SPECIAL EXAMINATION REPORT

OF THE

EMPIRE HEALTHCHOICE, INC.

EMPIRE HEALTHCHOICE ASSURANCE, INC.

EMPIRE HEALTHCHOICE HMO, INC.

AS OF

JULY 26, 2002

DATE OF REPORT  SEPTEMBER 27, 2002

EXAMINER  STEPHEN J. WIEST
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1. **SCOPE OF EXAMINATION**

Pursuant to instructions contained in Appointment Number 21857 dated March 19, 2002, attached hereto, the Department conducted a special examination of Empire HealthChoice, Inc. (d/b/a Empire Blue Cross and Blue Shield), a non-profit corporation licensed as a health service corporation pursuant to the provisions of Article 43 of the New York Insurance Law. The special examination was conducted to review certain compensation adjustments given to the senior management of Empire HealthChoice Inc. (“Empire” or “Company”), as well as issues regarding travel and entertainment expenses, conflicts of interest, and investments in and transactions with subsidiaries. These subsidiaries include Empire HealthChoice Assurance, Inc. (“EHCA”), which is licensed as a domestic accident and health insurance company pursuant to the provisions of Article 42 of the New York Insurance Law, and Empire HealthChoice HMO, Inc. (“EHC”), a health maintenance organization licensed pursuant to the provisions of Article 44 of the Public Health Law. The examination covered the three-year period January 1, 1999 through December 31, 2001, however, transactions prior to and subsequent to this period were reviewed where deemed appropriate.
2. TRAVEL AND ENTERTAINMENT EXPENSES

The examiner’s review of the captioned expenses was focused primarily on four senior officers. These individuals are David Snow (Executive VP, and COO), Kenneth Klepper (Senior VP - System, Technology, and Infrastructure), and Bryan Birch (Senior VP, and Chief Sales Officer) of Empire; as well as Connie Klepper (former President & COO of Empire’s subsidiary, NexxtHealth). Connie Klepper is wife to the aforementioned Kenneth Klepper, and was voted to Senior VP of Empire’s – NexxtHealth Division in February 2002, upon the dissolution of NexxtHealth. Mrs. Klepper left Empire’s employ on July 31, 2002.

Expenses were reviewed from 1999 to first quarter 2002, where applicable. It should be noted that all of Empire’s expense documentation for the period prior to September 11, 2001, was lost in the World Trade Center attack.

The expense reporting itself was generally satisfactory, however, the examiner noted occasions where travel and entertainment expenses were:

i) not adequately documented;

ii) not paid in accordance with corporate policies/guidelines;

iii) inappropriate.

In some instances the applicable corporate policy was questionable. The findings of the review are as follows:

Empire’s approved corporate policy allows for individuals covered under its long-term incentive compensation plan to fly first class under certain conditions (when flying to or south
of Atlanta and/or to or west of Chicago, or when otherwise approved, or when certain other conditions exist). All four individuals whose expenses were reviewed were eligible to fly first class, and did so for all flights covered by the examiner’s review. All flights appeared to meet the aforementioned guideline. This encompassed a total of 57 flights, at a total cost of almost $94,000.

Although the aforementioned flights were consistent with Empire’s travel policy, the examiner questions why a policy which authorizes certain officers to travel in this manner exists for a non-profit company. In addition, in a response to an examiner request, Mr. Birch responded that, “…I rarely fly first class and where possible, I choose to fly coach.” Mr. Birch failed to opt for the “coach” option, however, for any of his 12 flights (over $20,000) covered by the period reviewed by the examiners.

There were several inappropriate expenses incurred by Mr. Birch, including:

1. Family related expenses incurred on a “business trip” that were erroneously requested by and paid to Mr. Birch by Empire. In response to an examination inquiry, he claimed that he refunded the money to Empire. However, the examiners were later informed that he in fact had not made restitution to Empire, and that Empire would be deducting the amount from his next paycheck. Mr. Birch has since refunded said erroneous payment.

2. Reimbursement for a “business lunch” in the amount of $90.21 was requested by Mr. Birch twice, and paid by Empire both times. Mr. Birch admitted this error to the examiners, but was silent as to whether he reimbursed Empire. In response to an exam inquiry, Empire stated that he had not, and it would withhold the amount from his next paycheck. Mr. Birch has since refunded said erroneous payment.

3. In conjunction with the above matters regarding the recoupment of expenses from Mr. Birch, the examiners learned that as a result of their inquiries, Empire was going to deduct $826 from Mr. Birch’s next paycheck as a result of erroneously reimbursing him for certain 2002 expenses related to his membership at a country club. Additional issues regarding country club memberships are discussed below. Mr. Birch has since refunded said erroneous payment.
4. Empire’s policy is to not reimburse individuals for tobacco products. However, Mr. Birch spent almost $800 on cigars to hand-out at various agent/broker events and was reimbursed by Empire.

5. A $17 reimbursement for gym use (against Empire’s policy) was initially denied, but then paid under Mr. Snow’s approval.

6. For a few months, Mr. Birch requested and received reimbursement for his home “broadband” internet connection, acquired through his cable company (about $60).

7. Mr. Birch authorized almost $4,700 for a group luncheon for the WTC Sales Division two weeks after the events of 9/11. Although attendance and purpose of the luncheon cannot be verified by the examiner, Mr. Birch stated, “…immediately following the WTC disaster, Empire’s Senior Management permitted off-site meetings such as this for its employees.”

8. Mr. Birch spent almost $3,200 for a holiday party at his Connecticut residence to “celebrate the success of the sales department”. Attendance at this party reportedly included Mr. Birch, his wife, and approximately 25 senior level sales personnel and their spouses/guests. The payment of expenses for spouses/guests appears to be against Empire’s corporate policy, however, Empire did state that following the WTC disaster, management was allowed some latitude with regard to such events for its employees.

On the whole, expenses that were found to have been paid in error and/or in violation of various policies were minor, both individually, and in the aggregate.

It is recommended that Empire implement procedures to ensure that expenses are not reimbursed by it more than once.

It is recommended that Empire also review Mr. Birch’s expenses from prior years to determine if any additional monies were paid to him against Company policy.

The Company has advised the Department that it has already reviewed all expenses submitted by Mr. Birch from the inception of his employment. Empire’s review did not identify any additional reimbursements made against Company policy. The examiner has not verified this fact.
There were several inappropriate expenses incurred by Mr. Snow, including:

1. Between April 21, 2000 and January 24, 2002, Mr. Snow purchased dinners and related alcoholic beverages at a cost of $2,806 for various occasions. The reimbursement of alcoholic beverages is against Company policy. Mr. Snow responded that many of these expenses were incurred on behalf of employees working long hours due to the recovery efforts from 9/11. These facts appeared to be accurate, but could not be verified by the examiner.

2. Mr. Snow requested that an individual who was President of Empire’s contracted pharmacy benefits management company give a speech in the metropolitan area for 250 CEOs who are members of the “Young Presidents Organization” (YPO). Mr. Snow was reimbursed $480 (included above) on a dinner for himself, his wife, this individual and his wife. This appears to be against Empire’s reimbursement policy. Further, Empire reimbursed Mr. Snow for his membership in the YPO ($2,250 annually). Mr. Snow’s justification for these expenses is that some of the employers included are present Empire customers and that he hopes that his contacts there will lead to more business for Empire.

