Some cases deal with death spirals and illusory trusts, especially in health insurance. The following opinion is illustrative of the issues raised in these cases.

IN THE UNITED STATES DISTRICT COURT
FOR THE DISTRICT IN MOUNTAIN STATE Case No. Civ ---

IMA PLAINTIFF

Plaintiff

Vs.

THE VERACIOUS INSURANCE COMPANY
OF AMERICA, AND BANK TRUST,

Defendants

EXPERT OPINION OF TIM RYLES, Ph.D.

My name is Tim Ryles, I am *sui juris*, competent to give testimony, and I base the opinions expressed herein on my personal knowledge and experience. I am the former Commissioner of Insurance, State of Georgia, for the term beginning in January, 1991 and ending in January, 1995. Attached hereto as Appendix B is my Curriculum Vitae which summarizes my education, experience, professional background and qualifications.

I am familiar with health insurance programs, statutes, and regulations which pertain thereto. I am also knowledgeable about insurance sales and marketing practices and the statutes and regulations pertaining thereto. Among other things, I served on the Board of Directors for the Atlanta Health Care Alliance, a board consisting of representatives of medical providers, large employers, and unions in the Atlanta Georgia area for a period of five years; I represented state government in one of Georgia's first efforts to contain health costs; authored Georgia's Basic Health Care Plan; spent three years developing and promoting comprehensive health care reform; regulated utilization review companies; developed and successfully promoted passage of legislation governing Multiple Employer Welfare Arrangements (MEWAs); and enforced laws governing both individual and group health insurance products. I also developed and passed regulations governing health insurance.

I have appeared several times before state legislative bodies and Congressional committees as a witness on insurance issues, including health insurance, MEWAs, and certain provisions of the Employee Retirement and Income Security Act of 1974 (ERISA). Through my experiences as Georgia's Commissioner, as well as my activities and responsibilities with the National Association of Insurance Commissioners (NAIC), I

am familiar with the regulatory schemes adopted for the purpose of regulating health insurance products, sales, and marketing practices. This includes familiarity with Mountain State's group health insurance reform measures, the Small Employer Health Insurance Availability Act.

During the past four years I have operated my own litigation support firm and have been associated with another litigation support firm, Robert Hughes Associates of Dallas, Texas. As part of my work, I have appeared as expert witness in both deposition and trial testimony with respect to formation of trust insurance products, such as the Veracious EBP 03 Trust involved in this case. I have also provided deposition testimony and other assistance in at least five cases involving what is conventionally termed, "closed books of business," which is another issue in this litigation. As Commissioner, I also authored statutes restricting the sale of closed books of business from one insurer to another. This statute appears in the Georgia Code as 33-52-1 through 33-51-6 and is known as the Assumption Reinsurance Agreements statute.

During my term as Commissioner, at my request, the Georgia General Assembly adopted Georgia's Unfair Claims Practices Statute, a Model Statute developed by the NAIC. The statute, appearing in Mountain State Laws at 41-1329, establishes standards of conduct expected of insurers in the claims settlement process. Additionally, I have appeared as expert witness and deponent in a number of cases involving an insurer's duty under these standards, including bad faith actions.

I have been asked to provide expert testimony in this matter on behalf of the plaintiffs. As part of my duties, plaintiffs specifically requested that I consider whether Veracious's conduct departed from appropriate regulatory standards and/or customary industry practice. Further, if I opined that Veracious's conduct did represent a departure from appropriate regulatory standards and /or customary industry practice, plaintiffs asked me to express an opinion as to whether such conduct represented an extreme deviation from appropriate regulatory and/or customary industry practice.

My opinions in this proceeding, including the basis therefor, appear in the body of this report. Specific sources relied upon in forming my opinions are cited in the body of this opinion (noted in parentheses) while a list of documents reviewed are identified in Appendix B. My rate of compensation for my work in this case is _____ per hour plus expenses.

1. The Plaintiffs purchased a Veracious health insurance policy from Veracious's agent/employee, Sooth Sayer. The policy coverages included unlimited benefits, lifetime coverage, and catastrophic care. The policy was sold to Mr. Plaintiff as a group policy, although Veracious used individual underwriting of insureds.

The record shows that Mr. Plaintiff wanted a policy encompassing unlimited benefits, lifetime coverage, and catastrophic care and so informed Mr. Sayer; Mr Sayer advised Mr. Plaintiff that Veracious offered a policy providing unlimited lifetime benefits, which

would include catastrophic care; Sayer, as Veracious's agent/employee sold the policy (EBP 03); and the documents affirm the terms of the bargain. In short, Mr. Plaintiff, agent/employee Sayer, and Veracious demonstrated a common understanding that the EBP 03 major medical policy included unlimited lifetime benefits, encompassing catastrophic care.

