco to 20% within three years and 5% within five years. For many months, BCC has argued that, to maximize the long-term value of any stock distributed as part of BCC's public benefit plan, the organization holding that stock should be a 501(c)(4) social welfare organization. The divestiture requirements that the Association has apparently insisted upon are much more onerous than the restrictions that BCC has sought to avoid under its proposal with respect to the 501(c)(4) organization. Since companies licensed by the Association have historically been not-for-profit, the Department does not understand the rationale behind the Association's requirement, nor has any such rationale been provided. In view of the significant impact that this divestiture requirement could have on BCC/Foundation, every reasonable effort should be made to have the Association eliminate or substantially modify this requirement.[6]

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[6] According to a May 17 memorandum from Marron, Reid & Sheehy, the Internal Revenue Service has expressed a concern that the premature disposition of Newco stock by BCC/Foundation could have an adverse effect on the tax treatment of the Conversion. Any such increased tax risk makes it more essential that the Association-imposed divestiture requirements be eliminated or substantially relaxed.

(3) BCC/Foundation is expected to enter into a Voting Trust Agreement reducing its right to control more than 49.9% of the Newco voting power. The Department does not understand the Association's rationale for this requirement and believes that this requirement effectively eliminates important rights that BCC/Foundation would otherwise have.

(4) The Articles give the Association a veto over any acquisition of more than 5% of Newco's voting stock. This provision could effectively impede Newco's strategic business plans and undermine BCC/Foundation's ability to liquidate its Newco stock. Accordingly, this condition does not appear to be fair and reasonable to BCC. Every reasonable effort should be made to eliminate this extremely unusual degree of control granted to an entity that is, in effect, a Newco vendor.

Through its actions, the Association may be significantly undermining the interests of 32 million Californians. Since the Association's principal asset is the goodwill associated with its Marks, it is difficult to see how these actions serve the Association's or BCC/Foundation's long-term interests.

BCC/Foundation as a 501(c)(4) Organization. BCC has proposed that the entity holding the Newco stock be organized as a 501(c)(4) social welfare organization. If the Department ultimately concludes that this proposal is acceptable, the Department believes that the following changes should be made to the BCC public benefit plan:

(1) The consideration to be distributed in connection with the BCC/WellPoint/HSI merger should be reallocated to reduce substantially that portion of the consideration to be paid to the 501(c)(4) organization and increase the consideration delivered to the 501(c)(3) private foundation. In view of the limited role that the 501(c)(4) should play in meeting BCC's public benefit responsibilities, the Department does not believe it is appropriate for the 501(c)(4) to receive up to $235 million in cash.

(2) The 501(c)(4) should commit to distribute all proceeds it receives from any monetization of Newco's stock, other than a *de minimis* amount of proceeds that BCC can demonstrate the 501(c)(4) must hold to preserve its tax status, to the 501(c)(3) within five days of the receipt of such proceeds.

(3) The minimum annual contributions to be made by the 501(c)(3) should be not less than 5% of the aggregate assets held by the 501(c)(4) and the 501(c)(3).

(4) The initial members of the 501(c)(4)'s Board should be selected pursuant to the nominating procedure set forth below, and thereafter the 501(c)(3) should have the

right to designate not less than a majority of the members of the 501(c)(4)'s Board.

(5) The 501(c)(4) should be subject to the same restrictions on lobbying or other political activities, conflicts of interest and self-dealing transactions (other than those relating to approved monetization transactions) and the same reporting obligations imposed on 501(c)(3) private foundations.

Fairness of the Bidding Process. The Department is requesting the following additional information:

(1) A copy of the Board minutes for the meeting held on or about March 26, 1995. (These minutes were not provided in response to the Department's May 3, 1995 information request.) According to the Preliminary Proxy Statement, Messrs. Knight and Besson were added as voting members of the Independent Committee at that Board meeting. To the extent not fully reflected in the minutes of the March 26 Board meeting, BCC should provide an explanation of: (a) the rationale behind the Board's decision to change the composition of the Independent Committee so late in the process and (b) what impact, if any, the decision to add Messrs. Knight and Besson had on the course of the Independent Committee's deliberations and recommendations.

(2) The Department requests written declarations from each member of the Independent Committee concerning any information or deliberative processes that each such member shared with members of BCC's management. These declarations are requested after considering Mr. Donnelly's representation that, to the best of his knowledge, no such sharing of information has taken place.

(3) During its review of the Preliminary Proxy Statement, the Department noted that the WellPoint Board of Directors has concluded that the proposed transaction is fair to holders of WellPoint's Class A Common Stock. The Department believes that the WellPoint Board has an obligation to conclude whether the proposed transaction is fair to WellPoint's largest shareholder, BCC, and has requested a written statement of the WellPoint Board's opinion in this regard. (It would, however, be appropriate for the WellPoint Board not to express an opinion with respect to the terms of the sale of certain of BCC's commercial assets that is being undertaken as part of the proposed BCC/WellPoint/HSI transaction).

The Nominating Process. The new directors of the 501(c)(3) foundation should be selected by a nominating committee consisting of four designees of the Department and two of the proposed seven members of the 501(c)(3) foundation. This nominating process should also

apply to the initial Board members of any 501(c)(4) social welfare organization and should commence as quickly as possible.

