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| IN THE MATTER OF<br><br>PacifiCare of Washington, Inc.,<br><br>Authorized Health Care Service Contractor. | OAH DOCKET NO. 2009-INS-0001<br>OIC ORDER NO. 09-0010<br><br>OIC'S RESPONSE TO MOTION FOR SUMMARY JUDGMENT RE: STATUTE OF LIMITATIONS |

## I. Introduction and Relief Requested

The Washington State Office of the Insurance Commissioner ("OIC") hereby responds to the Motion for Summary Judgment filed by PacifiCare of Washington ("PCW" or "Company"). Because PCW has applied the wrong body of law to this matter, is barred by the doctrine of equitable estoppel from benefitting from its own misconduct, and cannot distinguish the case law that is mandatory authority to deny this Motion, OIC respectfully submits that its action is timely and PCW's Motion for Summary Judgment should be denied.

## II. Counter-Statement of Relevant Facts

This is a very simple motion in a very simple matter. As such, OIC will not seek here to rebut any of the statements in PCW's Motion that are not relevant to the issue being decided. Instead, OIC sets forth this statement of the relevant facts. On a Motion for Summary Judgment, all facts and reasonable inferences must be taken in the light most favorable to OIC as the non-moving party.[1] Many of the facts as set forth by PCW are uncontested (although not all that are characterized by PCW as being so).

**August 9, 2007:** For many years, OIC believed that PCW was paying royalties (sometimes also called "franchise fees") to its parent company, in violation of Statutory Accounting Principles and, later, the Washington Holding Company Act for Health Care Service Contractors and Health Maintenance Organizations, Title 48.31C RCW. However, throughout those years, PCW continually denied that it was doing so. This included specifically denying paying royalties in response to direct questioning as part of two OIC Financial Examinations.[2] It was not until a conference call on August 9, 2007, that the Company at last admitted that these payments were royalties.[3]

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1 *See, e.g.*, Forest Mktg. Enters. V. Dep't. of Natural Res., 125 Wn. App. 126 (2005), *citing* Wilson v. Steinbach, 98 Wn.2d 434, 437, 656 P.2d 1030 (1982).

2 Declaration of Carl Baker ("Baker Declaration"), at ¶4.

3 Motion for Summary Judgment Re: Statute of Limitations at pg. 6, ll 4-18; Baker Declaration at ¶7.

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**August 13, 2008:** That admission and the subsequent follow-up led to Instruction Number 4 in the Financial Examination Report showing PCW's financial condition as of December 31, 2006.[4] Instruction 4 is the instruction quoted by PCW in its Motion at pg. 3 ll 17 – 26. The Order adopting that Financial Examination Report was entered on August 13, 2008.[5] It was identified as Order No. 08-111.

**November 12, 2008:** PCW was entitled to demand a hearing to Contest Order No. 08-111 within ninety days of its entry.[6] This period of entitlement to a hearing contesting the Order Adopting the Report of Financial Examination ended on November 12, 2008. PCW did not demand a hearing, thus making order 08-111 final on that date.

**February 9, 2009:** OIC mailed to PCW a proposed Consent Order Imposing a Fine of $400,000 for PCW's years of making royalty payments in violation of the Washington Insurance Code. The proposed consent order included a cover letter informing PCW of OIC's findings, the proposed fine, and explaining the method of resolving this matter on the basis of the proposed consent order.[7]

**February – August, 2009:** PCW responded to OIC's proposed consent order by retaining attorney Jeff Gingold. Mr. Gingold contacted the undersigned (OIC Staff Attorney Andrea Philhower) regarding this matter soon thereafter - on or about March 6, 2009. Through their respective counsel, PCW and OIC engaged in correspondence, meetings, and exchange of materials regarding the parties' positions and resolution of this matter from that time until OIC filed its request for hearing.[8]

**August 14, 2009:** Due to the parties' apparent inability to resolve this matter, OIC requested a hearing seeking to impose a fine on PCW for making royalty payments in violation of the Washington Insurance Code.[9]

## III. Argument And Authority

### A. The Statute of Limitations on Matter No. 09-0010 Does Not Expire Until the Second Half of 2010.

Actions by OIC to fine PCW for violations of the Insurance Code must be commenced within two years after the cause of action has accrued.[10] The cause of action for PCW's payment of

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4 Exhibit R-4 to PCW's Motion for Summary Judgment Re: Statute of Limitations, at pg. 8. PCW refers to this exam in its Motion as "the second exam" and "the '03-'06 exam." *See, also,* Baker Declaration, at ¶8.

5 Exhibit R-6 to PCW's Motion for Summary Judgment Re: Statute of Limitations, at pg. 3.

6 RCW 48.03.040(5), RCW 48.04.010(3), and Chapter 34.05 RCW.

7 Exhibits C-1 and C-2.

8 Declaration of Andrea Philhower (hereinafter "Philhower Declaration") at ¶3.

9 *Id.*, at ¶4.

10 RCW 4.16.005, 4.16.100.

royalties to its parent company accrued on November 12, 2008. Therefore, this action would have been timely if filed any time on or before November 12, 2010.

PCW seeks to apply the wrong body of law to this matter. The Company mistakenly argues that Chapter 4.16 RCW alone governs the time within which OIC may file its request to impose a fine in this matter. PCW has completely ignored the administrative nature of this action, including the body of law that governs all OIC actions, the Washington State Insurance Code. The Washington State Insurance Code determines when the OIC's "cause of action has accrued."

Under the Insurance Code, once a Financial Examination is complete, the examiner in charge has sixth days to make a full written report of the examination, including conclusions and recommendations. The report must be filed in the Commissioner's office. The OIC must provide a copy of the Examination Report to the examined company not less than ten or more than thirty days prior to the filing of the report for public examination. If, within this time period, the examined company requests a hearing to consider its objections to the report as proposed, the Commissioner may not file the report for public inspection until after that hearing.[11] PCW did not request a hearing to contest the proposed report. Therefore, the Commissioner had 30 days following the end of that period to consider the report, together with PCW's written response to the report, and enter an order either adopting the Examination Report, rejecting it, or calling for an investigatory hearing.[12]

The Commissioner entered the Order Adopting the Examination Report on August 13, 2008.