Case documents show that the coverages requested by Mr. Plaintiff were available at the time from Veracious. That Veracious was promoting such policies in 1978 is documented in Veracious's own literature, "Anatomy of EBP Rates," which asserts:

> *Unlimited lifetime maximum benefits. Most of our competitors cap their benefits at $1million. They say 'unlimited benefits aren't important - you'll never use them.' We say if they aren't important, why don't they offer them?

This document (VER00132) shows that Veracious was positioning itself to gain market share from competitors by offering a benefit other companies avoided at the time: Unlimited lifetime medical benefits. Also, according to Darth Spade, Veracious recognized a marketing opportunity to provide for small businesses the same kinds of major medical benefits previously limited to big employers. (See Darth Spade Deposition, p.22-23).

Agent Sooth Sayer testified that "I approached Plaintiff" about purchasing a group medical insurance plan. (See Sooth Sayer Deposition, pp. 203-204). One reason the EBP 03 group policy was offered to Plaintiff, according to Sayer, was that "the rate for the individual was more expensive than the group. So the better way to go is the group contract." (Sayer Deposition, p.257).

In describing the EBP 03 policy, agent Sayer says:

> I know it’s a catastrophic unlimited policy because that's what we had. It was the best contract in force at the time. We were talking about it and using terminology. Those two would stick in my mind, because that's what the contract was. (See Sayer Deposition, p. 214).

Sayer reasserts this understanding of the policy when Veracious unveiled a new series to replace the EBP 03 plan. At page 274 of his deposition, Mr. Sayer describes the new series as follows: "It is also an EBP, but the nature of it -- they took the unlimited portion away and put a million dollar limit to it, raised the deductible, changed some of the internal workings." Thus, in Veracious's agent's mind, the policy offered unlimited medical benefits.

Case documents show that in April of 1978 Larry Plaintiff understood that he purchased a health insurance policy from Veracious containing unlimited benefits, lifetime coverage,

and catastrophic care, as indicated in Mr. Plaintiff's Affidavit of September 26, 1996 at page 3:

> We spoke with a Veracious insurance salesman by the name of Sooth Sayer…. I agreed to the purchase of this policy in 1978, based on the representations made to us that this policy would provide lifetime, unlimited catastrophic medical insurance coverage.

Documents further reveal that a policy offering unlimited lifetime medical benefits is what Veracious thought it sold as well. Upon payment of premium and enrollment, Veracious Insurance Company issued a certificate of coverage (Certificate Number 519-44-5760) effective 04/14/78 to Sue & Plaintiff, the employer (Employer Number E1941), under Group EBP 03 providing coverage for employees and their dependents. The Certificate identified Major Medical Expense Insurance among the policy coverages, stipulated a $500 deductible limit under this section, and, under the "Annual Maximum" category, it said, "Not Applicable." Veracious's disclosure at the bottom of the certificate says:

> Your booklet, together with this Certificate of Coverage, is your Group Insurance Certificate…. The provisions of the Group Policy principally affecting the insurance are summarized in the Booklet. The insurance is subject in every respect to the Group Policy, which alone constitutes the agreement under which payments are made."

Further, under the MAXIMUM PAYMENT provision of the 1978 policy, the language reads:

> Total major medical payments for all of your illnesses while you're insured, whether continuously insured or not, are limited to $20,000 for all mental, psychoneurotic or personality disorders, *and are unlimited for all other illnesses. (*Italics mine.)

(The policyholder is identified as "Empty Benefits Program Insurance Trust No. 3." It is referred to as “EBP 03” here. No address or phone number is listed for the policyholder.)

These disclosures are consistent with the requirements set forth by Mr. Plaintiff to Sooth Sayer. Had the policy envisioned an annual or lifetime maximum limit to benefits, the limiting amount, not the language actually used ("Not Applicable) would have been used. Further, the certificate and booklet contain no limiting language, such as, "these provisions apply as long as the Master Policy is in force," and, as the drafter of the contract, Veracious had the prerogative of defining "lifetime" as "lifetime of the policy" or any other definition they might have chosen. Having elected to remain silent on this

definition, a reasonable person will resort to the dictionary for a common understanding of the term. Webster defines "lifetime" as "the duration of the existence of a living being or thing" while the American Heritage Dictionary is more direct, i.e., "lifetime" is "the period of time during which an individual is alive."