In that regard, please furnish updated curriculum vitae for each of these proposed members of the 501(c)(4)'s Board. BCC should also provide information concerning any preexisting personal or business relationship between any of nominees to the Board of the 501(c)(3) or 501(c)(4) and BCC, WellPoint, HSI or any proposed officer or director of Newco. None of the Department's four designees to the nominating committee will have any preexisting personal or other relationship with any Department personnel, including the Commissioner.

Miscellaneous Matters. The Department has the following additional comments or concerns that it wanted to bring to the attention of the BCC Board at this time:

(1) The broad public benefit guidelines to be followed by the 501(c)(3) foundation and the 501(c)(4) organization (if any) should be disclosed prior to approval of the public benefit plan and the proposed BCC/WellPoint/HSI merger.

(2) The Department intends to hold at least two additional public hearings. These public hearings will be held after the Definitive Proxy Statement is publicly available.

(3) The Department has previously requested a summary of any golden parachute or other payments that are being made as result of the proposed BCC/WellPoint/HSI transactions together with a summary of any proposed or anticipated changes in the compensation of members of WellPoint management to be made in connection with the proposed transaction. If any such payments are being made or any such changes in management compensation are being contemplated, BCC should furnish a summary of the reasons that led to the BCC Board's conclusion that such payments or changes are appropriate, fair and reasonable (to the extent that such considerations are not fully reflected in the BCC Board minutes). BCC's May 17 response indicated that the response to this inquiry was subject to future developments. The Department would like to restate that request.

The Department may raise additional issues during the course of its review; however, it is important that the Department articulate for you our present concerns, as detailed above. The issues raised can be addressed and resolved within a timeframe that will not delay the consummation of the proposed BCC/WellPoint/HSI merger. While we do not intend to be a

source of delay, we feel a compelling obligation to fully protect the public's interest with respect to this matter.

Very truly yours,

GARY S. MENDOZA
Commissioner of Corporations

cc: David Braun, Esq.
Counsel, Securities and Exchange Commission

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VIA: MESSENGER

August 17, 1995

Gary S. Mendoza
Commissioner of Corporations
State of California
Department of Corporations
3700 Wilshire Boulevard, Suite 600
Los Angeles, California 90010-3001

Re: **YOUR JULY 21, 1995 LETTER TO THE BLUE CROSS OF CALIFORNIA ("BCC") BOARD OF DIRECTORS**

Dear Commissioner Mendoza:

This is to respond to your July 21, 1995 letter (the "July 21 Letter") to the Board of Directors of BCC (the "BCC Board") and to follow up on the July 26, 1995 meeting among BCC representatives and you and your staff and advisors. This letter will respond to the specific assertions and inquiries in the July 21 Letter and will also summarize BCC's compliance with the concerns that have been raised by the Department of Corporations ("DOC") over the past two years.

BCC'S BASIC POSITION

It is essential that the DOC clearly understand BCC's view that it has complied in all material respects with its obligations under the Knox-Keene Health Care Service Plan Act of 1975, as amended, and the regulations promulgated thereunder ("Knox-Keene Act") and California laws and regulations pertaining to nonprofit public benefit corporations ("Public Benefit Law").[1] The proposed recapitalization and business combination (collectively, the "Transactions") among BCC, WellPoint Health Networks Inc. ("WellPoint") and Health Systems International, Inc. ("HSI"), which are described in detail in BCC's Notice of Material Modification dated May 12, 1995 (the "Material Modification"), reflect not only full and complete adherence to the letter and spirit of the Knox-Keene Act and the Public Benefit Law but are the product of unprecedented regulatory and public review and scrutiny and full performance of fiduciary duties of BCC's Board and the Independent Committee of BCC's Board (the "BCC Independent Committee"), after exhaustive consideration of all possible alternative courses.

BCC has devoted extensive resources and expended millions of dollars to address the DOC's concerns. BCC has fully cooperated with the DOC despite the fact that (i) BCC's current structure and its role as a nonprofit public benefit corporation were expressly

[1] This letter responds to the issues raised under the Public Benefit Law as set forth in the July 21 Letter. The issues raised under the Knox-Keene Act, as set forth in Ms. Anita Ostroff's letter of August 7, 1995, will be addressed in a separate letter.

approved by the DOC following an exhaustive regulatory review process in 1992 and 1993, which included high level administration review; (ii) the DOC has in effect sought to rescind its 1993 approval of the BCC restructuring and in the process has imposed dramatically new substantive and procedural requirements that no nonprofit licensee would have been able to predict; and (iii) the DOC has applied an erroneous legal standard to the conduct of BCC, the BCC Independent Committee and the BCC Board. BCC's efforts in developing the Transactions have been implemented through a process far more rigorous than any ever undertaken by a nonprofit public benefit corporation, have been passed upon by the largest array of experts ever assembled in a transaction of this type and have been exhaustively documented. The resulting Transactions, having been negotiated in an open, competitive marketplace, reflect phenomenal benefit to Californians.

For convenience, the following summarizes the operative facts relating to this matter.

- BCC filed a Public Benefit Plan with the DOC on September 15, 1994 (the "Public Benefit Plan"). In the intervening eleven months, BCC has received no comment letter on that filing from the DOC.

- In the course of its discussions with BCC, the DOC has introduced new, previously unknown requirements on nonprofit Knox-Keene Act licensees, including minimum annual expenditure requirements. The DOC has also taken the unprecedented position that a private nonprofit entity such as BCC is somehow owned by the citizens of California and directly governed by the State of California. BCC believes that these requirements, which are without legal foundation, undermine the entire basis of the Public Benefit Law.

