

Government of the District of Columbia
Department of Insurance, Securities and Banking



Thomas E. Hampton
Commissioner

BEFORE THE
INSURANCE COMMISSIONER OF
THE DISTRICT OF COLUMBIA

Re: Report on Examination – **Central Benefits Mutual Insurance Company** as of
December 20, 2007

ORDER


Pursuant to Examination Warrant 2007-5, a Financial Condition Examination of **Central Benefits Mutual Insurance Company** as of December 20, 2007 has been conducted by the District of Columbia Department of Insurance, Securities and Banking (“the Department”).

It is hereby ordered on this 16th day of May, 2008, that the attached financial condition examination report be adopted and filed as an official record of this Department.

Pursuant to Section 31-1404(d)(1) of the D.C. Official Code, this Order is considered a final administrative decision and may be appealed pursuant to Section 31-4332 of the D.C. Official Code.

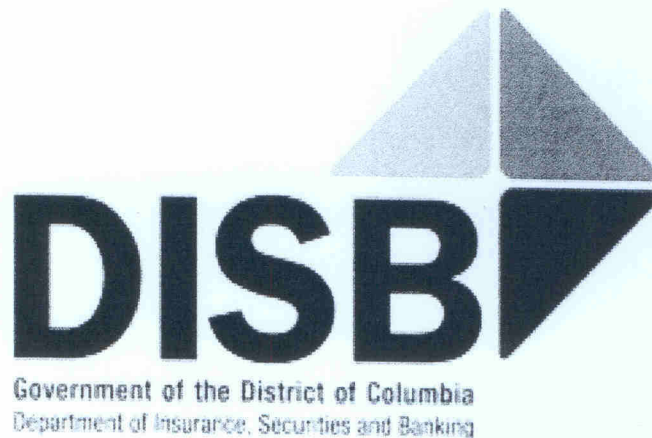
Pursuant to Section 31-1404(d)(1) of the D.C. Official Code, within 30 days of the issuance of the adopted report, the company shall file affidavits executed by each of its directors stating under oath that they have received a copy of the adopted report and related order.

Pursuant to Section 31-1404(e)(1) of the D.C. Official Code, the Department will continue to hold the content of the report as private and confidential information for a period of 10 days from the date of this Order.



Thomas E. Hampton
Commissioner

GOVERNMENT OF THE DISTRICT OF COLUMBIA
DEPARTMENT OF INSURANCE, SECURITIES AND BANKING



REPORT OF LIMITED SCOPE EXAMINATION
OF
CENTRAL BENEFITS MUTUAL INSURANCE COMPANY
DECEMBER 20, 2007

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Washington, D.C.
January 22, 2007

The Honorable Thomas E. Hampton
Commissioner of Insurance
Department of Insurance, Securities and Banking
Government of the District of Columbia
810 First Street, NE, Suite 701
Washington, D.C. 20002

Dear Sir:

In accordance with Section 31-1402 of the District of Columbia Official Code, we have conducted a limited scope examination of certain activities of

Central Benefits Mutual Insurance Company

hereinafter referred to as "CBMIC." The examination was conducted at the principal offices of the Company located at 4079 Executive Parkway, Westerville, Ohio 43081. The report of limited scope examination thereon is respectfully submitted.

BACKGROUND

CBMIC is the successor to Blue Cross of Central Ohio, which was incorporated in the state of Ohio on December 31, 1938. CBMIC was incorporated in the state of Ohio on May 22, 1986 as a domestic nonprofit mutual property casualty insurance company and became licensed to write sickness and accident insurance. On November 9, 1998 revisions to CBMIC's Articles of Incorporation converted CBMIC from a property casualty insurer to a life insurance company. Following the conversion, CBMIC redomesticated to the District of Columbia effective February 3, 1999.

CBMIC has two wholly-owned subsidiaries, Central Benefits National Life Insurance Company (CBNLIC), an Ohio domestic life insurer, and CenBen USA, Inc. ("CenBen USA"), a non-insurance holding company that operates four third party administrator ("TPA") businesses that perform claims and benefits administration services for self-funded employee benefit plans and Taft-Hartley plans. In addition, CBMIC and CBNLIC, write approximately \$11 million of Medicare supplement business. In accordance with a directive from the District of Columbia Department of Insurance, Securities and Banking ("DISB"), CBMIC

stopped writing new insurance policies effective in October 2007. While no similar restriction is in place for CBNLIC, it is not actively marketing new business.