The certificate language is also significant for another reason: The EBP 03 policy, consistent with Mr. Sayer's understanding, is clearly identified as a "group" insurance policy. Group insurance has certain identifying characteristics distinguishing it from individual health insurance. With group insurance, there is a master policy issued to the policy owner and individual subscribers receive certificates verifying coverage; experience rating applies; and group as opposed to individual underwriting is practiced. Group underwriting may take into account a variety of group characteristics, e.g., size, industry type, stability of the group, age, gender, geographical location, and, according to one authority, "Probably the most fundamental group underwriting principle is that a group must have been formed for some purpose other than to obtain insurance for its members." (See Burton T. Beam, Jr., Group Benefits: Basic Concepts and Alternatives, 6th Edition: Bryn Mawr, PA: The American College, 1995, p.55).

For insureds, group insurance also creates the reasonable expectation that premium costs will be lower. This, too, is consistent with reasons why Sayer offered the EBP 03 policy to Plaintiff.

From the beginning, however, Veracious administered EBP 03 as an individual insurance plan. For example, the material supplied in 1978 (WHEN YOUR INSURANCE BECOMES EFFECTIVE), advised potential enrollees that "With your enrollment, you are required to furnish, at your own expense, evidence of your insurability." The same requirement applied to dependent enrollment. This is commonly regarded as individual underwriting. Indeed, each applicant was subjected to medical underwriting standards, just as one would expect to find in individual policies.

This raises questions about just what kind of "group" EBP 03 insured; moreover, it also raises questions about the motives behind Veracious's methods of designing and marketing the EBP 03 program. My opinions regarding these matters are addressed in opinion 2.

2. Veracious set up a dry trust to which the EBP 03 policy was issued in the State of Heartland. This method of issuing and marketing the policy misled both policyholders and regulators into the false belief that a genuine, bona fide trust arrangement established the trust and governed it in a fiduciary capacity. Altogether, it is an extreme deviation from appropriate regulatory standards and customary industry practice.

It is common in the insurance business to issue master policies to trusts. Taft-Hartley negotiated trusteeships and Multiple Employer Welfare Arrangement trusts (MEWAs), set up under both the Employee Retirement and Income Security Act of 1974, as amended, and various state laws are examples. In describing trusts, Ballantine's Law

Dictionary (1969 edition) says: "In its literal significance, the word 'trust' implies nurturing and sheltering of a sacred confidence."

"Nurturing and sheltering of a sacred confidence" is not descriptive of the EBP 03 trust. Rather, Veracious set up (a) a "dry" or "illusory" trust; (b) managed the trust in a manner inconsistent with regulatory and industry custom; (c) ignored regulatory requirements regarding which groups are eligible for being master policyholders under trust arrangements; and (d) the arrangement vested authority in a trustee which abdicated its duties to insureds.

The Dry Trust

The method chosen by Veracious to sell the EBP 03 policy represents a scheme to circumvent state regulatory practices and deceive policyholders into believing that they are participants in a legitimate trust. The trustee turns out to be the Upper Trust Company, later succeeded as trustee by Bank Trust, later succeeded by Lower Trust Capital Management. The trust was established by Veracious; the Master Policy for EBP 03 was authored by Veracious; the trust paid no consideration for the policy; under the trust agreement, Veracious is administrator of the trust; the trustee benefits from a hold harmless agreement guaranteed by Veracious; the trust has no governing board, no minutes, no assets, no regular meetings, no reports to "beneficiaries" or to regulatory authorities. Indeed, it is effectively the alter ego of Veracious and is nothing more than a "dry" or "illusory trust."

According to Black's Law Dictionary, this arrangement deviates from the requirements for establishing a genuine trust:

> "Where a settlor in form declares himself trustee of, or transfers to a third party, property in trust, but by the terms of the trust, or by his dealings with the trust property, in substance, exercises so much control over the trust property that it is clear he did not intend to relinquish any of his rights in the trust property, the trust is invalid or illusory. A trust arrangement which takes the form of a trust, but because of powers retained in the settlor has no real substance … in reality is not a completed trust." (See Black's Law Dictionary, 6th Ed., p. 749 and In re Huron's Estate, FL Appeals, 237 S.2d 563, 566.)

EBP 03 Departs From Established Methods

In short, the EPB 03 trust is a sham. EBP 03 also is an extreme deviation from the appropriate way trusted policies are normally established and marketed in the insurance industry. For example, regulators expect trusted products to issue from bona fide trusts with a board of directors, a set of established rules and procedures, assets, and a trustee

guided by a sense of fiduciary duty in looking out for the interests of insureds under their master policy.