- Despite the extensive documentation BCC has provided to the DOC, and despite the many meetings and conferences we have had with the DOC and its advisors, the July 21 Letter reflects persistent misunderstandings concerning the nature and structure of the Transactions and their factual underpinnings. BCC addresses each of those misunderstandings in this letter.

- Despite having no legal obligation to do so, BCC will, upon consummation of the Transactions, create multi-billion dollar foundations for the benefit of Californians and will support a viable and successful managed care company employing thousands of Californians and headquartered solely in California. BCC has taken all steps required to complete the Transactions, including the appropriate filings with the Internal Revenue Service (the "IRS"), the Securities and Exchange Commission, federal antitrust regulators, various state insurance departments, and the DOC.

- As we have informed you, if the Transactions are not promptly approved or if the DOC insists on material changes to the Transactions such that immediate judicial review cannot be obtained to reverse such changes, the parties will, in all likelihood, be unable to complete the Transactions. Every day of delay by the DOC exposes the businesses of BCC, WellPoint and HSI to deterioration.

I. BACKGROUND

In January 1993, the DOC approved the restructuring of BCC that resulted in the creation of WellPoint. The DOC expressly approved the structure and operations of BCC as a nonprofit entity. The DOC's approval was based on BCC's commitment to augment its public benefit activities, but the types and amounts of such augmented activities were, appropriately, left to the judgment of BCC's Board. BCC has augmented those activities to embrace more than $105 million in public benefit commitments in 1994 alone, and has maintained complete fidelity to the terms of the DOC's 1993 approval.

In a good faith response to the DOC's suggestions that BCC's efforts in augmenting its public benefit activities were not sufficient, BCC filed the Public Benefit Plan. The Public Benefit Plan provided for a complete separation of BCC's nonprofit and charitable functions from its commercial operations. The nonprofit and charitable functions were to be contributed to a new foundation while the commercial operations were to be transferred, for fair value, to WellPoint.

The DOC's May 6, 1994 letter to the BCC Board urged that BCC "transfer not less than 40% of BCC's WellPoint holdings into a new . . . foundation . . ." The Board subsequently determined that all of BCC's WellPoint holdings would be contributed to a new foundation, and that the new foundation would be given the responsibility to "monetize" those holdings over time. This decision clearly met and exceeded the DOC's request.

Thereafter, in conjunction with the Public Benefit Plan and over a period of many months, BCC conducted extensive, arm's-length negotiations with WellPoint in order to develop a plan of "monetization". The monetization effort responded to the DOC's view that BCC should change its asset holdings to emphasize cash and also reflected new procedural imperatives imposed by the DOC that culminated in the creation of the BCC Independent Committee.

Although BCC is not, and has never been under any legal obligation to sell any of its assets, BCC again proceeded to address the DOC's concerns that it "monetize" its assets, principally its holdings in WellPoint. After several months of negotiations between BCC and WellPoint and multiple meetings with the DOC, the DOC suggested that BCC consider reasonable alternatives which could include the sale of all or a portion of BCC's holdings in WellPoint, in one or more transactions. Again, BCC responded to the DOC's concerns, in spite of contrary judicial authority that emanated from the conversion of FHP Inc., and through its investment bankers conducted a broad market assessment and survey of parties that might have been interested in acquiring BCC's assets, including its holdings in WellPoint.

After carefully considering available alternatives resulting from the market assessment process, and while continuing to meet new and additional requests of the DOC, BCC agreed to enter into the Transactions as fully described in the Material Modification and the draft Proxy Statement/Prospectus previously filed with the DOC on a confidential basis (the "Proxy Statement"). The Transactions contemplate that (i) BCC will transfer all or substantially all of its non-commercial assets to Western Health Partnerships ("Western Partnerships") and The Western

Foundation for Health Improvement ("Western Foundation" and together with Western Partnerships, the "Foundations"), both of which are nonprofit foundations, (ii) BCC will reorganize and either be converted to a for-profit business corporation or become a nonprofit public benefit corporation without members (option based on anticipated tax ruling), (iii) a recapitalization will occur under which WellPoint will acquire BCC's commercial operations for up to $235 million and will pay a dividend in the approximate amount of $1.2 billion to BCC (and BCC will donate its portion of the dividend to the Western Foundation) and to WellPoint's public shareholders, and (iv) WellPoint will combine with HSI. The ultimate parent company of the WellPoint subsidiaries and HSI, which company will have its stock traded on the New York Stock Exchange, is referred to in this letter as "Newco".

Upon consummation of the Transactions, the Foundations will hold approximately $3 billion in assets, including substantial holdings of Newco stock. Through great effort and difficulty in the negotiating process and through coordination with multiple tax and other advisors, the Transactions were structured so as to avoid BCC paying any unnecessary and inappropriate taxes, thereby increasing the funds available for public benefit purposes. This is an absolutely remarkable result, one that all can take their share of credit in having accomplished.

II. THE JULY 21 LETTER

The following responds to specific inquiries set forth in the July 21 Letter.