The Insurance Code provides that a "final administrative decision" that may be appealed under the Administrative Procedure Act had not been made until entry of the Order Adopting the Report on August 13, 2008.[13] This Administrative Hearing could therefore appropriately find that the statute of limitations for a regulatory action based upon this report will expire on August 13, 2010.

However, given the appeals period provided in the Insurance Code, the more appropriate finding is that the statutory period will expire on November 12, 2010. The Code provides the Company ninety days in which to appeal the adoption of the report.[14] As a result, the Order Adopting the Examination Report became final only after this ninety day appeals period has expired.

PCW did not appeal the adoption of the report. Therefore, the report became final on November 12, 2008. "A cause of action accrues when the party has a right to apply to a court for relief."[15] OIC had the right to apply to a court for relief for PCW's violations in the Exam Report

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11 RCW 48.03.040(3).
12 RCW 48.03.040(4).
13 RCW 48.03.040(5).
14 RCW 48.04.010(3).
15 U. S. Oil & Ref. Co. v. State, 96 Wn.2d 85 (1981), *citing*, Lybecker v. United Pac. Ins. Co., 67 Wn.2d 11, 15, 406 P.2d 945 (1965) (add'l citations omitted).

beginning on November 12, 2008. That is the date upon which OIC's "cause of action ha[d] accrued" under RCW 4.16.100.

When the Examination Report is final, the Insurance Commissioner is explicitly authorized to "initiate any proceedings or actions as provided by law" if he or she determines that regulatory action is appropriate as a result of the examination.[16] In the case of PCW, the Commissioner determined that the appropriate regulatory action for the violations found in the 2003-2006 Financial Examination was a fine of $400,000. He has now timely initiated this regulatory action seeking to impose that fine.

PCW's arguments in support of its Motion are entirely dependent upon an assumption that OIC was authorized to fine PCW for its violations upon discovery of those violations. That assumption is false. Under the Insurance Code statutes set forth above, OIC became authorized to bring the instant action when the Report of Financial Examination became final. PCW's Motion is not supported by law and should be denied.

Because the statute of limitations on this matter has not yet run, consideration of PCW's Motion should end here. However, there are additional bases upon which the Motion should be denied.

### B. The Statute of Limitations was Timely Tolled by OIC's Actions.

Even if the Examination chapter of Insurance Code did not provide that the statute of limitations has not yet run on this matter, OIC's action would still be timely under RCW 4.16.005 and -.100. OIC did not have constructive knowledge of PCW's violations until August 9, 2007. Under RCW 4.16.100, the limitations period for this action would have ended on August 9, 2009. OIC tolled the statute of limitations by taking enforcement action for these violations six months earlier, on February 9, 2009.

#### 1. PCW is Equitably Estopped From Benefitting From Its Misdeeds. Therefore, the statute of limitations on this matter did not begin to run until August 9, 2009.

For many years, OIC believed that PCW was paying royalties or franchise fees to its parent company, in violation of Statutory Accounting Principles and, later, the Washington Holding Company Act for Health Care Service Contractors and Health Maintenance Organizations, Title 48.31C RCW. These fees were hidden within payments for management and administrative services that PCW's parent company performed for PCW pursuant to inter-holding company agreements.[17] Although administrative services agreements are permissible between companies that are members of a holding company group, these transactions must be conducted on a cost-

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16 RCW 48.03.040(6)(c).

17 PCW's Motion for Summary Judgment Re: Statute of Limitations, at pg. 5, ll 15-19 (quoting PCW's Form B filing dated May 13, 2003. *See, also,* Baker Declaration, at ¶¶2 and 5-6.

only basis.[18] This means that one member of a holding company group, such as PCW, may only pay to another member the actual cost of the service. It may not include in its payments any additional amounts. Here, OIC believed that PCW was being billed for the benefit of the use of the "PacifiCare" name, and PacifiCare software – bills that have no cost associated with them. OIC calls these fees "royalties" or "franchise fees," and they are not allowed within a holding company system.

PCW knew that this was OIC's position since at least November of 1998 when PCW first proposed paying such franchise fees and was told this was not allowed under Washington law.[19]

However, for many years, PCW paid these royalties while continually denying that it was doing so. It made these denials in three ways. First, during both of the Financial Examinations during the time period at issue, the Company flatly stated that it was not paying royalties.[20] Second, for all the years at issue, PCW misclassified royalty payments in its own accounting records and in the records supplied to OIC's Examination Team.[21] Third, PCW engaged in a shell game in which its immediate parent company, PacifiCare Health Plan Administrators, Inc. ("PHPA") paid PCW's royalty fees to an affiliate, PacifiCare Life and Health Insurance Company, which then paid them to the ultimate parent company. The royalty fees were then recouped by being included in monthly inter-company billings from PHPA to PCW.[22]

It was not until a conference call on August 9, 2007, that the Company at long last admitted that it was paying royalties to its parent company.[23]

PCW has characterized this as "the latest possible date on which OIC became specifically aware of the alleged indirect payment of royalty fees at issue[.]".[24] On the contrary, August 9, 2007 is the *earliest* possible date upon which a court could hold that OIC had constructive knowledge of PCW's actions. Any other result rewards PCW for its attempts to hide the royalty payments. PCW must be held to account for its years of denial that royalty payments were occurring. To hold that the statute of limitations began to run at any earlier date would be to reward the Company for its decade-long intentional campaign of false information regarding these payments that began in November of 1988 and did not end until August 9, 2007.

Without the doctrine of equitable estoppel, all a wrongdoer would have to do is deny its wrongdoing and hide the evidence for the limitations period and it would then be able to publicly trumpet its misdeeds without consequences. That is, of course, not the law. The doctrine of equitable estoppel precludes a party from asserting a claim or position based on equitable

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18 Statement of Statutory Accounting Principles ("SSAP") No. 70. *See* Declaration of Dennis Julnes ("Julnes Declaration") and Exhibit C-6.