CenBen USA operations have not been profitable for several years. In August 2005, a change in executive leadership was made at CBMIC by the Board of Directors ("Board") in order to stem the financial losses incurred at CenBen USA and to address long-term strategic issues related to CBMIC's mutual form of organization and the looming tontine issue for its policyholders. Since the management change in 2005, numerous steps were taken to improve the profitability of the TPA operations. While there have been improvements in the financial results, the TPA business is still not profitable. TPA losses were approximately \$4.5 million for the 11 month period ended November 30, 2007.

From August 2005 until the fall of 2007, CBMIC made contact with several potential merger/demutualization partners. All potential partners withdrew their interest. Management indicates their reasons were two-fold. First, they were concerned with the TPA profitability and, second there was interest in the TPA business or the insurance, but not both. Thus, during 2007, the Board decided to separate the transaction by offering for sale the TPA business, and then, following the TPA sale, merging CBMIC with another mutual insurer. The Board hoped to stop the continuing losses on the TPA business in order to preserve the value of CBMIC's investment in the TPA business.

The sale process culminated in a Form D filed December 3, 2007 to sell CenBen USA's TPAs to an investor group led by management of the TPAs for approximately \$6 million. The \$6 million purchase price is comprised of a note receivable of \$300,000 and cash of \$5,700,000, which will be reduced by the transaction's legal and financial advisor expenses of approximately \$200,000.

SCOPE OF EXAMINATION

This limited scope examination encompasses a review of the Form D filed December 3, 2007. The examination was conducted in accordance with examination policies and procedures of the DISB and guidelines promulgated by the National Association of Insurance Commissioners and included such tests of the accounting records and other examination procedures as were considered necessary in the circumstances.

COMMENTS AND RECOMMENDATIONS

The Sale Process

From the August of 2005 until fall of 2007, the Board and management made contact with several potential merger/demutualization partners, which did not result in a transaction. In August of 2007, the Board engaged Stifel Nicolaus & Company ("Stifel"), a Cleveland-based investment banking firm, to assist with identifying and advising CBMIC concerning opportunities for "Sales" as defined in the engagement letter. The terms of Stifel's engagement letter required an initial fee of \$50,000, plus incremental fees of \$100,000 if Stifel was asked to deliver a fairness opinion in conjunction with a "Sale," \$100,000 if a definitive

agreement was signed regarding a "Sale," and \$100,000 after receipt of regulatory approval upon consummation of a "Sale."

The Board consists of five outside directors. The outside directors are Tadd Seitz, Chairman, Jon Eesley, George Hairston, David Meuse and Cecil Petitti. Tadd Seitz is the retired CEO of Scotts Lawn Service, a publicly traded company. Jon Eesley is a CPA and former audit partner of a Big Four accounting firm and chairs the Board's audit committee. George Hairston is a retired partner with a large regional law firm. David Meuse is a principal in a privately held Columbus-based investment banking firm, and Cecil Petitti is the CEO and founder of Calltech Communications, LLC. All directors are well qualified and experienced with regard to corporate strategies and transactions.

The Board met seven times from December 2006 through December 2007 and was very involved in the sales process. Stifel states the TPAs were marketed broadly to 68 parties, of which 30 signed confidentiality agreements. Ultimately the operating losses and negative working capital of the TPAs led most suitors to decline further interest. The Board closely evaluated proposals from three groups, Diamond State/Joe Edwards, Azeros, and Universal Fidelity. The offer from Universal Fidelity was quite low with an initial cash payment of \$2.5 million and contingent payments up to \$1.5 million if 2008 operations reach \$30 million in revenue. Thus, their offer was rejected.

The Board advised Diamond State/Joe Edwards group and Azeros to revise their proposals and provide their best and final offers. The final offer from Azeros was \$8.2 million but required a \$2.2 million capital infusion, which effectively reduced the purchase price to \$6 million. It also required CenBen USA to fund an escrow account for \$1.5 million for unspecified severance costs that they expected to incur, which could have potentially reduced the net proceeds to \$4.5 million. Azeros' final offer also included a five year non-compete clause for CBMIC and a two year non-compete clause for CenBen USA's officers, neither of which was acceptable to the Board. The final offer from Diamond State/Joe Edwards was similar to its previous offer of \$6 million with no contingent payments. The offer includes involvement of two officers of the CenBen USA and its affiliates, who have active involvement with the TPA. CBMIC management stated that the Board believes the Diamond States/Joe Edwards offer is financially the best, that they were the most cooperative and timely in their dealings with the CBMIC, that their terms were more favorable and that it was more likely that the transaction with them would close by year end.