APPROPRIATE STATUTORY STANDARD

The second paragraph of the July 21 Letter cites a number of sections of the California Corporations Code (the "Code"), apparently reflecting the DOC's view that the referenced sections are applicable to BCC and the Transactions. Of critical importance is the statement that the DOC is ". . .seeking to determine whether . . . prior to authorizing the transaction the BCC directors considered and in good faith determined after reasonable investigation under the circumstances that BCC could not have obtained a more advantageous arrangement with reasonable effort under the circumstances. . ." pursuant to Section 5233(d)(2)(D)(i) of the Code. That Section is not applicable to the Transactions. Section 5233 applies only to ". . . transactions to which [a nonprofit public benefit] corporation is a party and in which one or more of its directors has a material financial interest. . ." BCC categorically disagrees with the proposition that any of its directors has a material financial interest in the Transactions. The DOC has never articulated any legal or factual basis for the applicability of the standard of Section 5233(d)(2)(D)(i) of the Code and BCC objects to being held to a standard that has no bearing on the Transactions as a matter of law.

BCC is also deeply disturbed by the DOC's suggestion that the Transactions are not fair or reasonable to BCC or that a more advantageous arrangement should be available. A thorough market assessment process was conducted on behalf of BCC by a highly respected investment banking firm. Six major investment banking firms, including the investment banking firm chosen by and engaged on behalf of the DOC, have rendered fairness opinions concluding that the Transactions are

fair from a financial point of view. It appears to us that in the July 21 Letter the DOC is essentially suggesting that the opinions of all those qualified experts have missed the mark, that an unspecified wrong has been perpetrated, and that an unspecified remedy to this perceived wrong should be undertaken. These suggestions could only be based on the substitution of a regulatory agency's personal preferences as opposed to findings and decisions based on the facts and the overwhelming weight of expert opinion.

CONTROL PREMIUM

The July 21 Letter refers to an alleged uncompensated loss of BCC's control premium and identifies the rules of the Blue Cross Blue Shield Association ("BCBSA") and certain terms of the Transactions regarding voting arrangements as specific concerns of the DOC. The Transactions resulted from an arm's-length, broad market assessment process which involved the consideration of 33 major financial, health and insurance companies throughout the United States which might conceivably be interested in a transaction and which resulted in inquiries made to 13 parties. The BCC Independent Committee received preliminary indication of interest letters from four parties and each of the four conducted due diligence on BCC and WellPoint. The BCC Independent Committee ultimately received revised proposals from three parties. Given that each of the parties to the Transactions, and their respective financial advisors, as well as (we believe) Bear, Stearns & Co., Inc., the DOC's financial advisor, concluded that no other alternatives were superior, it once again defies logic to suggest that BCC should somehow have held out for greater value than any available transaction would afford. It should be noted, in particular, that one of the proposals that was considered, and which would have involved a change in control in favor of a financial buyer, was not deemed to be demonstrably superior by the BCC Board to other transactions considered.

As we indicate below in a more detailed discussion of the BCBSA rules, BCC currently has the benefit of the Blue Cross name and mark ("Blue Cross Mark"), but as a consequence is encumbered with the restrictions adopted by the BCBSA, the owner of the Blue Cross Mark. If there were to be a sale of BCC there would be two choices. The buyer either must qualify and comply with the BCBSA rules or BCC must relinquish the right to use the Blue Cross Mark. We believe that the market assessment process has validated BCC's belief that BCC is far more valuable with the Blue Cross Mark, and attendant restrictions, than without it. We also believe that the market assessment process has established that a more advantageous arrangement than the Transactions is not available.

The July 21 Letter focuses on certain requirements associated with the use of the Blue Cross Mark and implies that such requirements place an undue burden on the Foundations. The July 21 Letter, however, ignores the offsetting benefits that were obtained in exchange for the use of the Blue Cross Mark. The primary benefit is approximately $3.0 billion of value to the Foundations. This value is maintained, in substantial part, by keeping the Blue Cross Mark and by accepting the BCBSA restrictions. The value is also supported by combining WellPoint and HSI to strengthen their respective businesses. To accomplish this, however, there had to be accommodation to the positions of the other parties to the

Transactions as to, among other things, ongoing representation on the Board of Directors of Newco (the "Newco Board").

VOTING RESTRICTIONS

You have stated that restrictions on voting, including the 49.9% voting trust restriction, and the 20% and 5% restrictions that apply over time to the Foundations and apply immediately to potential purchasers, constitute a disposition of control without appropriate compensation. This characterization is incorrect. No disposition of rights occurred as a result of the Transactions. The rights and the restrictions will continue to exist so long as Newco needs a license to use the Blue Cross Mark. Because these conditions pre-exist the Transactions, they were not created as a consequence of the Transactions. In addition, the market assessment process did take into account transactions both with and without these conditions. Potential bidders were told that the restrictions could be avoided if they did not need the Blue Cross Mark. No bidder was interested in pursuing a transaction without the Blue Cross Mark.

BOARD COMPOSITION

Paragraph numbered (1) at page 2 of the July 21 Letter refers to BCC's right to designate a certain number of directors to the Newco Board and states, in part, that the ". . . Board rights are an improvement over the even more inadequate Board rights that BCC previously enjoyed . . ." The January 7, 1993 Undertakings (the "Undertakings") entered into with the DOC by BCC and WellPoint at the time the DOC approved BCC's restructuring reflect the DOC mandated requirement that the composition of the BCC Board and the WellPoint Board be completely separate. This separateness was intended by the DOC to ensure a clear delineation between and understanding of the different duties applicable to directors of nonprofit and for-profit entities. The Undertakings reflect the DOC requirement that BCC representation on the WellPoint Board be limited to one director, the Chief Executive Officer of BCC. BCC notes that this point amounts to the DOC criticizing BCC's compliance with a DOC order.