19 Julnes Declaration and Exhibit C-7.

20 Baker Declaration, at ¶4 and Exhibit C-3.

21 Baker Declaration, at ¶6 and Exhibit C-4.

22 Baker Declaration, at ¶7 and Exhibit C-5.

23 PCW's Motion for Summary Judgment Re: Statute of Limitations at pg. 6, ll 4-18; Baker Declaration at ¶9.

24 PCW's Motion for Summary Judgment Re: Statute of Limitations at pg. 6, ll 20-22.

principles. The elements of equitable estoppel are: (1) an admission, statement, or act inconsistent with the claim afterwards asserted; (2) action by the other party on the faith of this admission, statement, or act; (3) injury to such other party resulting from allowing the first party to contradict or repudiate the admission, statement, or act.[25]

This is a textbook equitable estoppel scenario. PCW denied these payments, but now seeks to bar OIC from asserting lawful remedies for its violations on the basis that OIC knew the payments were occurring. The first element is easily met; for almost a decade, PCW concealed these royalties with vague descriptors such as "Corporate Charge Backs" and denied that royalty payments were being made.[26] The second element is also easily met; until PCW's Financial Manager finally admitted that the fees were, in fact, royalties and the Company began to cooperate, OIC was not able to prove the violations and therefore could not have brought this enforcement action earlier. OIC was unable to include these royalties in its first Examination Report because of PCW's misrepresentations. As to the final element of equitable estoppel, harm, PCW's Motion is its own proof. OIC would be barred from asserting the fine authorized by law for this conduct if PCW was now allowed to benefit from its campaign of misinformation.

### 2. Mandatory case law authority requires application of the Discovery Rule.

Even if the doctrine of equitable estoppel did not preclude PCW from using its prior concealment of these payments to bar OIC's enforcement action, the cases cited by PCW itself demonstrate that the discovery rule would. Exactly as in U.S. Oil & Refining Co. v. Dept. of Ecology[27], the Insurance Code (like the waste regulatory scheme in U.S. Oil) mandates the application of the discovery rule. OIC, like DOE, "must rely on industry reporting to discover violations."[28] "Since U.S. Oil did not properly report its discharges, discovery of the violations was delayed until DOE suspected that monitoring reports were inaccurate and investigated. Without a discovery rule, industries can discharge pollutants, and by failing to report the violation, can escape penalties."[29] To paraphrase this analogous situation: Since PCW engaged in a three-part program to conceal the nature of its payments to its parent company, discovery of the violations was delayed until OIC suspected that it was paying royalties and investigated – twice. PCW continued to deny paying royalties throughout the first Exam and partway into the second Exam. Without a discovery rule, PCW can pay illegal royalties, and by concealing the nature of the payments, can escape penalties. Just as the Washington Supreme court did not allow that in U.S. Oil, OIC submits that the hearing officer should not allow it here.

"In determining whether to apply the discovery rule, the possibility of stale claims must be balanced against the unfairness of precluding justified causes of action. That balancing test has dictated the application of the rule where the plaintiff lacks the means or ability to ascertain that

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25 Kinnebrew v. CM Trucking, 102 Wn. App. 226, 235 (2000)(internal citations omitted).
26 Baker Declaration.
27 96 Wn.2d 85 (1981)
28 96 Wn. 2d at 92. RCW 48.30.030, 48.30.120m 48.03.030
29 *Id.*

a wrong has been committed."[30] Certainly where OIC must rely upon PCW's self-created financial statements and documentation of the basis for inter-company payments, application of the discovery rule is entirely appropriate.

### 3. OIC tolled the statute of limitations by taking enforcement action for these violations six months before the limitations period would have ended, on February 9, 2009.

PCW has laid out the dispositive cases on this issue in its Motion. Both U.S. Oil & Refining Co. v. Dept. of Ecology[31] and Dolman v. Dep't of Labor & Industries[32] are mandatory authority requiring that PCW's Motion be denied. PCW argues that these cases are distinguishable on the basis that the fine assessments at issue were unilaterally binding, while the February 9, 2009 fine assessment by OIC was not. However, PCW's attempt to distinguish those cases again ignores the administrative nature of this matter and the Washington Insurance Code governing it.

As PCW explains, citing the language of the case, a notice of fine assessment by the Department of Ecology ("DOE") tolled the statute because "the penalized party can either pay the penalty or have the claim fully adjudicated by the otherwise available administrative and judicial forums, with no liability actually arising until the completion of all available judicial review. The notice has much the same effect as a complaint or summons, and hence the action should toll when the notice is served."[33] As PCW acknowledges,[34] this is precisely the situation that occurred when OIC sent PCW its notice of fine assessment and proposed Consent Order.

PCW argues that the statutory schemes which allowed DOE and the Department of Labor & Industries to unilaterally impose a fine present a "dispositive distinction" from the Insurance Code, which does not. This is a distinction without a difference. PCW "had a right to apply to a court for relief," thus tolling the statute of limitations, on February 9, 2009 when OIC informed it that it intended to levy a fine on PCW. RCW 4.04.010(1)(b) provides that the Commissioner shall hold a hearing "upon written demand for a hearing made by any person aggrieved by any act, threatened act, or failure of the commissioner to act." Although OIC cannot unilaterally impose this fine upon PCW absent a hearing, that is irrelevant to the date upon which that hearing on the proposed fine could have been requested, which is the relevant inquiry here. On February 9, 2009, OIC notified PCW that it had assessed a fine against the Company. This was an act or, at the very least, a threatened act which entitled PCW to a hearing under the statute. Thus, that was the date upon which *either* party could have requested a hearing on OIC's proposed fine. OIC did request that hearing on August 14, 2009, when it became clear that settlement discussions were not likely to result in a timely resolution of this matter.

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30 U.S. Oil, 96 Wn.2d at 93 (citations omitted).