Veracious's illusory trust adopts the forms associated with trusts but deletes the substantive elements. This enables Veracious to market EBP 03 as group insurance to small employers who are unaware that they are receiving insurance from a trust that serves essentially as the alter ego of an insurance company (Veracious). Furthermore, issuance of the policy to a foreign trust enables Veracious the issuer to take the position (though erroneously) that the policy is governed by the laws of that foreign state, Heartland. It further enables Veracious to blame the trust, or, at least, take the position that it is the trust's responsibility to inform policyholders of contractual provisions, as occurred when Mr.Plaintiff requested a copy of the master policy.

Ignores Regulatory Requirements About Eligible Groups

While the practical effect of setting up an illusory trust is that Veracious issued a group policy to itself, from a regulatory perspective, Veracious's actions represent an extreme deviation from recognized methods of marketing trusted insurance products. For example, under Mountain State insurance statutes, which appear to follow NAIC Model Law language, group health insurance contracts may be issued to the following groups:

(1) an employer or trustees of a fund established by an employer;

(2) an association or labor union with a constitution and bylaws which is organized for some purpose other than buying insurance;

(3) trustees of a fund established by two or more employers in the same or related industry or by one or more labor unions or by one or more employers and one or more labor unions to insure employees of the employers or members of the unions;

(4) groups eligible for group life insurance contracts; and

(5) discretionary groups, or those not identified in the above examples but which gain regulatory approval for policy issuance. (See Mountain State Statutes….).

It is noteworthy that all of the groups to which group contracts may be issued have a reason for existence other than buying insurance, i.e., insurance is secondary to the main purpose of the master policyholder.

In substance, the EBP 03 looks like individual health insurance masquerading as group health insurance.

Veracious contends that EBP 03 is a form of Multiple Employer Trust (MET) and Article III, Section 3 (1) of the trust agreement obligates the trustee to "procure the policy" of

insurance, which, according to Article II, Section 1, is the purpose of the trust. Yet, if we look at the substance instead of the form of the trust arrangement, a different picture emerges. For example, under typical MET arrangements, "a trust purchases coverage from the insurance company, and what is being marketed to employers is the availability of insurance through participation in the trust, not an insurance contract from the insurance company." (See Burton T. Beam, Jr., Group Benefits: Basic Concepts and Alternatives, 6th Edition, Bryn Mawr, PA: The American College, 1995, p. 69).

In form, the criteria stipulated by Beam is what the trust agreement presupposes. In substance, there is virtually no emphasis upon membership in the trust itself; there is no evidence that the trustee ever bargained with Veracious on behalf of subscriber employees for insurance coverages; and no payment for the policy was ever issued from the trust to Veracious. In another instance with almost identical facts, the Maryland Appeals Court held that in original form, the master policy issued to another illusory trust not only failed to insure anyone, but also failed to meet the definition of "insurance" under Maryland law. (See Guardian Life Insurance Company vs. Commissioner, 446 A.2d 1140, MD App.1982).

Also, a review of the Veracious trust agreement language, especially Articles I and III, leaves the impression that premium dollars and subscriber dues will be deposited into an account managed by the trust with Veracious as administrator and that a fund account in the name of the EBP will be a repository for monies remaining after Veracious receives premium payments due. There is also the implication that dividends may be payable to policyholders. Again, the foregoing terms of the contract represent form; in substance, all money went to Veracious and there is no record of separate accounting or of dividend payments.

The Trustee Abdicated Its Role

With regard to the trustee role in facilitating the sham, my understanding of a trustee's role is that it bears a fiduciary relationship with those for whom the trust is established. (This is akin to the "nurturing and sheltering of a sacred confidence" cited in Ballantine above.) Consistent with this notion, Article II, Section 2 of the trust agreement states that "The purpose of the Trust is to provide, through a Policy, insurance coverage for Employees of Subscribers and members of families of such Employees, such coverage hereinafter referred to as the Insurance Program." A subscriber becomes a "beneficiary for benefits" (Article III, Section 5).

In stark contrast to the formal contractual requirements, the trustee, from the initial days of the trust formation, assumed a passive role, remained inattentive to the interests of policyholders, and thereby breached this fiduciary duty. Indeed, the true beneficiary of the illusory trust was Veracious.