3. On a “business trip” to Florida, Mr. Snow paid $869 for “food and entertainment” (included as part of #1 above) for sales representatives and their spouses. The payment of expenses for spouses is against Empire’s corporate policy.

4. Mr. Snow received reimbursement for $47 for (one-way only) car service from Empire’s offices to the US Tennis Open. Mr. Snow stated that it was a reimbursable expense since, IBM, an Empire vendor, invited him.

5. Mr. Snow was reimbursed $75 for a lunch with Kenneth and Connie Klepper. Reimbursement of lunches among employees is against Empire’s policy.

There were several inappropriate expenses incurred by Mr. Kenneth Klepper, including:

1. Mr. Klepper incurred an $1,100 car service bill for a one–day trip from his home to various locations around the New York City area reviewing various relocation sites.

2. There were several receipts submitted by Mr. Klepper that included expenses incurred by Connie Klepper (i.e. dinners, hotel), but the examiner was unable to determine whether there was a business purpose for all of her expenses.
Although Empire has a general corporate policy not to pay for expenses related to country club memberships, it was noted that David Snow approved three country club memberships and Dr. Michael Stocker, CEO, approved one, during the period 1999 - 2002. Empire’s policy is that the use of country clubs is generally restricted to employees in the sales and provider contracting areas. Also, the Company allows that corporate members can make use of country club privileges for personal use at their own expense.

The cost of these memberships for the period 1999 through the first quarter of 2002 totaled almost $71,000. It should be noted that one of the memberships was actually put in the name of the aforementioned Mr. Birch, as opposed to Empire’s corporate name. Further, the membership was actually a “family” membership when corporate policy only allowed “single” memberships. There was no evidence of Mr. Birch requesting reimbursement for these personal expenses from Empire. Mr. Birch, however, did request and receive reimbursement from Empire for certain indirect expenses. These are the aforementioned “family” membership, an annual holiday gratuity, certain assessments levied by the country club, and locker room fees.

There was also evidence that certain individuals who were authorized to use the country clubs both signed-off on and approved expenses incurred not only for their guests, but also for themselves. Empire’s Finance Department does not question these types of expenses since these individuals are deemed to have the authority to approve them. Also, on at least one occasion, Mr. Birch played golf with an individual from a company that Empire does business with, I-Health. Mr. Birch was the President of I-Health prior to his joining Empire. I-Health performs functions for Empire regarding the “downcoding” of procedures during claims adjudication. It seems unlikely, or arguably inappropriate that Mr. Birch would be involved with any matters
regarding his former company since he is in sales and I-Health’s functions seem unrelated to his duties.

Empire agreed to pay for memberships in a limited number of country clubs on the premise that country club memberships were a common business practice used to solicit business and increase sales, and an accepted means by which business guests may be entertained. It is questionable for a not-for-profit entity such as Empire to enter into and allow for such memberships. Further, the examiner requested that Empire receive an opinion from its CPAs regarding the tax implications for the personal use of the country club memberships. Subsequent to the examiner’s review, Empire replied that it would provide Mr. Birch with an amended W-2(s).

In 2002, Empire determined that the country clubs were not being used as anticipated and it terminated (or allowed to lapse) all country club memberships it maintained. Empire stated that it has not renewed any such memberships and does not have any current intention to do so.

It was also noted that Empire’s Internal Audit Department completed a review in 2001 of travel and other employee expenses for payments made in 2000. The results of this audit stated in part:

“Our testing disclosed that expense reporting operations were generally satisfactory. However, we did note occasions where travel and employee expenses were not adequately documented and paid in accordance with corporate policies/guidelines. We also noted that policies and procedures defining acceptable practices for the giving of gifts and other business entertainment should be more clearly defined...”
“Management agreed to take appropriate corrective action on all matters included in our report.”

The above finding was stated in a memo from the Vice President of Empire’s Auditing and Fraud Control Department to Empire’s Chairman of the Board, Philip Briggs and its CEO, Dr. Michael Stocker. The audit included a review of expenses incurred by the Chairman and 20 senior officers, totaling $257,000, which resulted in 106 exceptions (($17,539) or $17,539/$257,000 = 6.8%). A review of 233 expenses incurred by non-senior officer employees totaling $263,000, resulted in 31 exceptions (($24,892) or $24,892/$263,000 = 9.5%). In addition, 32 instances totaling $7,619, where gifts/entertainment were given to current/potential customers or other business associates were noted. Empire’s controller, Michael Palmateer, was to review the findings and make and/or plan that appropriate corrective action would be made within 30 days of the memo, which was dated August 13, 2001. Empire stated that this process was not completed within that timeframe since the audit report was issued in August 2001, shortly before Empire’s main offices were destroyed in the World Trade Center on 9/11, and that the draft for the follow-up procedures was lost in the WTC disaster.

It is recommended that Empire’s management implement procedures to address the findings from Empire’s 2001 internal audit on travel and other employee expense payments made in 2000.

It is further recommended that Empire review its travel and entertainment expenses paid since 1999 to determine whether any amounts should not have been reimbursed.
When advised of these recommendations, Empire stated that subsequent to the examination, it implemented the changes called for in the audit, in 2002, and it provided certain documentation to the Department to substantiate this action. However, the examiner has not verified the implementation of Empire’s new procedures. Further, Empire stated that it reviewed all expense reports submitted by corporate officers for the years 2000 and 2001 and that there were no findings of reimbursements made against Company policy. The examiner did not verify this review.

3. INVESTMENTS IN AND TRANSACTIONS WITH SUBSIDIARIES

A. NexxtHealth

NexxtHealth was a subsidiary created by Empire in 2000 to initiate several of its e-business initiatives. It was dissolved in February 2002. Empire claims that NexxtHealth had received total funding of $22,129,219 for calendar years 2000 and 2001. Through December 31, 2000, NexxtHealth incurred significant start-up costs. It had operating losses of $4.65 million (expenses for research and development and administrative expenses), but no revenue was generated. For year-end 2001, NexxtHealth reported a $16.8 million net loss, which was mainly due to expenses for professional services, EDP equipment, and salaries. Despite over $22 million in funding, NexxtHealth never sold a product or service, other than those ceded to it by Empire. In addition, the examination reviewed other issues regarding the NexxtHealth transaction to determine whether there was proper management oversight of the transaction. These are detailed as follows:
There were several issues the examiner noted in the Board minutes that may have indicated a lack of communication between Empire’s management, NexxtHealth and OneHealthBank (this entity is described in the subsequent section of this report). For example, at one Board meeting, Connie Klepper identified “certain assumptions that have since been proven incorrect or overly optimistic since the Business Plan was first presented to the Board in January 2000.” In addition, NexxtHealth’s Point-of-Service settlement transaction software was delayed to November 2000 because it was thought that this software already existed. Also, Empire and NexxtHealth had to establish the banking relationships previously represented to have been put in place by OneHealthBank (“OHB”).