31 96 Wn.2d 85 (1981)

32 105 Wn. 2d 560 (1986)

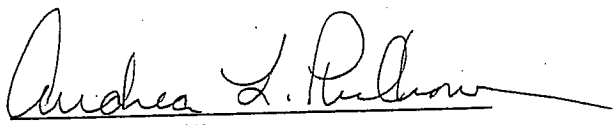
33 PCW's Motion for Summary Judgment re: Statute of Limitations, at pg. 10, ll 8-14 (internal citations omitted).

34 *Id.*, at ll 5-17.

Even if RCW 4.16.100 alone governed this matter, which it does not, the statute of limitations would still not have run until August 9, 2009 and was tolled by OIC action on February 9, 2009 which entitled PCW to a hearing. Therefore, OIC respectfully submits that there is no basis upon which to dismiss this action and PCW's Motion should be denied.

Executed at Tumwater, Washington, this 16th day of November, 2009.

MIKE KREIDLER
Insurance Commissioner

By: 
Andrea L. Philhower
Staff Attorney - Legal Affairs

## CERTIFICATE OF MAILING

The undersigned certifies under the penalty of perjury under the laws of the State of Washington that I am now and at all times herein mentioned, a citizen of the United States, a resident of the State of Washington, over the age of eighteen years, not a party to or interested in the above-entitled action, and competent to be a witness herein.

On the date given below I caused to be served the foregoing OIC'S RESPONSE TO MOTION FOR SUMMARY JUDGMENT RE: STATUTE OF LIMITATIONS on the following individuals in the manner indicated:

Cindy L. Burdue, Administrative Law Judge
Office of Administrative Hearings
2420 Bristol St. SW
Olympia, WA 98507

(XXX) Via Hand Delivery

Jeffrey Gingold
Lane Powell, PC
1420 Fifth Avenue, Suite 4100
Seattle, WA 98101-2338
Email: gingoldj@lanepowell.com

(XXX) Via U.S. Regular Mail & Email
(

**SIGNED** this 16th day of November, 2009, at Tumwater, Washington.

Jodie Thompson

Jodie Thompson

# EXHIBIT C-1

MIKE KREIDLER
STATE INSURANCE COMMISSIONER

STATE OF WASHINGTON

Phone: (360) 725-7000
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OFFICE OF
INSURANCE COMMISSIONER

February 9, 2009

Rebeca de la Torre – Director
Regulatory Affairs – West Region
PacifiCare of Washington
P.O. Box 9472
Minneapolis, MN 55440-9472

Email Rebeca.delatorre@phs.com

Re: PacifiCare of Washington payment of royalties issue
Proposed Consent and Order Levying a Fine No. 09-0010

Dear Ms. de la Torre:

This is in regard to the issue of royalty payments PacifiCare has made to its parents (PacifiCare, Inc. and subsequently United HealthCare), over several years. As you know, OIC questioned these payments over those years, because a subsidiary insurer may not pay royalties to its parent under RCW 48.31C.030 or prior statutory accounting principles adopted by the NAIC. The statute prohibits transactions within a holding company system to which an insurer subject to registration is a party, if the transactions do not meet the following standards:

(i) The terms must be fair and reasonable;
(ii) Charges or fees for services performed must be fair and reasonable;
(iii) Expenses incurred and payment received must be allocated to the insurer in conformity with customary insurance accounting practices consistently applied;
(iv) The books, accounts, and records of each party to all such transactions must 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; and
(v) The insurer's surplus regarding policyholders after dividends or distributions to shareholders or affiliates must be reasonable in relation to the insurer's outstanding liabilities and adequate to its financial needs.

In order to be considered "fair and reasonable," payments by a subsidiary to a parent for services must be at cost.

During the years when OIC questioned its payments to its parent companies, PacifiCare denied that the payments were royalties. In or about November 1998, PacifiCare of Washington filed a form D requesting approval of royalty fee payments to its holding company. OIC denied the form D, at which time PacifiCare's CFO informed OIC that PacifiCare would not implement royalty payments.

Finally, the issue of royalties was again raised during the financial examination of PacifiCare as of December 31, 2006. For months during this examination, the Company denied payment of royalty fees. However, PacifiCare of Washington finally acknowledged the amount of the 2004 royalty fees in a letter to Deputy Insurance Commissioner Jim Odiorne in response to the draft report of the examination. The Company admitted it had been paying royalties to its parent companies since 1999. PacifiCare calculated the total royalty paid as $72,914,631. At OIC's request, PacifiCare has now provided satisfactory documentation to OIC that it has recouped this money.

The number of violations is calculated as at least 96. We consider each royalty payment a violation and, at a minimum, a payment was made in each month for 8 years. For violations of the Insurance Code, RCW 48.44.166 authorizes OIC to impose a fine of up to $10,000 in lieu of revocation of the Company's authorization to do business.

The OIC has determined that the appropriate penalty for these violations is a fine against PacifiCare of Washington in the amount of $400,000. The committee that assesses OIC fines gives consideration to all relevant factors in determining appropriate action. In this case, one of the chief factors was the years of verbal and written misrepresentations by PacifiCare to this agency.

Attached is a Consent Order imposing this fine. PacifiCare of Washington may resolve this matter now without the need for further administrative action by simply having the appropriate person sign the Consent Order, and paying the fine.

Enclosed are two originals of the proposed Consent Order. If you would like to resolve this matter on the basis of this Consent Order and the fine and conditions outlined therein, both original Orders must be signed and dated by an authorized officer of PacifiCare of Washington and returned to me. The fine would then be due within thirty days of the date the Order is entered. If you wish to include payment with the Orders, please address your correspondence to the attention of Delia Zebroski, Fiscal Analyst, Operations Division, Office of the Insurance Commissioner, PO Box 40255, Olympia, Washington 98504-0255, or our physical location of 5000 Capitol Blvd., Tumwater, WA 98501, otherwise send your correspondence to my attention.

If we have not heard back from you by March 9, 2009, this offer must be withdrawn and the OIC will be forced to explore other options.