The Board did not ask Stifel for a fairness opinion with regard to the sale of the CenBen USA's TPA operations proposed in this Form D transaction. Management states the Board felt the expense was unnecessary since they accepted the highest bid, and felt it was a good deal based upon the Board's sense of the liquidation value of the TPA business. Moreover, Stifel has stated such an opinion would not be very useful due to the lack of relevant comparable arms-length transactions.

Employment/Severance Agreements

CenBen USA has six employment agreements in place, which provide employment guarantees for various periods, and in the event that employment is involuntarily terminated, severance payments to the following members of management:

- William Mechling, President and Chief Executive Officer
- Joseph Hoffman, Executive Vice President, Chief Financial Officer and Treasurer
- Joe Edwards, Chief Operations Officer, Healthscope Benefits, Inc. (one of the principals of the acquiring party)
- Mary Catherine Person, Executive Vice-President of Operations (one of the principals of the acquiring party)
- Ted Georges, Senior Vice-President of Sales
- Darren Ashby, Chief Operations Officer

The agreements were approved by Tadd Seitz, Chairman of CBMIC's Board. The agreements have terms of two to three years and also include payment of standard employee benefits. All except one of the agreements state that CenBen USA would use its best efforts to provide equity participation in the event of a corporate transaction such as a merger, affiliation, demutualization or consolidation. Further, all agreements provide that in the event of an involuntary termination without "cause," after a change in control, CenBen USA will continue to pay for two to three years, the base salary, employee benefits, CenBen USA retirement plan matching contributions and a bonus payment based on the average of bonuses paid during the past three years. CenBen USA estimates that payments resulting from the involuntary termination related to the pending change in control are anticipated to be approximately \$1,040,000.

Financial position of CBMIC as of November 30, 2007

The following is an unaudited statutory balance sheet of CBMIC as of November 30, 2007 showing the pro-forma effects of the Form D transaction:

	CBMIC as of 11/30/07	Form D Transaction		Pro-Forma if Form D is Approved	
<u>Assets:</u>					
Cash	\$2,243,122	5,500,000 (1)		\$7,043,122	
		(700,000) (2)			
Affiliated investments	21,053,757	(14,769,571) (3)		6,284,186	(4)
Deferred comp invested assets	3,632,510			3,632,510	(6)
All other invested assets	9,695,854			9,695,854	
All other assets	1,128,674	(609,418) (5)		519,256	
	<u>\$37,753,917</u>	<u>\$(10,578,989)</u>		<u>\$27,174,928</u>	
<u>Liabilities and Surplus:</u>					
Unpaid claims and adjustment expenses	1,233,599			1,233,599	
Advance premiums	529,876			529,876	
Deferred comp liabilities	3,632,510			3,632,510	(6)
Accrued expenses	1,153,777	(47,000) (7)		1,106,777	
All other liabilities	145,929			145,929	
	<u>6,695,691</u>	<u>(47,000)</u>		<u>6,648,691</u>	
Surplus notes	20,000,000			20,000,000	
Unassigned funds	11,058,226	(10,531,989)		526,237	
	<u>31,058,226</u>	<u>(10,531,989)</u>		<u>20,526,237</u>	
	<u>\$37,753,917</u>	<u>\$(10,578,989)</u>		<u>\$27,174,928</u>	

Notes:

- (1) Estimated cash due at closing.
- (2) 700,000 will be placed in an escrow account (and non-admitted) related to on-going litigation assumed by CBMIC from CenBen USA. This litigation arises over the acquisition of Morris Associates (a TPA acquired by CenBen USA) and events that occurred subsequent to that acquisition. CBMIC states it strongly disagrees with the allegations made in the complaint and intends to vigorously defend it. To date, an answer to the complaint and a motion to dismiss has been filed with the court.
- (3) Book value of CenBen USA, Inc.
- (4) Represents unaudited surplus of CBNLIC.
- (5) Write-off intercompany receivables, including the \$300,000 note received as consideration which is non-admitted.
- (6) Represent assets and liabilities in a non-qualified deferred compensation plan.
- (7) Accrual of investment banker's success fee.