Although the examiner was provided with numerous documents from Empire detailing its research into the above dealings, the documentation provided was not sufficient to clearly indicate that all of Empire’s documented due diligence procedures were followed. Empire maintains a “Due Diligence Guide and Procedures” manual. This 34-page document is used to direct Empire’s due diligence team in its assigned investigation into the facts behind assumptions regarding acquisitions or strategic investments in affiliated companies. It appears to be a comprehensive guide on procedures to complete during all steps of a proposed transaction. When the examiner interviewed specific Finance Department staff and senior officers in the Company, they claimed that Empire lost much of the pertinent documentation during the destruction of its offices at the World Trade Center on 9/11. Further, the Board minutes reflect that the matter was reviewed by the Board on a constant basis beginning January 31, 2000 through April 25, 2001 (when OHB merged with RealMed), and further through early 2002 (when NexxtHealth was dissolved).
• It also appears that miscommunication between Empire, NexxtHealth and OHB may have had at least a partial impact on NexxtHealth’s lack of success. NexxtHealth’s year 2000 business plan projected that OHB’s point-of-service (“POS”) settlement product would have been a key feature to NexxtHealth’s product, “MyMedPlan.com”. Empire personnel stated that it would have given NexxtHealth a “competitive advantage” and “less time to establish itself in the market.” However, this product was not made available to Empire nor NexxtHealth.

• The examiner’s review of NexxtHealth’s mission statements revealed that they did not change materially. However, the company’s business plan changed notably as regards its sales and network strategy, market regions, membership projections, and revenue sources. Some of these changes were a result of NexxtHealth’s decision not to move into the electronic third party administrator (ETPA) business. Frequent and material changes to the business plan may be evidence of insufficient due diligence when NexxtHealth was first established.

The examiner determined that Empire reviewed proposals from both Perotsystems (“Perot”) and IBM to become Empire’s outsourcing partner. Upon execution of an agreement, Empire’s outsourcing partner, in addition to taking over certain information technology (IT) operations, would pay Empire royalties on NexxtHealth technology that would be marketed to other entities. Empire would also receive revenue on co-developed products that are developed with its outsourcing partner and sold to other parties. Empire released an Employee Bulletin on April 24, 2002, addressing the outsourcing issue and some of its expected effects on Empire employees. Concurrent with the aforementioned Employee Bulletin, Empire’s Board authorized management to:
1) Continue negotiations with IBM (the preferred vendor partner), although negotiations may continue with Perot;  
2) continue to outsource print and mail operations;  
3) eliminate claims administration from consideration for outsourcing; and  
4) enter into negotiations to finalize an agreement, which will impact Information Technology (IT) employees, employees from Empire’s computer operations, core applications, and the help desk.

Empire entered into a ten-year contract with IBM in June 2002. Based on the terms of the contract, IBM will run the data center at Empire and share software development tasks. IBM will use a new form of claims processing software and will market the system to other insurers.

The subject outsourcing arrangement is a complex business decision which is difficult to analyze. Empire provided the examiners with numerous analyses, documents, and projections touting its outsourcing decision. However, as was detailed in the above section of this report, some documentation supporting due diligence was either not available or could not be provided since Empire claimed to have lost much of the pertinent documentation during the destruction of its offices at the World Trade Center on 9/11. All documentation provided to the examiner regarding cost-benefit analyses and related cost savings comparisons for the IBM decision was completed by Empire. The details, analyses and conclusions reached by Empire for the proposed transaction was not opined on by an independent party. Empire reviewed proposals from Perot Systems and IBM, presenting both to Empire’s Board of Directors for consideration over the course of several meetings, beginning July 25, 2001 through April 24, 2002, the date the Board approved the ultimate outsourcing decision. It is the position of the examiner that Empire’s decision-making process would have benefited from the retention of an independent party to review the proposal prior to its submission to the Board.
When questioned by the examiner, Empire responded that their independent auditors, Ernst & Young reviewed the decision and that Empire worked with outside counsel on this proposal.

There is also an additional concern that a conflict of interest might have existed inasmuch as Mr. Kenneth Klepper’s (Empire – SVP – Systems, Technology, and Infrastructure) wife, Connie Klepper, was made President and Chief Operating Officer of NexxtHealth, which was disbanded in February 2002. The subject of Conflicts of Interest is discussed further in Section 4 of this report.

As respects NexxtHealth, Empire addressed this issue, and verbally indicated that potential conflicts of interest were discussed with Empire’s Board and outside counsel. They determined that no conflict of interest existed. The examiners were not provided with any documented proof (i.e. Board minutes) that these discussions with the Board and outside counsel regarding potential conflicts of interest took place. Empire’s explanation was that the Board has had a long-standing policy to limit Board minutes to action items and discussions surrounding action items; therefore, no record of the discussions exist. Empire asserted that since NexxtHealth is a wholly-owned subsidiary, no personal gain would be recognized upon the sale of NexxtHealth and that only Empire would recognize such a gain.

Empire entered into an administrative services agreement with NexxtHealth. The examiners requested a copy of the agreement and any related Department of Insurance correspondence. However, Empire responded, “…that even though NexxtHealth was incorporated, it was never capitalized, and never operated as a separate entity. NexxtHealth was
always operated essentially as a division of Empire. Therefore, no formal, final administrative
services agreement between NexxtHealth and Empire was ever executed.”

The examiner sought further clarification as to why NexxtHealth was considered as a
division rather than a subsidiary. Empire subsequently stated that the term division should not
have been used to describe its relationship with NexxtHealth. NexxtHealth had occupied
Empire’s office space which it used to conduct its business, and was considered essentially to be
a division of Empire. Nevertheless, NexxtHealth was legally a subsidiary, not a division.

Section 1701(b)(iv) of the New York Insurance Law states in part:

“A domestic corporation subject to article forty-three of this chapter may invest in,
or otherwise acquire, subsidiaries… provided that notice of any such acquisition or
investment shall be given to the superintendent within five days thereafter…”

Section 1712 of the New York Insurance Law states in part:

“The business operations, corporate proceedings and fiscal and accounting records
of subsidiaries shall be conducted or maintained so as to assure the separate legal
and operating identities of the parent corporation and subsidiary… All
transactions between the parent corporation and its subsidiaries shall be fair and
equitable, charges or fees for services performed shall be reasonable and all
expenses incurred and payments received shall be allocated to the parent
corporation on an equitable basis in conformity with customary insurance
accounting practices consistently applied. The books, accounts and records of
each party to all such transactions shall be so maintained as to disclose clearly and
accurately the nature and details of the transactions, including such accounting
information as is necessary to support the reasonableness of the charges or fees to
the respective parties.”

The failure of Empire to correctly treat NexxtHealth as a subsidiary appears to violate the
provisions of Sections 1701(b)(iv) and 1712 of the New York Insurance Law. Although
NexxtHealth was disbanded in February 2002, Empire should assure the separate legal and
operating identities of its subsidiaries (a formal administrative agreement should have been
executed) and that all transactions with its subsidiaries are fair and equitable.

B. OneHealthBank (OHB)

In April 2000, Empire became a business partner with OneHealthBank (“OHB”), an “on-
line bank”, which Empire invested about $8 million in as part of its “e-business initiatives”. As
of December 31, 2001, Empire’s investment of $8 million in OHB was valued at $1,725,339.
The reduction in value was partly due to a merger between RealMed and OHB, and the incurring
of e-business development costs, and other administrative expenses. The examiner inquired
about the steps Empire’s management had taken and/or is planning to take if Empire continues to
lose its investment value in RealMed, the surviving company of the OHB merger; particularly
since the RealMed investment is not liquid and cannot be easily sold. According to Empire,
RealMed continues to search for additional investors and Empire is optimistic that it may recoup
some of its investment. Empire is currently under no contractual agreements with RealMed; it is
an investor. It will continue to reflect its investment in RealMed on the equity method of
accounting.