If you have questions or would like to discuss this matter further, please feel free to contact me by email, regular mail, or telephone. My contact information is below.

Sincerely,

Andrea L. Philhower
Staff Attorney
Legal Affairs Division
360-725-7063
360-586-0152 (facsimile)
andreap@oic.wa.gov

Enclosures

# EXHIBIT C-2

MIKE KREIDLER
STATE INSURANCE COMMISSIONER

STATE OF WASHINGTON

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OFFICE OF
INSURANCE COMMISSIONER

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| IN THE MATTER OF<br>PacifiCare of Washington, Inc.,<br><br>Authorized Health Care Service Contractor. | ORDER NO. 09-0010<br>CONSENT ORDER LEVYING A FINE |

The Insurance Commissioner of the State of Washington, pursuant to the authority set forth in RCW 48.44.160(1) and RCW 48.44.166, and having reviewed the official records and files of the Office of the Insurance Commissioner ("OIC"), makes the following:

**FINDINGS OF FACT:**

1. PacifiCare of Washington, Inc. ("PacifiCare of Washington" or "Company") is a health care service contractor authorized to do business in the state of Washington.

2. In or about November 1998, PacifiCare of Washington filed a form D requesting approval of royalty fee payments to its holding company. OIC denied the form D, at which time PacifiCare of Washington's Chief Financial Officer informed OIC that PacifiCare would not implement royalty payments.

3. Over the intervening years, OIC has questioned payments PacifiCare has made to its parents (PacifiCare Health Plan Administrators, Inc., and subsequently UnitedHealth Group, Inc.), which OIC believed were royalties. A subsidiary insurer may not pay royalties to its parent under RCW 48.31C.050 and prior statutory accounting principles, because such transactions, by definition, are not fair and reasonable. In order to be considered "fair and reasonable," payments by a subsidiary to a parent for services must be at cost.

3. During these years, whenever OIC questioned its payments to its parent companies, PacifiCare denied that the payments were royalties. During a financial examination for the period of January 1, 1997 through December 31, 2002, the Company classified these royalties as "corporate charge back" fees and stated that they were for services provided by the Corporate Office for treasury, legal, taxes and other regulatory functions not performed directly by the Company. During a second examination period of January 1, 2003 through December 31, 2006, the Company classified the royalties as "management contract fees." At that time, the Company claimed that these fees were for marketing costs and that the use of PacifiCare intellectual property is integral to the marketing of PacifiCare of Washington's products.

4. The payments were also made indirectly; the royalties were paid by PacifiCare of Washington's immediate parent company, PacifiCare Health Plan Administrators, Inc. ("PHPA") to an affiliate, PacifiCare Life and Health Insurance Company, and then the royalty charges were recouped by being included in the inter-company billing from PHPA to PacifiCare of Washington.

5. Finally, the issue of royalties was again raised during the financial examination of PacifiCare as of December 31, 2006. For months during this examination, the Company denied payment of royalty fees (see Paragraph 3 of this Order). However, PacifiCare of Washington finally acknowledged the amount of the 2004 royalty fees in a letter to OIC in a written response to the draft report of the examination. The Company admitted it had been paying royalties to its parent companies since 1999, and the amounts of those royalties.

6. PacifiCare of Washington calculated the total royalty paid as $72,914,631. At OIC's request, the Company has now provided satisfactory documentation to OIC that it has recouped this money from PHPA.

7. The number of violations is calculated as at least 96. Each royalty payment is a violation and, at a minimum, a payment was made in each month for 8 years. The effect on Washington consumers was indirect – moving such a significant amount of money out of the insurer could have harmed all policyholders in an insolvency, and possibly required premium increases.

8. The classification of these payments on PacifiCare of Washington's financial records has another effect. These payments could have been made from PacifiCare of Washington to its parent in the form of dividends without violating Washington law. However, in California, "dividends" are subject to an additional tax in addition to the base corporate tax on profits. Both PacifiCare of Washington's current and former parent companies are California corporations. Therefore, by classifying these payments as royalties, the parent companies avoided paying taxes that would have been owed if they had been appropriately classified as dividends. Thus the subterfuge of classifying them as "corporate charge backs" and "management contract fees" to avoid their being prohibited by Washington or taxed by California.

**CONCLUSIONS OF LAW:**

1. PacifiCare of Washington's payment of royalties to its parent company violated RCW 48.31C.050.

2. By its officers' verification of annual financial statements which they knew or should have known did not accurately state PacifiCare of Washington's financial condition, the Company violated RCW 48.44.095.

3. By knowingly filing with the OIC annual financial statements which did not accurately state PacifiCare of Washington's financial condition, the company violated RCW 48.44.100.

**CONSENT TO ORDER:**

PacifiCare of Washington, acknowledging its duty to comply fully with the applicable laws of the State of Washington, consents to the following in consideration of its desire to resolve this matter without further

administrative or judicial proceedings. The Insurance Commissioner consents to settle the matter in consideration of the Company's payment of a fine and such terms and conditions as are set forth below.

1. PacifiCare of Washington consents to the entry of this Order, waives any and all hearing rights, and further administrative or judicial challenges to this Consent Order.

2. By agreement of the parties, the Insurance Commissioner will impose a fine of $400,000, on the conditions that:

a. Within thirty days of the entry of this Order, PacifiCare of Washington pays $400,000.

b. PacifiCare of Washington understands and agrees that any future failure to comply with the statutes and regulations that are the subject of this Order constitutes grounds for further penalties.

3. PacifiCare of Washington's failure to timely pay this fine and to adhere to the conditions shall constitute grounds for revocation of the Company's Certificate of Authority, and shall result in the recovery of the amount of the fine through a civil action brought on behalf of the Insurance Commissioner by the Attorney General of the State of Washington.

EXECUTED this _____ day of _____, 2009.

PACIFICARE OF WASHINGTON, INC.