2008 Projection

Management of CBMIC prepared a one year projection of its 2008 statutory income statement assuming the Form D will be approved. The projection assumes CBMIC has approximately \$10,680,000 in renewal Medicare supplement premium. The Medicare supplement business will be administered by the existing CenBen USA TPAs under a transition services agreement with the acquiring party. The transition services agreement is renewable yearly and charges CBMIC 7% of the Medicare supplement premium. Management states it obtained a competing bid for services from an unaffiliated insurance carrier that would have charged 5% of premium; however, it excluded actuarial and financial reporting services. In addition, management prepared a "bottom-up" analysis of the monthly costs based upon its past experience with the TPAs and concluded the 7% fee was reasonable. The annual cost of the transition service agreement is projected to be \$748,000 in 2008.

Loss ratio assumptions were 75.4% making claims expense approximately \$8,056,000, which is consistent with historical results. Compensation and benefits expense is based upon CBMIC maintaining three employees at an annual cost of \$346,000. All other expenses for premium taxes, general administrative, legal, audit and overhead are projected to be \$836,000.

Gross investment income is projected to be \$1,260,000 using an average investment yield of 5%. The resulting earnings before interest expense are \$1,954,000. Due to utilization of tax loss carry forwards, no income tax was projected. Finally, interest expense on the \$20,000,000 of surplus notes is projected to be \$1,900,000. The interest rate on the surplus notes is variable and is based upon LIBOR plus 4.2% (currently 9.5%). The projection results essentially show break even results assuming management can operate CBMIC according to this plan.

Recommendations

Based upon a review of the Form D filing and due diligence performed by the Board, the examiners recommends the following:

- Since a timely fairness opinion is likely unavailable, require CBMIC's outside counsel to provide an opinion that such a fairness opinion is not required as a duty by the Board to its mutual policyholders, and also obtain a Board resolution stating the reasons a fairness opinion was not obtained.
- Require Mssrs. Mechling and Hoffman to complete the proposed 2008 consulting contracts with CBMIC that would have a contingent fee based only upon the successful completion of a mutual merger.
- Suspend approval of future interest payments on surplus notes until a further evaluation of CBMIC is completed. The rationale is that such interest payments should only be made from earned surplus which will likely be below \$500,000 as of December 31, 2007.
- A written corrective action plan including any needed adjustments to the 2008 projected income statement, balance sheet and statement of cash flows should be prepared by management. Such corrective action plan should be based upon a mutual

merger or other non-merger scenarios such as an orderly run-off of the company's assets and liabilities. It should be completed within 30 – 60 days.

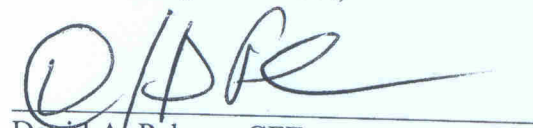
SIGNATURES

Rudmose & Noller Advisors, LLC as represented by Dana Rudmose, CPA, CIE, AIR, AIRC and Mark Noller, CPA, CIE, AIRC represented the DISB as examiners for this examination.

Respectfully submitted by,


Rudmose & Noller Advisors, LLC

Under the Supervision of,


David A. Palmer, CFE
Chief Financial Manager
District of Columbia Department of
Insurance, Securities and Banking

Government of the District of Columbia
Department of Insurance, Securities and Banking



Thomas E. Hampton
Commissioner

April 8, 2008

William Charles Mechling
President
Central Benefits Mutual Insurance Company
4079 Executive Parkway
Westerville, Ohio 43081

Dear Mr. Mechling:

Pursuant to the provisions of Section 31-1404 of the D.C. Official Code, enclosed is a draft copy of the Limited Scope Examination of the affairs and financial condition of **Central Benefits Mutual Insurance Company** as of December 20, 2007.

Please call our attention to any errors or omissions. In addition, if this Report on Examination contains a section entitled "Comments and Recommendations" that discloses certain areas requiring action, the Company shall submit a statement covering the corrective measures which will be taken. If the Company's position on any of these points is contrary to the Examiner's findings, an explanation should be submitted covering each contested comment and/or recommendation.

If there are no errors or omissions to be brought to our attention, and there are no "Comments and Recommendations" requiring a response, please submit a statement that the Company accepts the Report.