The examiner notes that in connection with Empire’s for-profit conversion, Empire
transferred its investment in RealMed, in May 2000, to WellChoice, Inc., a non-insurance
holding company, which at that time was a subsidiary of Empire. The transfer, approved by the
Department, was recorded at fair value.

It was also noted that the software that OHB developed for Empire was incompatible
with Empire’s server platform, and that OHB never finalized the banking relationships promised.
Empire had entered into negotiations with OHB to develop a healthcare administrative and financial transaction system that would bring the patient, provider and payer together at the point-of-service, i.e., in the physician’s office. The technology OHB developed turned out to be incompatible with Empire’s operating system. Since no agreement was executed between Empire and OHB, Empire stated that it did not incur any additional costs for the changes made to or the development of software to be made compatible with its needs. It appears that a lack of communication and/or a misunderstanding between Empire and OHB may have caused the development of incompatible software and the non-implementation of the banking relationship and may be indicative of a failure to properly oversee the vendor’s work; which in this case was a related party.

Empire provided numerous documents to the examiner detailing its research into the OHB and aforementioned NexxtHealth dealings. However, the documents provided appeared to be a synopsis of the proposal and did not take the place of due diligence procedures. Empire maintains a “Due Diligence Guide and Procedures” manual. This 34-page document is used to direct Empire’s due diligence team in its assigned investigation into the facts behind assumptions regarding acquisitions of target companies or strategic investments in affiliated companies. It appears to be a comprehensive guide on procedures to complete during all steps of a proposed acquisition or strategic investment. However, there was little evidence in the documentation provided to the examiner by Empire that these procedures were adhered to.

Empire asserted that the investment in OHB was not made for typical investment purposes, but was done in connection with a strategic arrangement that it believed was important to the Company. Empire cited this as one of the reasons why it did not undertake return on investment (ROI) calculations. Empire informed the examiner that the final results of the OHB
transaction were not successful. The examiner did not note any return on investment calculations for Empire’s investment in RealMed, formerly OHB. The matter regarding return on investment calculations is discussed further below in Section C of this report.

The examiner noted that Empire did not file an Information Report (IR) for OHB in accordance with Section 81-2.4 of Department Regulation 115. Empire stated that in April 2000, that it acquired $8 million in OHB preferred stock. Ownership of the preferred stock was subsequently transferred to WellChoice, an Empire subsidiary, in May 2000, as a capital contribution. However, no IR was filed in 2000. It appears that Empire should have filed an IR for OHB because OHB was indirectly owned by Empire through WellChoice. After further inquiry by the examiners, Empire stated that the failure to file an IR was an oversight. It also appeared that Empire failed to file a Preliminary Information Report (PIR) as required by the above Regulation, and Section 1701(b) of the New York Insurance Law.

It is recommended that Empire comply with the filing requirements of Section 81-2.4 of Department Regulation 115 and Section 1701(b) of the New York Insurance Law.

Upon completion of the proposed restructuring of the Company as a for-profit company, this recommendation will no longer apply.

C. Allocation of Expenses

It was noted that for Empire’s investments in its “e-business initiatives”, no return on investment calculations were prepared. In addition, certain expenses regarding Empire’s e-business initiatives were passed on to two of its subsidiaries, Empire HealthChoice Assurance, Inc. (“EHCA”), and Empire HealthChoice HMO, Inc. (“EHC”). In conjunction with this matter,
some general observations on Empire’s investments in its e-business initiatives were made in correspondence with Empire and members of the Health Bureau’s applicable Compliance Regulatory Unit; most notably with Principal Insurance Examiner, David P. Doran and Insurance Examiner, Roy Zabala.

The Bureau's January 29, 2002 desk audit letter regarding Empire's filed annual statement as of December 31, 2000, posed a series of questions to Empire pertaining to development costs on e-business. Specifically, the Bureau questioned $46,853,214 worth of software and e-business development costs incurred in 2000. Empire retained $8,730,784 of these costs and allocated the remaining $38,122,430 to four of its subsidiaries as follows:

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<th>Subsidiary</th>
<th>Amount</th>
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<tr>
<td>Empire HealthChoice Assurance Inc.</td>
<td>$28,661,180</td>
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<td>Empire HealthChoice HMO, Inc.</td>
<td>4,793,489</td>
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<td>Empire Health Plans Assurance Inc, (New Jersey)</td>
<td>20,469</td>
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<tr>
<td>Empire Health Care Inc.</td>
<td>4,647,292</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>$38,122,430</strong></td>
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After some follow-up questions on this matter by the Compliance Regulatory Unit, Empire recalculated the software and e-business development costs to be $49,574,232. Empire still retained $8,730,784, but $40,843,449 was now allocated to the four subsidiaries as follows:

<table>
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<th>Subsidiary</th>
<th>Amount</th>
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<td>Empire HealthChoice Assurance Inc.</td>
<td>$31,106,126</td>
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<td>Empire HealthChoice HMO, Inc.</td>
<td>5,069,561</td>
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<tr>
<td>Empire Health Plans Assurance Inc, (New Jersey)</td>
<td>20,469</td>
</tr>
<tr>
<td>Empire Health Care Inc.</td>
<td>4,647,293</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>$40,843,449</strong></td>
</tr>
</tbody>
</table>

Empire related that it allocated e-business costs to its for-profit subsidiaries in 2000 under the theory that the costs would benefit these subsidiaries in future periods in anticipation of the expected corporate restructuring, which was finally achieved in late 2002, as a for-profit
conversion. Empire conceded that in 2001, it changed the method of allocation of these expenditures to one that recognized "the volume of business" of both Empire and its subsidiaries.

The Department determined Empire’s allocation of the e-business expenses to its subsidiaries to be in violation of Section 1712 of the New York Insurance Law and Department Regulation 33.

Section 1712 of the New York Insurance Law states in part:

“The business operations, corporate proceedings and fiscal and accounting records of subsidiaries shall be conducted or maintained so as to assure the separate legal and operating identities of the parent corporation and subsidiary... All transactions between the parent corporation and its subsidiaries shall be fair and equitable, charges or fees for services performed shall be reasonable and all expenses incurred and payments received shall be allocated to the parent corporation on an equitable basis in conformity with customary insurance accounting practices consistently applied (emphasis added). The books, accounts and records of each party to all such transactions shall be so maintained as to disclose clearly and accurately the nature and details of the transactions, including such accounting information as is necessary to support the reasonableness of the charges or fees to the respective parties.”

The subsidiary receiving the largest allocation was Empire HealthChoice Assurance, Inc. (“EHCA”), a domestic accident and health insurer licensed pursuant to the provisions of Article 42 of the New York Insurance Law. Therefore, it is subject to the provisions of Section 1608 of the New York Insurance Law and Department Regulation 33.