By: _____

Printed Name: _____

Typed Corporate Title: _____

**ORDER**

Pursuant to the foregoing Findings of Fact, Conclusions of Law, and Consent to Order, the Insurance Commissioner hereby orders as follows:

1. PacifiCare of Washington, Inc. shall pay a fine in the amount of $400,000.

2. The Company's failure to pay the fine within the time limit set forth above shall result in the revocation of the Company's Certificate of Authority and in the recovery of the fine through a civil action brought on behalf of the Insurance Commissioner by the Attorney General of the State of Washington.

ENTERED AT TUMWATER, WASHINGTON, this ____ day of _____, 2009.

MIKE KREIDLER
Insurance Commissioner

By _____
Andrea L. Philhower
OIC Staff Attorney
Legal Affairs Division

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| IN THE MATTER OF<br><br>PacifiCare of Washington, Inc.,<br><br>Authorized Health Care Service Contractor. | OAH DOCKET NO. 2009-INS-0001<br>OIC ORDER NO. 09-0010<br><br>DECLARATION OF ANDREA PHILHOWER IN SUPPORT OF OIC'S RESPONSE TO MOTION FOR SUMMARY JUDGMENT RE: STATUTE OF LIMITATIONS |
|---|---|

I, Andrea L. Philhower, make the following declaration based upon my own personal knowledge:

1. I am a staff attorney with the Office of the Insurance Commissioner ("OIC") and am the attorney assigned to handle this matter on behalf of OIC.

2. On or about February 9, 2009, I drafted two documents. The first was a proposed consent order imposing a fine of $400,000 for PCW's years of making royalty payments in violation of the Washington Insurance Code. The second was a cover letter informing PCW of OIC's findings and the proposed fine, and explaining the method of resolving this matter on the basis of the proposed consent order. At my request, my Legal Assistant, Jodie Thompson, mailed the proposed consent order and cover letter to PCW.

3. True and correct copies of that proposed consent order and cover letter are attached to the OIC's Response to PCW's Motion for Summary Judgment as Exhibits C-1 and C-2.

4. On or about March 6, 2009, attorney Jeff Gingold contacted me regarding this matter on behalf of PCW. Mr. Gingold and I engaged in correspondence, meetings, and exchange of materials regarding the parties' positions and worked toward resolution of this matter from that time until OIC filed its request for hearing. Despite good faith efforts and productive work on both sides, we have been unable to resolve this matter.

5. As a result, some time prior to August 14, 2009, I drafted the document that became OIC's Notice of Request for Hearing for Imposition of Fines (Exhibit R-1 to PCW's Motion for Summary Judgment). Because I was out of the office on the day I wanted to



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file it, I asked my supervisor, Deputy Insurance Commissioner Carol Sureau, to sign the document for me. Ms. Sureau made some changes from my original draft and signed the document, which was filed on August 14, 2009.

I declare under penalty of perjury under the laws of the State of Washington that the foregoing is true and correct.

Executed this 16th of November, 2009 at Tumwater, Washington.

Andrea Philhower
WSBA #28400

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|---|---|
| IN THE MATTER OF<br><br>PacifiCare of Washington, Inc.,<br><br>Authorized Health Care Service Contractor. | OAH DOCKET NO. 2009-INS-0001<br><br>OIC ORDER NO. 09-0010<br><br>DECLARATION OF CARL BAKER IN SUPPORT OF OIC'S RESPONSE TO MOTION FOR SUMMARY JUDGMENT RE: STATUTE OF LIMITATIONS |

I, Carl Baker, make the following declaration based upon my own personal knowledge:

1. I am a Certified Public Accountant, a Certified Financial Examiner, and a Certified Information Systems Auditor. I have over 25 years of auditing and examining experience. I am a Financial Examiner with the Office of the Insurance Commissioner. I have been with the OIC for over eight years. I am the supervisor of the team of financial examiners that examines health carriers. I was the Examiner in Charge during the examination of PacifiCare of Washington for the period January 1, 1997 through December 31, 2002. I supervised Jeannette Liao, who was the Examiner in Charge during the examination of PacifiCare of Washington for the period January 1, 2003 through December 31, 2006.

2. For many years, I and the Financial Examination unit of the Company Supervision division of OIC believed that PacifiCare of Washington ("PCW") was paying royalties to



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its parent company, in violation of Statutory Accounting Principles and, later, the Washington Holding Company Act for Health Care Service Contractors and Health Maintenance Organizations, Title 48.31C RCW.

3. The Company Supervision division of the Office of the Insurance Commissioner ("OIC") investigated this matter as part of two Financial Examinations. However, throughout the OIC's investigations of this matter over the years, PCW continually denied that the payments in question were royalties.

4. PCW specifically denied that it was paying royalties in response to direct questioning as part of the two OIC Financial Examinations. As an example, Exhibit C-3 is a true and correct copy of Request for Information No. K006 to the Company in which PCW states "PacifiCare of Washington does not pay any royalty fees."

5. Exhibit C-4 consists of true and correct copies of the relevant portions of PCW's Underwriting and Investment Exhibit ("UIE") for 2004, which is part of PCW's Annual Statement. It also includes an E-mail string in which OIC asks what is included in the Corporate Charge Back entry. Finally, the exhibit includes a spreadsheet prepared by PCW for OIC's Financial Examiners in answer to this question.

6. Exhibit C-4 is one example showing that, for all the years at issue, PCW misclassified the royalty payments in its Annual Financial Statement and in the documents supplied to OIC Financial Examiners. On PacifiCare of Washington's UIE, the royalty payment from PCW to its corporate parent is included in the category "Corporate Charge Back". When we asked the Company to show what was included in this item, it provided a spreadsheet which stated this amount was made up of many things, but did not include royalty fees.

7. PCW engaged in a shell game in which its immediate parent company, PacifiCare Health Plan Administrators, Inc. ("PHPA") paid PCW's royalty fees to an affiliate, PacifiCare Life and Health Insurance Company, which then paid them to the ultimate parent company. The royalty fees were then recouped by being included in monthly inter-company billings from PHPA to PCW.