All of your comments concerning these matters must be in writing and shall be furnished to this Department within **thirty (30) days from the date of this letter (May 8, 2008)**.

Sincerely,

David A. Palmer
Chief Examiner

Enclosure

Central Benefits

Established 1938

Central Benefits Mutual Insurance Co.
A Life Insurance Company

April 14, 2008

Mr. David Palmer
Chief Examiner
Government of the District of Columbia
Department of Insurance, Securities & Banking
810 First Street, NE, Ste. 701
Washington, D.C. 20002

Dear Mr. Palmer:

Thank you for the opportunity to review the draft of the Limited Scope Examination of Central Benefits Mutual Insurance Company ("CBM") as of December 20, 2007. CBM has concluded its review of this draft and has not identified anything that it would consider to be an error or omission. Pertaining to the specific recommendations set forth in the draft report, CBM offers the following:

- CBM's outside legal counsel advised CBM (copy enclosed) that a fairness opinion was not required in the sale of CenBen USA, Inc. In addition, the CBM Board of Directors passed a Resolution (copy enclosed) setting forth the reasons that a fairness opinion was not obtained in the sale of CenBen USA, Inc.
- William Mechling and Joseph Hoffinan have executed consulting contracts with CBM and are working diligently to wind down the business of the company as soon as practical in 2008.
- CBM made surplus note interest payments, with the approval of the District of Columbia Department of Insurance, Securities and Banking, in February, 2008. The next scheduled surplus note interest payments are scheduled to be made in May, 2008, and a request for approval has been sent to DISB. It is CBM's intent to enter into discussions with the surplus note holders prior to July 1, 2008 in an effort to negotiate an early payoff of the notes, which would obviate the necessity of any future interest payments. Should these discussions not result in the payoff of the surplus notes, CBM would request the approval of the District of Columbia Department of Insurance, Securities and Banking prior to making any further surplus note interest payments.
- CBM has prepared a business wind down plan that entails completing the wind down of the CBM business as soon as practical in 2008. This plan calls for the sale of CBM assets and payment to creditors in the summer of 2008, followed by the dissolution of CBM after the creation of a wind down trust. The wind down trustee will be responsible for paying any

post-dissolution liabilities, as well as distributing remaining surplus (if any) to former CBM policyholders on a fair and equitable basis. This wind down plan was previously provided to the District of Columbia Department of Insurance, Securities and Banking.

Please be advised that CBM hereby accepts the aforementioned report. CBM also wishes to acknowledge the professionalism in which the Limited Scope Examination was performed and thanks the District of Columbia Department of Insurance, Securities and Banking for its cooperation in this matter.

Sincerely,



William C. Mechling
President & Chief Executive Officer

WCM/lbm

cc: Mr. Joe Hoffman

Enclosures

Government of the District of Columbia
Department of Insurance, Securities and Banking



Thomas E. Hampton
Commissioner

May 16, 2008

William Charles Mechling
President
Central Benefits Mutual Insurance Company
4079 Executive Parkway
Westerville, Ohio 43081

Dear Mr. Mechling:

We are in receipt of your response, dated April 14, 2008, which addresses the corrective actions taken by Central Benefits Mutual Insurance Company to comply with the recommendations made in the Report on Examination as of December 20, 2007, dated January 22, 2008.

Your response adequately addresses the recommendations made in the Report. During our next examination of the Company, we will review the implementation of the corrective actions taken.

The adopted Report (which includes a copy of this letter), and the Order evidencing such adoption are enclosed. Pursuant to Section 31-1404(e)(1) of the D.C. Official Code, the adopted Report will be held private and confidential for a period of 10 days from the date of the Order evidencing such adoption. After this 10 day period has passed, the Report will be publicly available.

Pursuant to Section 31-1404(d)(1) of the D.C. Official Code, within 30 days of the date of the above-mentioned Order, affidavits executed by each Company director stating under oath that he or she has received a copy of the adopted examination Report and related Order shall be filed with this Department. Please send these affidavits to my attention here at the Department.

William C. Mechling
Central Benefits Mutual Insurance Company
May 16, 2008
Page 2 of 2

Please contact me at 202-442-7785 if you have any questions.

Sincerely,

A handwritten signature in black ink, consisting of a large, stylized 'D' followed by a 'P' and a long, sweeping horizontal line that extends to the right.

David A. Palmer
Chief Financial Examiner

Enclosures