It is critical to note that the composition of the Newco Board was the subject of exhaustive and contentious negotiations. BCC, with 97% of the vote, has selected all WellPoint directors. Seen from HSI's perspective, these are all BCC nominees. The BCC Independent Committee carefully reviewed the composition of the Newco Board and its impact on protecting the value of the Foundations' interest in Newco stock. In evaluating the reasonableness of the terms of the Transactions relating to governance, it considered both the nature of these negotiations and the fact that eight of the ten directors who would not be BCC designees would have to be independent. The BCC Independent Committee felt it was critical that the Newco Board be made up of men and women who have the depth of experience to direct a company of Newco's stature and derived considerable comfort from the independent director requirements. There is nothing in the arrangement under which BCC designates three directors that in any way suggests, as the July 21 Letter has, that ". . . no reasonable effort was made to protect BCC's control premium or controlling interest in Newco.",

Footnote 2 on page 2 of the July 21 Letter requests that BCC provide the DOC with written background concerning a proposal that Newco would choose the three BCC directors from six designees proposed by BCC. BCC notified the DOC several months ago that such proposal was incorrect. I take complete responsibility for allowing that to appear in the May 17, 1995 letter that I wrote to Mr. Thompson in connection with a document request. A copy of the explanatory letter, dated June 7, is attached. Newco will have no right to choose BCC's nominees.

Footnote 2 on page 2 of the July 21 Letter further requests that BCC describe the procedure that is now proposed to be followed with respect to BCC's designees to the Newco Board. The director members of the BCC Nominating Committee have met as an Ad Hoc Nominating Committee. They have presented nominees to the full BCC Board, which selected three Newco directors.

NOMINATING COMMITTEE AND VOTING ARRANGEMENTS

Paragraph numbered (2) at page 2 of the July 21 Letter further states, in part, that, ". . . Dr. Hasan and Mr. Schaeffer will be two of the initial three members . . ." of the Nominating Committee. This statement is incorrect. The Nominating Committee will be comprised of independent directors only (see Article IV, Section 2 of the Newco Bylaws and page 99 of the Proxy Statement). Based upon the response set forth above, we trust that footnote number 4 requires no comment. We do not believe the Nominating Committee process is at odds with arrangements often implemented in complex mergers. In addition, we have every reason to believe that the New York Stock Exchange will act to list Newco's stock, as it has in similar situations in the past.

Paragraph numbered (2) at page 2 of the July 21 Letter references the proposed terms of the Voting Agreement among the parties to the Transactions and the terms of Newco's Bylaws relating to the election of directors, and states that such terms do not appear to be fair and reasonable to BCC in light of its controlling ownership interest in Newco. Those provisions go to the very heart of the arm's-length bargaining underlying the Transactions. The voting arrangements provide certainty as to the governance of Newco and fairly reflect the fact that (i) the Transactions will enable Newco to access favorable pooling of interests accounting treatment (through a reduction of the Foundations' voting interest to 46% by reason of the voting trust arrangement called for by the Transactions) and (ii) the Transactions must embrace a structure which will not jeopardize access to the valuable Blue Cross Mark held by BCC (which will be protected only through the orderly reduction in voting interests and concomitant rights to elect directors). The Nominating Committee and voting arrangements do not bind other purchasers of Newco stock but they do commit the parties to the Transactions to a board controlled by independent directors, an outcome the parties consider essential to a successful public company.

NEWCO CHARTER DOCUMENTS

Paragraph numbered (3) at page 3 of the July 21 Letter refers to prohibitions against shareholder action by written consent, rights to call special meetings of shareholders and certain super-majority voting requirements.

With respect to the rights of shareholders to call special meetings, BCC is aware that under Section 600(d) of the Code, holders of shares of not less than 10% of the votes entitled to be cast at the meeting may call a special meeting. BCC will seek to amend the proposed charter documents of Newco to reflect this requirement. BCC will also seek to amend the proposed charter documents to conform to Section 212(a) of the Code, which requires that the maximum number of authorized directors be no more than twice the minimum number minus one. The provision prohibiting, by agreement of the parties to the Voting Agreement, shareholder action by written consent, along with the two year only super-majority requirements for removal of Mr. Schaeffer and Dr. Hasan, are essential to preserve the benefit of the agreements reached on voting and will assure an appropriate degree of certainty in matters of governance and senior management.

BCBSA

The July 21 Letter comments extensively on the requirements of the BCBSA. As we mentioned at our July 26 meeting, we are puzzled by your position. As we have explained several times, the BCBSA, and not BCC, owns the rights to the Blue Cross Mark. It is extremely important to BCC and to the other Blue Cross and Blue Shield organizations throughout the country that the Blue Cross and Blue Shield names and marks be protected. It is abundantly clear that BCC's exclusive rights to the Blue Cross Mark in California have great value, which is reflected in the terms of the Transactions. That value, however, comes with significant limitations.

The July 21 Letter asserts that "BCC has not demonstrated that more favorable arrangements in this regard were not available to BCC with reasonable effort . . ." We categorically disagree. As we have repeatedly advised the DOC, in June, 1994 the BCBSA adopted narrowly defined rules permitting for-profit licensees, for the first time, to use its names and marks provided that the for-profit licensees agreed to abide by such rules. These rules were adopted by the BCBSA before BCC had developed the Public Benefit Plan or even commenced the process culminating in the Transactions. The BCBSA rules are not BCC's rules, they are the BCBSA's rules. After decades of allowing only nonprofit licensees to use its names and marks, the BCBSA promulgated these rules to address issues raised by its 68 member plans, and not to accommodate BCC.