8. Exhibit C-5 is a true and correct copy of Request for Information K028, in which PCW admits that royalty fees are paid by PHPA on its behalf.

9. It was not until a conference call on August 9, 2007, that the Company at long last admitted that these payments were royalties.

10. That admission and the subsequent follow up led to Instruction Number 4 in the Financial Examination Report showing PCW's financial condition as of December 31, 2006.

I declare under penalty of perjury under the laws of the State of Washington that the foregoing is true and correct.

Executed this _____ day of November, 2009 at Tumwater, Washington.

_____

Carl Baker, CPA, CFE, CISA

9. It was not until a conference call on August 9, 2007, that the Company at long last admitted that these payments were royalties.

10. That admission and the subsequent follow up led to Instruction Number 4 in the Financial Examination Report showing PCW's financial condition as of December 31, 2006.

I declare under penalty of perjury under the laws of the State of Washington that the foregoing is true and correct.

Executed this 16 day of November, 2009 at Tumwater, Washington.

Carl M. Baker

Carl Baker, CPA, CFE, CISA

# EXHIBIT C-3

| PacifiCare of Washington, Inc. | Request for Information (RFI) |
|---|---|

Provided by Company on 03-29-07. Its response is in bold print.

Per telephone conference with Linda Spaulding on 3-29-07, she confirmed company's response with 1.a. The OIC did not approve the Form D filing regarding royalty fees. They are not legal per Washington State Statutes.

## Request No. RFI—K006

**Date and Time Requested: March 22, 2007**

**Request Due by: March 29, 2007**

**To: Rebeca de la Torre**
**Cc: Lori Cottingham**

**From: Kathy Hicks**

**Subject: PCW Related Party Cycle - Royalty Fees**

Dear Rebeca,

1.) Royalty Fees

a.) Please explain why PacifiCare of Washington pays PacifiCare Life and Health Insurance Company royalty fees.

**Company Response:**

**PacifiCare of Washington does not pay any royalty fees. The Washington Office of Insurance Commissioner denied our original Form D and precluded PacifiCare of Washington from paying any license fees to PacifiCare Life and Health Insurance Company. This disclosure related to royalty fees should not have been included in the notes to the financial statement.**

b.) Are these also known as enterprise fees?

**Company Response:**

N/A

c.) Describe the nature of the intellectual property that benefits PCW.

**Company Response:**
N/A

d.) Why was the "Royalty Rate" set at 1.75%?

**Company Response:**
N/A

e.) Show the formula used to determine the amount of the fees.

**Company Response:**
N/A

f.) Name the Company that PCW pays directly.

**Company Response:**
N/A

g.) Refer to PCW's 2006 Notes to the Financial Statement, Note #10;

**Company Response:**

*The Company pays a royalty fee income to an affiliated company with respect to the usage of the PacifiCare Health System's intellectual property.*

Why is PCW paying PacifiCare Life and Health Insurance Company for **PacifiCare Health System's** intellectual property?

**Company Response:**

**This statement is not correct. The Washington Office of Insurance Commissioner denied our original Form D and precluded PacifiCare of Washington from paying any license fees to PacifiCare Life and Health Insurance Company.**

2.) Agreements

a.) In relationship to the royalty fees, list the intercompany agreement(s) that were in effect during our period of examination (2003-2006).

N/A

b.) Provide those agreements not previously given to us. Please include the Master License Agreement between PacifiCare of Washington and PacifiCare Life and Health Insurance Company.

**All affiliated agreements have been previously provided.**

c.) Include all the amendments to date.

Note that we were previously given the "First Amendment to Master License Agreement" effective 01-01-2007. It is between PacifiCare Life and Health Insurance Company and PacifiCare of Washington.

**N/A – This amendment was not filed with the OIC and has not been executed.**

3.) Show how the royalty fees were calculated for 2006.

**N/A**

4.) What general ledger accounts record the information? Provide the last journal entry in 2006 recording the liability.

**N/A**

I can be reached by phone at 206-230-7192 if you have questions.

Thank you,

Kathy Hicks
*Insurance Examiner*
*State of Washington*
*Office of Insurance Commissioner*

# EXHIBIT C-4

Purpose of document: To document the allocation method and expenses that are included in Corporate Charge
Back amount of $9,539,984. jt 4-15-04

From: Harvey Susan K [Susan.Harvey@phs.com]
Sent: Thursday, April 15, 2004 10:40 AM
To: Juanita Turley; Harvey Susan K
Cc: Carl Baker
Subject: RE: Corporate Charge Back

(2) These would be all the services provided by Corporate including Treasury, Legal, Taxes and any other Regulatory Filing that is not performed by Statutory reporting. It has been the same 1.75% of revenue since the beginning.

> -----Original Message-----
> From: JuanitaT@OIC.WA.GOV [SMTP:JuanitaT@OIC.WA.GOV]
> Sent: Thursday, April 15, 2004 9:26 AM
> To: Susan.Harvey@phs.com
> Cc: CarlB@OIC.WA.GOV
> Subject: Corporate Charge Back
>
> Hi Susan,
> What type of expenses are included in the Corporate Charge Back, Line
> 25.6 in the U&I, Part 3, Analysis of Expenses in the amount of
> $9,539,984? Thanks,
>
> Juanita Turley
> Insurance Examiner
> Office of the Insurance Commissioner
> 810 Third Avenue, Suite 650
> Seattle, Washington 98104-1615
> Phone: (206) 464-7054
> Fax: (206) 587-4244
> e-mail: Juanitat@oic.wa.gov <mailto:Juanitat@oic.wa.gov>
>
>

(1)

This electronic message transmission, including any attachments, contains information from PacifiCare Health Systems Inc. which may be confidential or privileged. The information is intended to be for the use of the individual or entity named above. If you are not the intended recipient, be aware that any disclosure, copying, distribution or use of the contents of this information is prohibited.
If you have received this electronic transmission in error, please notify the sender immediately by a "reply to sender only" message and destroy all electronic and hard copies of the communication, including attachments.