Section 1608 of the New York Insurance Law states in part:

“(a) The business operations, corporate proceedings and fiscal and accounting records of subsidiaries organized or acquired pursuant to this article shall be conducted or maintained so as to assure the separate legal and operating identities of the parent and subsidiary… (b) All transactions between the insurer and its subsidiaries shall be fair and equitable, charges or fees for services performed shall be reasonable and all expenses incurred and payments received shall be allocated to the insurer on an equitable basis in conformity with customary insurance accounting practices consistently applied. (c) The books, accounts and records of
each party to all such transactions shall be so maintained as to clearly and accurately disclose the nature and details of the transactions, including such accounting information as is necessary to support the reasonableness of the charges or fees to the respective parties…”

Section 91.4(a)(1) of Department Regulation 33 (11NYCRR 91.4) states in part:

“It is the responsibility of each life insurer to use only such methods of allocation as will produce a suitable and equitable distribution of income and expenses by lines of business…”

In addition, Section 91.4(a)(5) of Department Regulation 33 (11NYCRR 91.4) states:

“Allocation of income and expenses between companies shall be treated in the same manner as if made for major annual statement lines of business.”

Further, Section 91.4(f) of Department Regulation 33 (11NYCRR 91.4), pertaining to "general expenses, taxes, licenses and fees", states in part:

“In distributing costs to lines of business, each company shall employ those principles and methods that will reasonably reflect the actual incidence of cost by line of business…” (emphasis added).

The aforementioned Regulation requires insurers such as EHCA that are licensed under Article 42 of the New York Insurance Law, to match expenses with revenues. Thus, inasmuch as the e-business costs pertained to contracts already on the books of Empire, the allocation of those e-business costs as joint expenses to EHCA was prohibited by Regulation 33. It is the examiner’s position that the e-business expenses incurred were directly related to the benefits and services for policyholders services and claimants, therefore, the expenses should have been charged against the revenue received from policyholders for each separate entity.
It is recommended that Empire comply with the provisions of Section 1712 of the New York Insurance Law and that EHCA comply with the provisions of Section 1608 of the New York Insurance Law and Department Regulation 33.

It is Empire’s position that its methodology for allocating expenses is in full compliance with applicable statutes and regulations. This issue was the subject of extensive meetings during which Empire’s CFO, John Remshard, and its outside auditors, Ernst & Young, testified under oath as to the propriety of the expense allocation methodology under the Insurance Law and Department Regulation 33.

Empire's allocation of expenses methodology helped to create an underwriting income for Empire, the Article 43 corporation, as of December 31, 2000, in the amount of $29.6 million, although it had no impact on the overall underwriting income of Empire and its subsidiaries on a consolidated basis. If the $40.8 million had stayed in Empire, an underwriting loss in the amount of $11.2 million would have been reported for that entity. The allocation altered Empire's expense limitation as prescribed by Section 4309(a) of the New York Insurance Law, as applicable to the Article 43 company. Part 3 of Empire's 2000 Underwriting and Investment Exhibit reports total expenses incurred of $415.7 million. Without the allocation, total expenses for that entity would have been $456.5 million, thereby increasing its Section 4309 expense limit calculation from 10.95% to 12.05%, a materially higher result, but still in compliance with its statutory limitation. There would have been no impact on the overall administrative expenses of Empire and its subsidiaries on a consolidated basis. Also, the allocation had no impact on Empire's December 31, 2000 statutory surplus.
Another result of the aforementioned allocation of expenses was that capital contributions had to be made to EHCA to cover those expenses. These capital contributions had Article 17 implications and required the Superintendent’s prior approval. This approval was not obtained at the time of the contribution. It should be noted that, theoretically, the capital contributions offset the allocation of expenses in terms of calculating the surplus of EHCA. Further, it did not appear that the distortion of the Article 43 corporation’s underwriting results was used to justify bonuses for Empire’s senior officers. Generally, the criteria used for the bonuses did not include underwriting results or profitability.

The Bureau's aforementioned January 29, 2002 desk audit letter (“Letter”) asked, "Were return on investment (ROI) calculations made on these projects? If so, please provide them." Empire's response of February 27, 2002 was, "These projects were deemed strategic in nature and as such, no ROI calculations were performed." Similar to the OneHealthBank investment described above, Empire asserted that the investments were not made for typical investment purposes, but in connection with a strategic arrangement that was believed to be important to the Company. Accordingly a traditional ROI was not prepared.

Basic investment theory indicates the need to determine expected return in making business decisions. The ROI approach to management decision-making was developed to relate the quantity of the expected return to the quantity of the investment. Within this context, capital budgets should be prepared to estimate investment value and the returns and timing of returns related to that investment. The most significant characteristic of capital budgeting is that each project constitutes a distinct venture that is considered by itself. Empire has acknowledged that, “nothing of this sort exists.”
Empire maintains that this investment was prudent and that although it completed sufficient due diligence procedures, no ROI type of analysis was completed since it saw this as a strategic investment. As a consequence, the examiner did not see evidence of, nor did Empire provide the examiner with any quantifiable analysis of the benefits of this investment. While the Department recognizes that standard ROI calculations may not have the best application for information technology investments, the concept of a project being "strategic" should have no bearing whatsoever on the necessity of applying ROI techniques.

The Bureau's Letter further asked, "What material financial benefits have accrued to Empire to date as a result of its e-business expenditures?" Empire responded by forwarding copies of information from its 2000 annual report and its website. The material contained no references to any specific dollar amount benefits pertaining to the year 2000 expenditures of $49.6 million, or of any benefits attained.

It was also noted that although Empire passed the majority of the e-business costs on to its subsidiaries, there were no sales or use tax paid by the subsidiaries on the e-business vendor contracts. Empire entered into the vendor contracts directly and was deemed exempt from sales tax due to its tax-exempt status. There were no vendor contracts entered into directly by Empire’s insurance subsidiaries. Any subsidiary on whose behalf the non-profit parent (Empire) incurred the expense may be responsible for payment of a “use tax” on the amount charged to them. The use tax rate is the same as the State sales tax. There was no evidence of any payment for use or sales taxes by Empire’s subsidiaries as regards the aforementioned e-business vendor expenses. Consulting services, where a report is rendered for a specific client, are not subject to sales tax.
Subsequent to the exam date, Empire has informed the Department that although it has not reached a final settlement regarding the tax liability for its vendor contracts, it estimates that the tax liability is not material and has already been accrued for in its financial statements. The examiner has not verified this fact.

It is recommended that Empire and its subsidiaries determine what amount, if any, of the aforementioned e-business costs allocated to the for-profit subsidiaries was for “vendor contracts”, and determine whether the appropriate entities must pay any applicable taxes owed by them, including any related fines and penalties. Empire should provide the Department with documentation deemed sufficient by the NYSID regarding the payment of, or exemption from, said taxes within 30 days of the filing of this report.

4. CONFLICTS OF INTEREST

The examination reviewed Empire’s policy on conflicts of interest. In particular, the examination reviewed the situation where Empire signed a contract with I-Health, a utilization review company that was headed by Mr. Snow’s acquaintance and former Oxford Health Plans, Inc. (“Oxford”) business associate, Bryan Birch. Subsequently, Mr. Birch was hired as Chief Sales Officer at Empire.

Empire personnel refuted any allegation that Mr. Snow was involved in the negotiations with Mr. Birch in his capacity of President of I-Health. They stated that Gloria McCarthy, Empire Senior Vice President of Operations, exclusively negotiated the contract. Empire stated that all negotiations and decision-making for selecting I-Health (d/b/a Vivra) was done by a cross-functional team of several individuals from Empire’s Finance, Claims, Internal Audit and
Medical Management Departments, and that Mr. Snow was not part of this team. The examiners found no evidence to the contrary.