Because of the value and uniqueness of BCC's exclusive right to use the Blue Cross Mark in California, the Transactions had to be specifically tailored to meet the limitations of the BCBSA. It took a significant amount of negotiating skill and diplomacy to secure the agreement of the BCBSA, and the vote of its member plans, to waive certain of its rules to permit BCC to fulfill its public benefit obligations and allow the Transactions to go forward. BCC cannot alter the fact that the Blue Cross Mark is only available through compliance with the BCBSA's rules.

Paragraph numbered (1) at page 4 of the July 21 Letter questions whether BCC was the source of certain conditions to the BCBSA's approval of Newco's use of the Blue Cross Mark. As we have advised the DOC before and will repeat again, the

BCBSA rules were promulgated long before BCC decided to go forward with the Transactions. The anchor points that the Board of the Section 501(c)(4) foundation be comprised of a majority of former members of the BCC Board and that the Foundations remain independent of any governmental authority other than the Attorney General were adopted by the BCBSA. They were initially suggested by the BCBSA and reflect the BCBSA's concerns that its members be privately governed. Assuring continuity in licensee governance and barring control by "special interests," in particular government agencies, have long been cornerstones of BCBSA policy. That policy has simply been reiterated by the BCBSA in the terms of its approval.

Responding to the DOC's request for supporting documentation, BCC has supplied the DOC with copies of all of the correspondence between BCC and the BCBSA relating to this matter. A chronological summary of all verbal communications between any BCBSA representative and any BCC representative is impossible to provide, given the extensive ongoing interaction between all levels of the two organizations. The correspondence BCC has provided to the DOC, together with the BCBSA's direct responses to the DOC, provide a clear understanding of what occurred in the course of BCC securing the BCBSA's approval of the Transactions and the related waiver of its rules. There is no more.

The DOC further questions the BCBSA's rationale for a voting trust arrangement that reduces the voting control of Western Partnerships. The logic is simple. The BCBSA owns the rights to use the Blue Cross Mark. The BCBSA has determined that a "Blue Plan" should not be controlled by a single special interest. BCC is not in a position to suggest nor will the BCBSA agree that the BCBSA substantially revise its long-standing and founding principles.

Paragraph numbered (4) at page 5 of the July 21 Letter asserts that the BCBSA has a "veto over any acquisition of more than 5% of Newco's voting stock . . ." The BCBSA has no such veto. It simply has the right to terminate the license agreement for the Blue Cross Mark if that threshold of voting power is exceeded. The July 21 Letter also asserts that the BCBSA rules are not fair and reasonable and that "Through its actions, the Association may be significantly undermining the interests of 32 million Californians. . ." It is difficult to imagine how the added value of the Blue Cross Mark to Newco, and therefore to the Foundations, could possibly be undermining the interests of 32 million Californians. BCC believes that the market assessment process confirms that those interests are, in fact, advanced by the availability of the Blue Cross Mark. The BCBSA rules are third party rules whose content is not within BCC's control. Therefore, we are at a loss to address the suggestion that they are not fair and reasonable and should somehow be changed. The DOC is apparently suggesting that BCC either breach the rules or compel them to be changed. BCC will not do the former and cannot accomplish the latter. All of these matters have also been addressed in a July 27, 1995 letter from the BCBSA to the DOC.

To state it simply, the Transactions are as good as they can get under the BCBSA rules.

TAX ISSUES

As you know, BCC has been deeply troubled by paragraph numbered (2) at page 4 of the July 21 Letter, which erroneously states that the BCBSA has imposed a divestiture requirement on Western Partnerships. As is expressly reflected in the Material Modification (see page 8), there is no divestiture requirement. Western Partnerships is merely required to reduce its voting interest over a stipulated period. This can be accomplished through a sale of shares or through depositing shares in a voting trust. It is in Western Partnerships' sole discretion whether to sell such shares or place the shares in a voting trust. The voting trust arrangement preserves the economic benefit of ownership and merely calls for shares deposited in the voting trust to be voted in conformity with the votes of Newco's public stockholders. The voting interest reduction is phased in to allow Western Partnerships an appropriate period of time to meet the BCBSA requirement that no more than 5% of the voting power of any licensee reside with any particular entity.

Footnote number 6 on page 4 of the July 21 Letter states that, ". . . the premature disposition of the Newco stock by the foundation could have an adverse effect on the tax treatment of the Conversion." That is correct. However, the voting trust arrangement described above accommodates the requirements of the BCBSA without endangering the tax treatment of the Transactions.

In response to our concern about the impact the comments in the July 21 Letter may have upon BCC securing the favorable tax treatment that will benefit Californians, the DOC has provided us with a letter of correction which we have forwarded to the IRS. We appreciate the correctional letter.

FOUNDATION AS A SECTION 501(C)(4) ORGANIZATION

Turning to paragraphs numbered (1) and (2) at page 5 of the July 21 Letter, BCC believes that it has amply demonstrated the desirability, and in fact the necessity, of having a Section 501(c)(4) organization serve as the entity holding Newco stock after consummation of the Transactions. It is critical that the organization holding the Newco stock be a tax-exempt Section 501(c)(4) organization in order for the Foundations' monetization and other objectives to be met. The IRS has requirements respecting the organization and operation of Section 501(c)(4) organizations. A tax exemption under Section 501(c)(4) for the Western Partnerships has been requested from the IRS.