The responses of deponent Luce N. Steele, III, the representative of Upper Trust Company, and of Sam Stoop, Harris Trust Bank's authority on METs, show the indifference of the trustee's responsibilities at the initiation of EBP 03. From their

testimony, we learn that there were no deposits in the bank in connection with the trust; that the trustee had no involvement with insureds; played no role in selecting underwriting criteria; had no involvement in determining rates; played no role in determining coverage or changes in coverage provided to insureds; had no knowledge of the master policy's provisions; had no involvement in the decision to close the group had no participation in approving/disapproving brochures explaining insurance program details; had no involvement in selection of the market for EBP 03; had no way of overseeing claims handling; and had no role in other matters one would normally expect to fall under the duties of a trustee.

3. The illusory trust arrangement provided a cover enabling Veracious to hide the important material fact that it had total control of the EBP 03 program. This conduct is an extreme deviation from appropriate regulatory standards and custom in the industry.

Setting up an illusory trust, marketing EBP 03 as group insurance, issuing a certificate plus a booklet explaining coverages, and refusing to provide terms of the master contract resulted in the concealment of vital contract provisions from insureds. Insureds never saw the master policy, nor did they receive any communications regarding policy performance, premium growth, claims experience, policy changes, added or deleted benefits or any information of substance as one might expect from a genuine trust. Dot Week’s letter of January 14, 1986 to Paul Plaintiff is illustrative of the "top secret" approach taken by Veracious as administrator of the trust when Mr. Plaintiff requested a copy of the Master Policy. In addition to rejecting Mr. Plaintiff's request, the Veracious letter says that the policy:

> "is held by the Upper Trust Company as policyholder. The policy is available for review at the policyholder's address…. Of the volumes and volumes of pages comprising EBP Policy 03, only a relatively few of them are applicable to a Mountain State Law Firm participant of the trust. The applicable pages of the policy have, in effect, already been furnished to you in the form of your Booklet and Certificate." (See Exhibit 9 of Paul Plaintiff's Affidavit of 9-26-96.)

Conspicuously absent from the documents referenced by Sarazin as having been provided to Plaintiff is the language of the master policy's incontestable clause, which reads:

> Incontestability of Policy. The Group Policy may be amended at any time, without the consent of the insured employees or any other person having a beneficial interest in it, upon written request made by the policyholder and agreed to by Veracious, Any such amendment shall be without prejudice to any claim arising prior to the date of change.

Nothing in the material supplied to Plaintiff contained any such disclosure even remotely resembling this important material fact about the EBP 03 program. Yet, this policy provision speaks precisely to the circumstances confronting the Plaintiffs when Veracious nonrenewed all EBP 03 policies in Mountain State.

Further, if "only a relatively few" of the "volumes and volumes of pages" apply to a Mountain State law firm, why can't they be sorted out and made available?

The Master Policy remains a phantom throughout the discourse between Mr. Plaintiff and Veracious. In maintaining the secrecy of its contents, Veracious gained substantial leverage in dealing with its insureds, placed its interests above those of insureds who filed claims under the policy, and seriously compromised the notion of an insurance contract being a contract of utmost good faith as recognized extensively in the insurance industry and as stipulated by Mountain State's insurance code, which says:

> The business of insurance is one affected by the public interest, requiring that all persons be actuated by good faith, abstain from deception, and practice honesty and equity in all insurance matters.

Veracious's pattern of concealment, facilitated by the dry trust arrangement, represents an extreme deviation from appropriate regulatory standards and customary industry practice.

4. Veracious secretly closed the book of business known as EBP 03, and, in doing so, deprived the Plaintiffs of their contractual rights. This decision to close the book of business also propelled EBP 03 into a death spiral. The death spiral resulted in escalating premium costs that further undermined contractual rights of insureds.

To elaborate on the death spiral process, "closing a book of business" means that the insurer will no longer sell the EBP 03 policy: the policy is taken off the market, although existing policyholders will continue paying premiums, filing claims, and carrying on as if there has been no change in the insured-insurer relationship. Yet, closing a book of business has grievous consequences for insureds. With no new insureds signing up for the policy to refresh the risk pool, claims increase as insureds age. The insurer's response is inevitable: Premiums must be increased to provide indemnity for the claims. As premium levels rise, the healthier insureds abandon the policy in pursuit of new, more affordable insurance coverages, leaving behind the persons most in need of health insurance. As this process escalates, premiums reach astronomical levels forcing everyone to either cancel their policy or pay exorbitant premiums. In the purest form of death spiral practice, the insurer itself opens up a new pool of insureds and actively converts the healthier risks in the old pool into the new one. When the old pool ultimately spirals into death, i.e., no one is left in it, the insurer takes the reserves set aside as liabilities to pay claims and moves them to the asset side of the accounting ledger.