A Request for Proposal (“RFP”) was not completed as regards the I-Health transaction, since Empire’s policy did not require that an RFP be conducted given that Empire determined that there was only one other company that provided the same services as I-Health, and that company was not as established. Certain documentation analyzing the I-Health transaction was said to be lost in the WTC disaster (i.e. proposals submitted by I-Health and Intelliclaim, the other company being considered, and Empire’s “evaluation matrix”).

Empire personnel stated that its management and the Board were aware that both Mr. Snow and Mr. Birch were former employees of Oxford. However, Empire further stated that, “the fact that an Empire employee knows personnel at the vendor is not a basis for excluding the vendor. Similarly, there is no prohibition on hiring an individual who works for a vendor. That is not a conflict of interest, and no investigation is required.” Empire hired Mr. Birch in June of 2000. At the time the agreement was executed between Empire and Vivra on October 29, 1999, he was the President of the Northern Region of Vivra. At the time he left Vivra, he was Executive Vice President of I-Health Technologies.

Mr. Kenneth Klepper holds the Empire title of SVP-Systems, Technology and Infrastructure. A concern was raised by the examiner that a conflict of interest might exist, since his wife, Connie Klepper, was made President and Chief Operating Officer of NexxtHealth. The matter of NexxtHealth was discussed previously in Section B of this report. Also, as noted above, Ms. Klepper left Empire’s employ on July 31, 2002.
The examiner noted that Empire’s Conflict of Interest Program did not require the disclosure of business associates, except where a family member is employed by an entity that does business with Empire. Empire personnel contend that the aforementioned situations were discussed with senior management and/or the Board. However, discussions the examiner had with Empire’s Corporate Secretary, Peter Liria, who reviews the conflict of interest questionnaires submitted, and other Empire personnel, revealed that no written documentation was maintained regarding these discussions. Mr. Liria explained that Empire further clarified its conflict of interest disclosure forms to specifically require that its Board, as well as all employees disclose “material relationships of any kind.” The current Conflict of Interest program now requires disclosure of material relationships, including relationships with vendors having a business relationship with Empire and its affiliates.

Empire asserted to the examiner that, “We strive to avoid even the appearance of impropriety in all that we do.” Therefore, the examiner recommends that it would be a prudent business practice that any material conversations or background discussions regarding conflict of interest disclosures should be documented and maintained by Empire and reviewed by Empire’s senior management or Board when deemed appropriate.

5. EXECUTIVE COMPENSATION

A. Employment Agreements

In 2001, Empire entered into “change in control” agreements (“Agreements”) with about 20 members of its senior management. These Agreements were to be used essentially to provide job security and compensation in the case of the termination of employment without cause following a proposed or actual acquisition by a third party. The duration of these Agreements
was from March 1, 2001, through February 28, 2003, however, the Agreements automatically renewed every March 1st thereafter. Section 4312(b) of the New York Insurance Law states in part:

“No corporation subject to the provisions of this article shall hereafter enter into any agreement, directly or indirectly, with an officer, director, or salaried employee of such corporation whereby it agrees that for any services rendered or to be rendered he shall receive any salary, compensation or emolument that will extend beyond a period of thirty-six months from the date of such agreement…”

Subsequent to discussions with the Department, Empire terminated the Agreements on August 30, 2002.

B. Kenneth Klepper – Special Performance Award

It was noted by the examiner that Empire entered into a three-year (2000 - 2002) “Special Performance Contract” (the “Contract”) with Mr. Kenneth Klepper, Senior VP - System, Technology, and Infrastructure. The examiners were told that Mr. Klepper had previously made Empire’s senior management aware of his intention to leave Empire. Since Mr. Klepper was very involved in Empire’s information technology (IT) projects and Empire’s senior management deemed that individuals with his experience and knowledge were in high demand, they made a business decision to enter into the Contract.

The Contract was reviewed and approved by Empire’s Board, based on a recommendation by its Nominating and Compensation Committee, as well as its outside benefit consultant, Frederick W. Cook, Inc. Under the Contract, Mr. Klepper received $500,000 (the maximum amount allowable under the terms of the Contract) in 2001 with respect to service performed in 2000 and $750,000 (the maximum amount allowable under the terms of the
Contract) in 2002 with respect to service performed in 2001. In 2003, he received a bonus of $500,000, one third less than the potential award to which he was entitled ($750,000) with respect to service performed in 2002. The awards were contingent upon his achievement (as determined by Empire’s Compensation Committee) of certain strategic performance goals which were established for each year of the three-year Contract. In each year, Empire’s Board of Directors reviewed Mr. Klepper's performance relative to the Contract, as evidenced by Board and Compensation Committee minutes that were provided to the examiner and the Board approved all such payments to Mr. Klepper.

The examiner noted that the achievement of Mr. Klepper’s goals was difficult to measure and they were subject to change during the term of the Contract. The Contract was not renewed.

C. Bonus Compensation

The Department’s report on examination of Empire as of December 31, 1991, which was filed on March 17, 1994, contained numerous criticisms of Empire’s bonus compensation plans. In particular, the report noted that, “Empire may do poorly while individual divisions and individual officers do well.” It was recommended that, “Empire’s management review its incentive award program to insure that these awards are not based on routine goals and are more heavily weighted to the performance of the Corporation as a whole.”

In a letter to then Superintendent of Insurance Salvatore Curiale, dated April 21, 1994, Mr. Philip Briggs, Empire’s then and current Chairman of the Board, responded to the above mentioned report on examination in regard to what action Empire had taken, or proposed to take,
in order to comply with the recommendations contained in the report. Mr. Briggs’ response to report recommendation item “N” is as follows:

“A new short-term incentive compensation plan for members of management was approved by the Board of Directors for 1994. Success under that plan will be measured by achievement of specific objectives as set forth in the 1994 Corporate Plan, which was approved by the Board in December of 1993.”

The current special investigation reviewed the most recent executive incentive compensation plans. As noted earlier in this Report, as part of Empire’s obligations under the Stipulation entered into with the Insurance Department in 1996 (subsequent to the release of the Report on Examination as of December 31, 1991 and the Market Conduct Review from 1995), Empire retained PricewaterhouseCoopers (PwC) to oversee its compliance with the stipulation and all recommendations contained within the Report on Examination and the Market Conduct Review. PwC provided regular updates to Empire’s Compliance Committee and supplied detailed annual reports to the Insurance Department for three years. Those reports appeared to evidence Empire’s compliance with all said recommendations, but the Department did not verify said compliance. With specific reference to the recommendation concerning incentive plan goals, PwC reviewed Empire’s annual and long term incentive plans, as well as the annual and strategic business plans and found that the incentive plans were “tied to the corporate goals and objectives as outlined in the Annual Plans and Three-Year Strategic Plans.”

It was noted, however, during the examiner’s current review of incentive compensation, that for almost all of the goals and objectives, no weight was given to the financial performance of the Company. For example, Empire’s 1998 – 2000 Long-Term Incentive Compensation Plan contained only one measure out of five for financial strength, that being surplus. It can be
further argued that surplus is a result of investment gains as well as underwriting results, so even this standard does not measure profitability. Both the 2000 Annual Executive Incentive Compensation Plan and 2000-2002 Long-Term Incentive Compensation Plan contain only one measure out of seven, and five, respectively, for financial strength/profitability; that being return on average GAAP equity. However, this measure also includes investment income, which tends to skew the actual profitability of the Company in terms of its business operations.