As we have indicated to the DOC over the past year, the BCC Board believes that the Section 501(c)(4) entity should be organized and operated in a manner that does not involve inappropriate lobbying or political activities and ensures that information regarding its activities is publicly available, that its assets are committed entirely to public benefit activities and that conflicts of interest and self-dealing transactions are avoided. BCC has provided the DOC with substantial information on these subjects, including conflict of interest standards for adoption by both the Section 501(c)(4) organization and the Section 501(c)(3) organization. Moreover, these subjects will be addressed in the governing documents of both organizations.

In further response to paragraphs numbered (1) and (2), it is possible that some reallocation of the cash between the Section 501(c)(3) and the Section 501(c)(4) foundations can be discussed. However, it is a necessary precondition for such discussions to be meaningful and that all participants have a thorough knowledge of the pertinent law and regulations concerning Section 501(c)(4) foundations, as actually applied by the IRS.

SECTION 501(C)(3) FOUNDATION

With respect to paragraph numbered (3) at page 5 of the July 21 Letter, we do not agree that the minimum annual contribution to be made by the Section 501(c)(3) foundation should be at least 5% of the aggregate assets held by the Foundations. The DOC has no basis for making this assertion. As you know, a substantial proportion of the assets of the Section 501(c)(4) foundation will be comprised of non-dividend paying stock. To satisfy the DOC demand of a 5% annual contribution of the total assets of both Foundations would require expenditure of principal, thereby diminishing the value of one of the Foundations for future generations. There is no basis in law or regulation for such a demand. Moreover, the demand contradicts the basic principle that the DOC is to act to review and approve matters within its jurisdiction, not to substitute its judgment for that of the nonprofit corporation directors charged with carrying out public benefit obligations. To the contrary, the only requirement for a Section 501(c)(3) organization that is a private foundation is that it make distributions of not less that 5% of its assets. Moreover, distributions take various forms, not only contributions.

As was discussed at our July 26 meeting, a Section 501(c)(4) organization was not BCC's preference as a foundation corporate vehicle. The use of the Section 501(c)(4) entity was necessitated in order to make the Transactions a reality. We suggested at the meeting that the charitable activities of the Section 501(c)(4) entity should be considered in any determination of the level of charitable contributions or activities of the Foundations. Unless I am mistaken, the DOC rejected that proposal. We suggest that the DOC is incorrect in rejecting the idea that the charitable activities of the Section 501(c)(4) foundation are not appropriately "counted" in determining the level of charitable activities of the combined Foundations.

Imposing a requirement that may impair the longevity of the Foundations in order to satisfy a requirement that appears in no statute, in no judicial decision and in no regulation, but could at most constitute an 'underground' regulation, would be illegal as well as destructive of the Foundations. We are unable to understand the purpose of the DOC's apparent view on this subject.

FOUNDATION BOARD NOMINATIONS

Paragraph numbered (4) at page 5 of the July 21 Letter sets forth the DOC's directive that it in essence designate the Boards of Directors of both Foundations. We believe that in the July 26 meeting, and in further materials we have provided the DOC, we have allayed the DOC's concerns by presenting a complete

description of the professional, hands-off approach to the nomination process as set forth in the Material Modification.

As requested, BCC has provided the DOC with (i) the Request for Proposals which BCC distributed in order to select an executive search firm, (ii) the proposal submitted by Ward Howell and its consortium, and (iii) a progress report by the executive search firm and the consortium to indicate what has been accomplished and how it is being accomplished. Based on the conversations at the July 26 meeting and after review of the documents we have provided, we are confident that the DOC will agree that the nomination process for the Foundations' Boards serves the public interest and the interests of the DOC, the Wilson Administration and the Foundations.

As memorialized in the Material Modification, BCC has agreed to present a slate of twenty-four possible candidates to the DOC for comment prior to final nominations.

PROCESS

Paragraph numbered (1) at page 6 to July 21 Letter requests copies of the minutes of the March 26, 1995 BCC Board meeting and an explanation of the reasons and impact, if any, of adding Messrs. Knight and Besson to the BCC Independent Committee on March 26, 1995. BCC's records indicate the draft minutes were forwarded to the DOC as part of the documents provided to the DOC on May 17, 1995.

Messrs. Besson and Knight were added to the BCC Independent Committee on March 26, 1995, at a time when the BCC Board believed that the Transactions had been completely documented and were only awaiting signature. As it turned out, it took an additional five days to complete the documentation. The principal reason for the addition was to combine in one committee the persons representing the monetization process (the four original Committee members), the person in charge of corporate governance matters (Mr. Knight) and the person in charge of public benefit programs (Mr. Besson). It was felt that to complete the Transactions it would be better to have all three work together and that joint committee participation would improve communications.

The addition of two new members on March 26 did not have any impact on the course of the BCC Independent Committee's deliberations. Mr. Knight had been an *ex officio* member of the BCC Independent Committee from its inception and had participated in most of the BCC Independent Committee's deliberations in that capacity. While Mr. Besson had not been involved in the BCC Independent Committee deliberations, he had been thoroughly briefed as a member of the BCC Board. All BCC Independent Committee decisions approving the Transactions or rejecting alternative transactions were unanimous both before and after the addition of two new members to the BCC Independent Committee.