Table 1 clearly delineates the impact of closing the book of business on the Plaintiff's premium, indicating that the total premium paid over the 18-year period is $192,917.28 and the 1995 premium is more than 46 times greater than the initial annual premium paid in 1978.

Table 1

Plaintiff Premium Experience, 1978 to 1995

Date	Monthly Premium	Annual Premium	Percent Increase over last year
April 1978	$ 55.02	$ 660.24	
April 1979	56.09	673.08	1.9
April 1980	61.08	732.96	8.8
April 1981	96.80	1161.60	58.4
April 1982	168.40	2020.80	73.9
April 1983	266.03	3192.36	57.9
April 1984	397.80	4773.60	49.5
April 1985	426.68	5120.16	7.2
April 1986	462.39	5548.68	8.4
April 1987	527.48	6329.76	14.1
April 1988	648.36	7780.32	22.9
April 1989	846.90	10162.80	30.6
April 1990	1243.52	14922.24	46.8
April 1991	1519.21	18230.52	22.8
April 1992	1896.93	22763.16	24.9
April 1993	2445.35	29344.20	28.9
April 1994	2565.27	30783.24	4.9
April 1995	2565.27	30783.24	0.0

Total premium paid: $192,917.28

What happened in the Plaintiff's experience with Veracious conforms to the death spiral model. In the first place, Plaintiff received no notice that the book of business of which he is a part was closed by Veracious. Second, the explanations given by Veracious for the inevitable premium increases did not include notification regarding closed books of business. Trish Pane’s April 20, 1992 letter to Plaintiff "explaining" the rate increases is an example:

> The amount of claims we pay on EBP plans like this, nationwide, is the primary factor used to determine the rates we have to charge for all EBP planholders. There are, of course, other factors involved, but it is this overall claim experience that is the most influential. As our claim expenses increase, so must our premiums. We do not like to increase rates, but we must charge enough to pay for the benefits provided. (See VER-AF 00196).

Dukes makes no mention of the fact that the EBP 03 program is closed to new entrants. Failure to disclose this fact is not only suppression of truth, but also a false reason for premium increases.

Third, Veracious poorly managed the underwriting and claims processes with EBP 03 and bears primary responsibility for the extreme increases in premium costs. For example, Darth Spade's July 29, 1982 memo for actuary Massey Frigate identifies six reasons for allegedly bad experience with the EBP series:

*Liberal benefit provisions
*Liberal home office underwriting
*Loose field underwriting
*Lax case administration
*One year rate guarantees
*Rates that were set too low (during one period)

Source: VER-UW 01788

In the same memo, Frigate says: "Also, if we were to set rates (in the new series) too low initially and then follow with abnormally high rate increases, *we may be accused of 'low-balling' again and receive many complaints."* (Italics mine.) "Low-balling" is a term describing the practice of setting premiums unreasonably low for the insurance provided in order to gain market share. The "again" language suggests that the strategy behind the 1978 EBP 03 policy insuring the Plaintiffs was to under price it initially; that is, engage in low-balling.

Additionally, the Revised Underwriting and Plan Administration Standards - 10-82 EBP/GSP Series memo of July 16, 1982 (VER-UW-01807 through 01811 admits:

> Various studies that we have done and the report of our Actuarial Consultants indicate that we have not been selective enough in underwriting new business. Also, our monitoring of inforce cases has been too lax, with the result that too much poor quality business has been retained. Specifically, these practices have involved problems with participation levels, contribution rules and premium payment requirements.

The Revised Plan delineates several changes that will be made to address past acts of negligence on Veracious's part. Conspicuously absent from the announced changes is any indication that the Trustee had any knowledge of the previous poor management practices or of the changes outlined in the Revised Plan; nor is there any indication that the Trustee approved the new Plan.

Shortly after Darth Spade's *mea culpa* memo, Veracious unveiled its Revised Series of EBP/GSP Plans. Predictably, the newer plans cost less, offer less coverage, and have more cost containment provisions. (See Jane Vowel's August 16, 1982 memo to the field force, VER-UW-01782).

Jane Vowel, who was Senior Vice President and Chief Actuary of Veracious at the time, encouraged the field force (Veracious's agents) to switch healthy insureds from the old EBP 03 series to the newer policies after the official closing of the old policies on October 1, 1982:

> SWITCHING EXISTING CASES TO THE NEW SERIES
>
> Only about 50% of our existing cases are expected to qualify for the new series. In order to qualify, a case must have had satisfactory claim experience, have had a satisfactory record of premium payments, and in general satisfy our new underwriting requirements including minimum size and participation standards. Satisfactory claim experience means that recent loss ratios for the case must not be greater than certain limits. For EBP the limits are 75% for the past year and, for cases which have been inforce more than one year, 70% for the past two years. (See VER-UW-01785).