D. Schedule G – Disclosure

While the examiner requested the support underlying Empire’s 1999 - 2001 Schedule G filings, the examination focus was limited to 2001. The Supplemental Compensation Exhibit for Reporting Year 2001 (underlying support provided by Empire) reconciled to Empire’s Schedule G(NY) in its revised April 2002 New York Supplement for the year 2001. There was one exception noted, the compensation for President and COO of NexxtHealth, Connie C. Klepper. $455,516.60 was not reported on the underlying support provided, but was listed on the revised April 2002 Schedule G(NY) filing, applicable to year 2001.

The examiner traced bonuses and long-term payouts reflected in the Supplemental Compensation Exhibit for Reporting Year 2001 to underlying support provided by Empire. It was noted during this review that the vested portion under the Long-Term Incentive Compensation Plan 2000–2002, the first cycle for year 2000, was not reflected in the Supplemental Compensation Exhibit, or in the 2001 Schedule G(NY) filing, because the reporting requirements of Schedule G(NY) are on a paid basis.
The examiner inquired as to whether or not Empire reported the vested portion of the Long-Term Incentive Compensation Plan on an accrual basis as required by the annual statement filing. Empire responded that it reported the vested portion on an accrual basis within the balance sheet of its 2001 filing. The examiner requested the 2001 general ledger account numbers, descriptions, and amounts to show where the accrual was reflected. It was noted that Empire’s accrual of $3,143,851 represented approximately one-half the amount of the $6,173,542 to be accrued because the amount vests over two years. The examiner believes this to be reasonable and in accordance with Empire’s Compensation Plan.

E. Consultant Review – Frederick Cook

The examiner’s review determined that Empire’s executives participate in three incentive compensation plans, as follows:

1. 2000 Annual Executive Incentive Compensation Plan:

   • Contains one measure of “productivity” (20%), three measures of “higher quality” (5%, 5%, 10%), one measure of e-business growth (15%), one measure of membership growth (20%) and one measure of financial strength (25%). There is a possibility that the target thresholds can be exceeded and a score of greater than 100% can be applied to each measure.

2. 1998–2000 Long-Term Incentive Compensation Plan:

   • These amounts are based on a three-year term strategic plan and are measured against 1997 results that according to Empire included reserve strengthening. The examiner questioned whether the results are updated on an annual basis. Empire stated that
they do not update these long-term goals on an annual basis, and as a result, since
NexxtHealth did not exist in 1997, they do not reflect losses attributable to
NexxtHealth in the calculation. The plan targets managed care business.

3. 2000–2002 Long-Term Incentive Compensation Plan:
   - These amounts are vested, but will not be paid until January 2003. Empire stated that
     these amounts are reported on an accrual accounting basis and are reflected as a
     liability in its filed annual statements.

Non-officer employees participate in one of the following incentive plans:

1. Success Sharing Plan;

The payout per employee on these plans averaged about $1,000 per employee.

In 2000, the Empire Board of Directors had Frederic W. Cook (“Cook”), a consultant,
perform a compensation study that ultimately compared Empire’s executive compensation to
certain for-profit healthcare entities. Empire entered into this contract without employing a
Request for Proposal (“RFP”). An RFP was not required per Empire’s guidelines. However,
when an RFP is not utilized, Empire’s guidelines direct that the rationale for the decision must be
reviewed and approved by appropriate Division management. In a response to an examiner
request for the rationale against utilizing an RFP, Empire provided copies of the minutes from its
March 29, 2000 meeting of its Nominating and Compensation Committee. In the minutes,
Robert D. Paul, a Committee member, “called for the retention of a compensation consultant,
such as Fred Cook, in an effort to be creative when considering total compensation.”
Empire hired Cook to conduct a study of its executive compensation versus companies deemed to be in like industries and corporate structure, under the guise that the for-profit corporate restructuring was imminent. It was noted that the Cook report bases its findings on the fact that Empire was competing for employees with, and eventually expecting to be, a for-profit company. While this conversion was expected to occur, the Department questions the basis of Cook’s study, especially since the conversion process occurred over a five-year period.

Subsequent to Cook’s findings, Empire increased both the executive base pay and resultant incentive pay, which itself is based in part on base pay, in excess of amounts suggested by Frederic W. Cook, Inc. While executive pay was increased and resulting incentive compensation was increased, Empire touted the fact that it was moving away from merit pay (that is, longevity based pay), and toward a variable performance based pay.
6. **SUMMARY OF COMMENTS AND RECOMMENDATIONS**