As will be noted from the March 26, 1995 minutes provided to the DOC, the BCC Independent Committee was directed by the BCC Board to monitor the Transactions from execution of definitive agreements to closing. Please note that

the BCC Board further resolved that upon the execution of definitive agreements, Leonard D. Schaeffer would no longer be recused from any aspect of the closing of the Transactions. He was directed by the BCC Board to play an appropriate role as Chief Executive Officer in the process of closing the Transactions.

With respect to paragraph numbered (2) at page 6 of the July 21 Letter, which requests that each member of the BCC Independent Committee provide a written declaration covering any information the member shared with BCC management, we question the appropriateness of the DOC's request. There is nothing illegal or improper in a member of the BCC Independent Committee or any other committee of the Board discussing its activities with BCC management. The BCC Independent Committee was obliged to be independent of WellPoint management, not of BCC management, in negotiating a transaction with WellPoint. To suggest that the sale of BCC's assets to WellPoint for up to $235 million is the result of flawed or inappropriate behavior of the BCC Independent Committee defies logic. As you well know, the appropriateness of the Transactions has been passed upon by six leading investment banking firms, including the investment banking firm chosen by and engaged on behalf of the DOC.

Every aspect of the Transactions was conducted properly. The BCC Independent Committee members have no need to defend themselves against suggested or implied accusations. The results they have obtained are unprecedented. If there are specific accusations the DOC wishes to bring, please state them. Nonetheless, to avoid any further suggestions by the DOC that the BCC Independent Committee acted improperly, we have enclosed the requested declarations of the members of the BCC Independent Committee.

Paragraph numbered (3) at page 6 of the July 21 Letter provides, in part, that the DOC ". . .believes that the WellPoint Board has an obligation to conclude whether the proposed transaction is fair to WellPoint's largest shareholder, BCC. . ." We strongly disagree with this assertion.

BCC agreed in the Transactions to be represented by its own legal counsel and its own investment banking firm, which provided BCC with a fairness opinion regarding the Transactions. BCC was a moving force in the Transactions. It specifically undertook to look after its own interests. Accordingly, the agreements memorializing the Transactions provide that WellPoint will use its best efforts to cause its financial advisors to provide a fairness opinion with regard to the stockholders of WellPoint *other than BCC*. Knowing that the Transactions would involve elements requiring arm's-length negotiations with WellPoint, BCC relied on its own independent financial advisors to assist in the Transactions and provide it with a dependable fairness opinion. BCC specifically stipulated that WellPoint would not determine the fairness of the Transactions to BCC (see page 28 of the Agreement and Plan of Reorganization).

Further, as noted above, an integral portion of the Transactions involves the acquisition by WellPoint of certain commercial assets of BCC which the DOC referred to in the July 21 Letter (the "Asset Acquisition"). The terms of the Asset Acquisition were arrived at through arm's-length negotiations between WellPoint

and BCC, making it impracticable for WellPoint to determine that the Transactions, as a whole, are fair to BCC.

SECTION 501(c)(4) FOUNDATION DIRECTORS

In regard to the first full paragraph of page 7 of the July 21 Letter, we will be happy to provide biographical information for directors of the Section 501(c)(4) entity. As we explained, there will be no overlapping directors. No Foundation director will serve on the Newco Board, and no Section 501(c)(4) director will serve on the Section 501(c)(3) board and vice versa.

MISCELLANEOUS

We are puzzled by paragraph numbered (1) at page 7 of the July 21 Letter. BCC filed the Public Benefit Plan with the DOC on September 15, 1994 and has received no comments on its terms, in particular its important programs, from the DOC, except for the minimal comments in the July 21 Letter. BCC has more than fulfilled any possible obligation it may have had with respect to its public benefit responsibilities. Rather than BCC commenting, BCC believes that specific comments from the DOC are more than overdue. BCC also requests a copy of any report the DOC may have received from Dr. Nancy Kane (the consultant engaged by the DOC and paid for by BCC to analyze the Public Benefit Plan). Presumably this report will also be made available to the public.

With respect to paragraph numbered (2) at page 7 of the July 21 Letter, the timing of any hearings in addition to the hearings that have already been held would appear to have the effect of continuing to delay this process as much as possible. As you are aware, the definitive Proxy Statement will likely become publicly available on or about mid-September. To conduct public hearings sometime after such date is a clear contradiction of the DOC's statements that it does not intend to be a source of delay and that the resolution of outstanding issues will not delay consummation of the Transactions. Moreover, as you are aware, BCC has requested, in accordance with Section 1352(b) of the Knox-Keene Act and earlier correspondence to the DOC, that the DOC issue an order regarding the Transactions by no later than August 22, 1995.

Turning to paragraph numbered (3) at page 7 of the July 21 Letter, BCC has revealed to the best of its knowledge the extent of any golden parachute or other payments that may be made as a result of the Transactions in its May 19, 1995 response to the DOC's request for documents. With respect to WellPoint, it will respond to the DOC directly.

Commissioner Gary S. Mendoza
Re: RESPONSE TO JULY 21 LETTER
August 17, 1995
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We appreciate having the opportunity to respond to the July 21 Letter. We strongly urge you to complete the DOC regulatory process by August 22, 1995.

Very truly yours,

Brian J. Donnelly

Brian J. Donnelly

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Enclosures