And in classic death spiral practice, the memo says in VER-UW-01787:

> Non Qualifying cases. For cases which do not qualify for switching to the new series we will send the employer only the rerate notice for the current plan; no information about the new series will be sent. A notice will be sent to the agent explaining that the case does not qualify.

That this strategy worked as Veracious planned is revealed in an April 26, 1984 memo from Allan Haight to Lurch: "Our 'switch' offer drained both inforces of their best cases…."

In instituting the death spiral, Veracious not only breached its contractual commitment to provide lifetime, unlimited benefits and catastrophic coverage for the Plaintiffs, but also converted an insurance contract into noninsurance. Here's why. Insurance is based upon

certain fundamental principles, widely accepted by industry custom, regulatory authorities, and courts, including: (1) insurance is a transfer of risk from the insured to the insurer; (2) insurance involves pooling of risks; (3) by use of the law of large numbers, insurers try to select a book of business enabling the insurer to substitute average loss for actual loss; and (4) insurance premiums must be affordable if the insurance mechanism is to work. These principles represent product standards for "insurance." (See George E. Rejda, Principles of Risk Management and Insurance, 5th Edition, New York: Harper Collins, 1995, pp.20-25).

Identifying insurance policies as "products" is common in the insurance community, among regulators, and among agents who sell insurance. In fact, sellers of insurance are called "producers" by both regulators and insurers.

What Veracious did with EBP 03 stands the above principles on their heads. Escalating premiums reallocates risks to the insureds who are forced through higher premiums to become their own risk bearers; risk pooling is negated since no new risks are recruited to the book of business (a "de-pooling effect" ensues); the law of large numbers is sacrificed to the principle of decreasing numbers; and insurance becomes unaffordable.

With respect to the view that insurance is a product distinguishable by certain identifiable product standards, I conclude that Veracious's use of the death spiral converted the EBP 03 product into a nonconforming product, rendering it unfit for the purposes for which it was sold.

Additionally, Veracious's administration of the health insurance contract effectively defeated the dominant purpose of the EBP 03 "group insurance" program. Again, here's why. When Mr. Plaintiff bargained for unlimited benefits, catastrophic coverage, and lifetime benefits, he had a reasonable expectation that the product he purchased would conform to these expectations: Health insurance should remain health insurance.

The dominant purpose of a health insurance contract is to indemnify the insured against losses falling within the terms and conditions of the policy. While insureds, including Mr. Plaintiff, may expect health insurance premiums to increase over time, they do not reasonably expect premium costs to reach virtually unmanageable levels, nor do they expect their premium levels to equal the expected claims paid.

In summary, Veracious designed and sold an insurance product; Veracious under priced the policy to gain competitive advantage; Veracious later revised rates to recapture premium that should have been loaded into the policy from the beginning; Veracious increased the costs to drive the more expensive risks out of the policy; Veracious closed the EBP 03 policy and deliberately steered the better, healthier risks into the new revised series of policies. These actions were taken without any intervention, one way or another, by the trustee. Thus, Veracious used the trust as its alter ego to undermine the dominant purpose of the insurance contract, or, in Uniform Commercial Code language, Veracious's contract was manipulated in such a way as to destroy the contract's implied warranty of fitness for the purpose for which it was sold: to pay unlimited benefits,

including catastrophic care, over the insured's life time. This conduct is an extreme deviation from appropriate insurance standards.

5. In failing to train personnel in the terms and conditions of the master policy, providing no special method of handling long term catastrophic claims, and by disregarding standards of fair claims settlement practices, Veracious's claims handling procedures represent extreme deviations from appropriate regulatory and customary industry practice.

From the insured's perspective, the ultimate test of an insurance contract's viability occurs when claims are filed. Regulatory custom and public policy in the United States also place special emphasis on the claims handling process. Among factors of importance in the claims handling process is that of company personnel's understanding the policy's terms and conditions if insureds are to gain the full benefits of the insurance bargain and not be subjected to arbitrary and capricious maneuvers by claims adjusters.