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| A. **Travel and Entertainment Expenses** &nbsp;&nbsp;&nbsp;&nbsp;&nbsp;&nbsp;&nbsp;&nbsp;&nbsp;&nbsp;&nbsp;&nbsp;&nbsp;&nbsp;&nbsp;&nbsp;&nbsp;&nbsp;&nbsp;&nbsp;&nbsp;&nbsp;&nbsp;&nbsp;&nbsp;&nbsp;&nbsp;&nbsp;&nbsp;&nbsp;&nbsp;&nbsp;&nbsp;&nbsp;&nbsp;&nbsp;&nbsp;&nbsp;&nbsp;&nbsp;&nbsp;&nbsp;&nbsp;&nbsp;&nbsp;&nbsp;&nbsp;&nbsp;&nbsp;&nbsp;&nbsp;&nbsp;&nbsp;&nbsp;&nbsp;&nbsp;&nbsp;&nbsp;&nbsp;&nbsp;&nbsp;&nbsp;&nbsp;&nbsp;&nbsp;&nbsp;&nbsp;&nbsp;&nbsp;&nbsp;&nbsp;&nbsp;&nbsp;&nbsp;&nbsp;&nbsp;&nbsp;&nbsp;&nbsp;&nbsp;&nbsp;&nbsp;&nbsp;&nbsp;&nbsp;&nbsp;&nbsp;&nbsp;&nbsp;&nbsp;&nbsp;&nbsp;&nbsp;&nbsp;&nbsp;&nbsp;&nbsp;&nbsp;&nbsp;&nbsp;&nbsp;&nbsp;&nbsp;&nbsp;&nbsp;&nbsp;&nbsp;&nbsp;&nbsp;&nbsp;&nbsp;&nbsp;&nbsp;&nbsp;&nbsp;&nbsp;&nbsp;&nbsp;&nbsp;&nbsp;&nbsp;&nbsp;&nbsp;&nbsp;&nbsp;&nbsp;&nbsp;&nbsp;&nbsp;&nbsp;&nbsp;&nbsp;&nbsp;&nbsp;&nbsp;&nbsp;&nbsp;&nbsp;&nbsp;&nbsp;&nbsp;&nbsp;&nbsp;&nbsp;&nbsp;&nbsp;&nbsp;&nbsp;&nbsp;&nbsp;&nbsp;&nbsp;&nbsp;&nbsp;&nbsp;&nbsp;&nbsp;&nbsp;&nbsp;&nbsp;&nbsp;&nbsp;&nbsp;&nbsp;&nbsp;&nbsp;&nbsp;&nbsp;&nbsp;&nbsp;&nbsp;&nbsp;&nbsp;&nbsp;&nbsp;&nbsp;&nbsp;&nbsp;&nbsp;&nbsp;&nbsp;&nbsp;&nbsp;&nbsp;&nbsp;&nbsp;&nbsp;&nbsp;&nbsp;&nbsp;&nbsp;&nbsp;&nbsp;&nbsp;&nbsp;&nbsp;&nbsp;&nbsp;&nbsp;&nbsp;&nbsp;&nbsp;&nbsp;&nbsp;&nbsp;&nbsp;&nbsp;&nbsp;&nbsp;&nbsp;&nbsp;&nbsp;&nbsp;&nbsp;&nbsp;&nbsp;&nbsp;&nbsp;&nbsp;&nbsp;&nbsp;&nbsp;&nbsp;&nbsp;&nbsp;&nbsp;&nbsp;&nbsp;&nbsp;&nbsp;&nbsp;&nbsp;&nbsp;&nbsp;&nbsp;&nbsp;&nbsp;&nbsp;&nbsp;&nbsp;&nbsp;&nbsp;&nbsp;&nbsp;&nbsp;&nbsp;&nbsp;&nbsp;&nbsp;&nbsp;&nbsp;&nbsp;&nbsp;&nbsp;&nbsp;&nbsp;&nbsp;&nbsp;&nbsp;&nbsp;&nbsp;&nbsp;&nbsp;&nbsp;&nbsp;&nbsp;&nbsp;&nbsp;&nbsp;&nbsp;&nbsp;&nbsp;&nbsp;&nbsp;&nbsp;&nbsp;&nbsp;&nbsp;&nbsp;&nbsp;&nbsp;&nbsp;&nbsp;&nbsp;&nbsp;&nbsp;&nbsp;&nbsp;&nbsp;&nbsp;&nbsp;&nbsp;&nbsp;&nbsp;&nbsp;&nbsp;&nbsp;&nbsp;&nbsp;&nbsp;&nbsp;&nbsp;&nbsp;&nbsp;&nbsp;&nbsp;&nbsp;&nbsp;&nbsp;&nbsp;&nbsp;&nbsp;&nbsp;&nbsp;&nbsp;&nbsp;&nbsp;&nbsp;&nbsp;&nbsp;&nbsp;&nbsp;&nbsp;&nbsp;&nbsp;&nbsp;&nbsp;&nbsp;&nbsp;&nbsp;&nbsp;&nbsp;&nbsp;&nbsp;&nbsp;&nbsp;&nbsp;&nbsp;&nbsp;&nbsp;&nbsp;&nbsp;&nbsp;&nbsp;&nbsp;&nbsp;&nbsp;&nbsp;&nbsp;&nbsp;&nbsp;&nbsp;&nbsp;&nbsp;&nbsp;&nbsp;&nbsp;&nbsp;&nbsp;&nbsp;&nbsp;&nbsp;&nbsp;&nbsp;&nbsp;&nbsp;&nbsp;&nbsp;&nbsp;&nbsp;&nbsp;&nbsp;&nbsp;&nbsp;&nbsp;&nbsp;&nbsp;&nbsp;&nbsp;&nbsp;&nbsp;&nbsp;&nbsp;&nbsp;&nbsp;&nbsp;&nbsp;&nbsp;&nbsp;&nbsp;&nbsp;&nbsp;&nbsp;&nbsp;&nbsp;&nbsp;&nbsp;&nbsp;&nbsp;&nbsp;&nbsp;&nbsp;&nbsp;&nbsp;&nbsp;&nbsp;&nbsp;&nbsp;&nbsp;&nbsp;&nbsp;&nbsp;&nbsp;&nbsp;&nbsp;&nbsp;&nbsp;&nbsp;&nbsp;&nbsp;&nbsp;&nbsp;&nbsp;&nbsp;&nbsp;&nbsp;&nbsp;&nbsp;&nbsp;&nbsp;&nbsp;&nbsp;&nbsp;&nbsp;&nbsp;&nbsp;&nbsp;&nbsp;&nbsp;&nbsp;&nbsp;&nbsp;&nbsp;&nbsp;&nbsp;&nbsp;&nbsp;&nbsp;&nbsp;&nbsp;&nbsp;&nbsp;&nbsp;&nbsp;&nbsp;&nbsp;&nbsp;&nbsp;&nbsp;&nbsp;&nbsp;&nbsp;&nbsp;&nbsp;&nbsp;&nbsp;&nbsp;&nbsp;&nbsp;&nbsp;&nbsp;&nbsp;&nbsp;&nbsp;&nbsp;&nbsp;&nbsp;&nbsp;&nbsp;&nbsp;&nbsp;&nbsp;&nbsp;&nbsp;&nbsp;&nbsp;&nbsp;&nbsp;&nbsp;&nbsp;&nbsp;&nbsp;&nbsp;&nbsp;&nbsp;&nbsp;&nbsp;&nbsp;&nbsp;&nbsp;&nbsp;&nbsp;&nbsp;&nbsp;&nbsp;&nbsp;&nbsp;&nbsp;&nbsp;&nbsp;&nbsp;&nbsp;&nbsp;&nbsp;&nbsp;&nbsp;&nbsp;&nbsp;&nbsp;&nbsp;&nbsp;&nbsp;&nbsp;&nbsp;&nbsp;&nbsp;&nbsp;&nbsp;&nbsp;&nbsp;&n
B. **Nexxthealth**

Empire should assure the separate legal and operating identities of its subsidiaries (a formal administrative agreement should have been executed) and that all transactions with its subsidiaries are fair and equitable.

C. **One HealthBank**

It is recommended that Empire comply with the filing requirements of Section 81-2.4 of Department Regulation 115 and Section 1701(b) of the New York Insurance Law.

Upon completion of the proposed restructuring of the Company as a for-profit company, this recommendation will no longer apply.

D. **Allocation of Expenses**

i. It is recommended that Empire comply with the provisions of Section 1712 of the New York Insurance Law and that EHCA comply with the provisions of Section 1608 of the New York Insurance Law and Department Regulation 33.

ii. It is recommended that Empire and its subsidiaries determine what amount, if any, of the aforementioned e-business costs allocated to the for-profit subsidiaries was for “vendor contracts”, and determine whether the appropriate entities must pay any applicable taxes owed by them, including any related fines and penalties. Empire should provide the Department with documentation deemed sufficient by the NYSID regarding the payment of, or exemption from, said taxes within 30 days of the filing of this report.

E. **Conflicts of Interest**

The examiner recommends that it would be a prudent business practice that any material conversations or background discussions regarding conflict of interest disclosures should be documented and maintained by Empire and reviewed by Empire’s senior management or Board when deemed appropriate.
STATE OF NEW YORK
INSURANCE DEPARTMENT

1. GREGORY V. SERIO, Superintendent of Insurance of the State of New York, pursuant to the provisions of the Insurance Law, do hereby appoint:

Stephen Wiest

as a proper person to examine into the affairs of the

Empire HealthChoice, Inc.

and to make a report to me in writing of the said

Company

with such information as he shall deem requisite.

In Witness Whereof, I have hereunto subscribed by the name and affixed the official Seal of this Department, at the City of New York.

this 19th day of March 2002

[Signature]
Gregory V. Serio
Superintendent of Insurance