In this respect, Veracious falls far short of providing proper staff training in claims handling. For example, while admitting that the EBP series of contracts were complicated and voluminous, Veracious, nevertheless, provided no training for persons handling claims under these policies. Furthermore, neither Rea Dade nor Jessee Bare nor anyone else at Veracious acknowledges having ever seen the master policy. Rea Dade believes the master policy and the booklet provided to insureds are the same (See Rea Dade Deposition, p. 39); she is unable to ascertain the master policy's provisions regarding how treatment of existing claims are to be handled if the book of business is nonrenewed (pp. 149-150); and holds the view that the certificate covers issues relating to effects of nonrenewal on existing claims (p.157). (It is also of interest that insurance broker Bill Pindrop, a 28-year Veracious veteran, said that "the trust agreement was the contract." (See Pindrop Deposition, p. 63.).

It is indisputable that Ima Plaintiff's claim was recognized from the beginning as a catastrophic claim demanding a long-term commitment from Veracious. Despite this fact, however, the claim was handled in a routine manner. Even worse, claims personnel did not consult medical personnel in key decisions (Jessee Bare deposition, p.141); the claims procedure did not require contact with the treating physician (Bare, p. 41); and non-medical claims personnel made medical judgments without contacting medical professionals (Susie Parity deposition, p.87). In fact, my overall impression is that Veracious administered this claim as if it were just another bill to be paid.

Arbitrary judgments followed from the unprofessional claims procedure, resulting in Veracious's failure to adhere to fair claims settlement practices. For example, following issuance of the ExtraPay Report to Veracious, Susie Parity interpreted the report to say "excessive" costs were incurred, although the report did not use the term "excessive" to describe Ima's treatment (See Parity Deposition, pp. 122 -124). Plaintiff was told that his insurance coverage for Plaintiff would end, forcing the insured to resort to legal action to secure benefits of the contract. This insurer conduct is directly counter to Mountain State's Unfair Claims Settlement Practices Act which specifically declares that

"Compelling insureds to institute litigation to recover amounts due under an insurance policy by offering substantially less than the amounts ultimately recovered in actions brought by such insureds" is an unfair claims practice.

Moreover, failure to acknowledge that the claim is an ongoing one also runs afoul of the same Act, to wit: "Misrepresenting pertinent facts or insurance policy provisions relating to coverages at issue." As supporting evidence, reference may be made to the notice of cancellation effective December 31, 1996 and to the continuing belief asserted by Veracious spokespersons that the only reason Ima's medical claims are being paid is that a court order requires it. (See Gale Bustum's Deposition, p. 106, which reads: Q. Let me understand what you just said. Is what you're telling me that the only reason you're paying this is because of court order? A. Yes.).

With respect to the cancellation notice, Peach Blossom's March 28, 1996 letter to Mr. Plaintiff explains that coverage will be extended through December 31, 1997 because of the policy provision stipulating that "benefits will be extended for persons who are totally disabled from sickness or injury and who are under a Doctor's care … until the end of the calendar year after the year in which coverage terminates." (See Exhibit 12 to Plaintiff's Affidavit of September 26, 1996.) The same representation is made to Ms. J. Straight of the Mountain State Insurance Department in a letter from Jacque Blair (VER-CF 00014). Both letters are silent on the Incontestability Clause of the master policy; therefore, important policy provisions are misrepresented.

6. Although Veracious sold the EBP 03 policy as one providing unlimited, lifetime benefits, the evidence suggests that Veracious never intended to fulfill this promise. This represents an extreme deviation from the utmost good faith standards of an insurance contract.

Darth Spade testified that EBP was developed to provide small businesses the same kinds of health insurance coverages available to larger businesses at the time, that it was projected to be profitable as a new market for Veracious(Spade Deposition, pp. 22-23).

To reiterate a point made above, Veracious's literature at the time read as follows:

> *Unlimited lifetime maximum benefits. Most of our competitors cap their benefits at $1million. They say 'unlimited benefits aren't important - you'll never use them.' We say if they aren't important, why don't they offer them?

Veracious further emphasized:

> Total major medical payments for all of your illnesses while you're insured, whether continuously insured or not, are limited to $20,000 for all mental, psychoneurotic or

> personality disorders, *and are unlimited for all other illnesses. (*Italics mine.)

In stark contrast to these positions, Darth Spade asserted that Veracious never intended to provide unlimited lifetime benefits (Spade Deposition, p.19, 20,54,55).

Thus, although Veracious represented the policy as one offering lifetime major medical benefits, its top officials did not intend to effectuate such a transaction with insureds. Furthermore, Veracious's decision to close the book of business and initiate a death spiral demonstrates a strategy of administering the contract in such a way as to destroy the unlimited lifetime benefits promise to insureds.

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I hereby submit this report this _____ day of _____ _____.

_____
Tim Ryles, Ph.D.