| | B | C | D | E | F | G | H | I | J | K | L | M | N | O | P | Q | R | S | T | U | V | W | X | Y |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| 1 | Care of Washington | | | | | Total G&A Expenses | U4 | 42,135,115 | | N.SI.3 Pg3 | | | | | | 12/31/01 Accrual | | PY | 1,263,877 | | | | | |
| 2 | rwriting and Investment Exhibit part 3 | | | | | Directly Allocated | U4 | 35,808,046 | | U5 = Amortization of Goodwill & Restructure Exp | | | | | | 12/31/02 Accrual | | U8 | 551,821 | | N.SI.3 Pg7 | | | |
| 3 | ar Period Ended 12/31/02 | | Used for allocation calculation | | | | | 6,327,069 | A | U6 = Marketing Exp | | U7 = SSAP 10 Tax adj | | | | | | | (712,056) | B | | | | |
| 4 | | | N.SI.3 Pg1 | | N.SI.3 Pg2 | | | | | N.SI.3 Pg4 | | N.SI.3 Pg6 | | | | Actuary Calculation | | | Actuary Calculation | | | | | |
| 5 | Examiner's notes in green font. | | Customer Service | | Direct WA expense | | | d = Y * c | | e | | f | g = d + e + f | h = z / X | | l = W * h | | | J = V * h | | k = g - J | | l = J + I | |
| 6 | | | z | | b | c = (a + b / Z) | | Allocation of | | | | | Total G&A | RCSC | | Allocation of | | | Allocation of | | Total G&A less | | Total CAE | |
| 7 | | | | | | | | Additional G&A | | | | Other | | Allocation | | CAE Expense | | | CAE Reserve | | CAE Expense | | Expense | |
| 8 | | | GenericOTC | | GenericOTC | Washington | | Expenses | | Direct | | Allocations | | Percentage | | | | | | | | | | |
| 9 | | | PCNW RCSC | | Wash. Cons. | Allocation | | | | | | | | | | | | | | | | | | |
| 10 | | | Actual Amts | | Actual Amts | Percentage | A | 6,327,069 | Y | Allocations | | | | | U8 | 8,092,699 | W | B | (712,056) | V | | | | |
| 11 | Rent (50 for occupancy of own building) | U3 | 748,044 | U4 | 1,730,770 | 5% | | 299,172 | | | | | 2,029,842 | 5% | | 364,342 | | | (32,058) | | 1,665,600 | U1 | 332,284 | U1 |
| 12 | Salaries, wages and other benefits | | 7,271,103 | | 18,226,974 | 49% | | 3,077,402 | | | | | 21,304,376 | 44% | | 3,541,459 | | | (311,604) | | 17,762,917 | | 3,229,855 | |
| 13 | Commissions | | | | | 0% | | - | U6 | 1,995,154 | | | 1,995,154 | 0% | | - | | | - | | 1,995,154 | | - | |
| 14 | Legal fees and expenses | | 17,289 | | 668,910 | 1% | | 82,818 | | | | | 751,728 | 0% | | 8,421 | | | (741) | | 743,307 | | 7,880 | |
| 15 | Certifications and accreditation fees | | | | | 0% | | - | | | | | - | 0% | | - | | | - | | - | | - | |
| 16 | Auditing, actuarial and other consulting services | | | | | 0% | | - | | | | | - | 0% | | - | | | - | | - | | - | |
| 17 | Traveling expenses | | 105,305 | | 580,788 | 1% | | 82,806 | | | | | 683,594 | 1% | | 51,290 | | | (4,513) | | 612,304 | | 46,777 | |
| 18 | Marketing and advertising | | | | | 0% | | - | U8 | 3,462,803 | | | 3,462,803 | 0% | | - | | | - | | 3,462,803 | | - | |
| 19 | Postage, express, and telephone | | 321,480 | | 773,460 | 2% | | 132,150 | | | | | 905,610 | 2% | | 156,580 | | | (13,777) | | 748,030 | | 142,803 | |
| 20 | Printing and office supplies | | 50,242 | | 138,068 | 0% | | 22,727 | | | | | 160,783 | 0% | | 24,471 | | | (2,153) | | 136,322 | | 22,318 | |
| 21 | Occupancy, depreciation and amortization | | 59,569 | | 249,478 | 1% | | 37,275 | | | | | 286,753 | 0% | | 28,916 | | | (2,544) | | 257,837 | | 28,372 | |
| 22 | Equipment | | 417 | | (9,773) | 0% | | (1,129) | | | | | (10,902) | 0% | | 203 | | | (18) | | (11,105) | | 185 | |
| 23 | Cost of depreciation of EDP Equip and software (note 1) | | | | | 0% | | - | | | | | - | 0% | | - | | | - | | - | | - | |
| 24 | Outsourced svcs including EDP, claims, and other svcs | | | | | 0% | | - | | | | | - | 0% | | - | | | - | | - | | - | |
| 25 | Boards, bureaus and association fees | | 9,701 | | 86,200 | 0% | | 11,574 | | | | | 97,774 | 0% | | 4,725 | | | (416) | | 93,049 | | 4,309 | |
| 26 | Insurance, except on real estate | | 7,262 | | 568,205 | 1% | | 69,454 | | | | | 637,659 | 0% | | 3,537 | | | (311) | | 634,122 | | 3,226 | |
| 27 | Collection and bank service charges | | | | | 0% | | - | | | | | - | 0% | | - | | | - | | - | | - | |
| 28 | Group service and administration fees | | | | | 0% | | - | | | | | - | 0% | | - | | | - | | - | | - | |
| 29 | Reimbursements by uninsured accident and health plans | | | | | 0% | | - | | | | | - | 0% | | - | | | - | | - | | - | |
| 30 | Reimbursements from fiscal intermediaries | | 6,903,986 | | 6,903,986 | 26% | | 1,668,505 | | | | | 8,570,491 | 42% | | 3,362,651 | | | (295,671) | | 5,207,840 | | 3,066,780 | |
| 31 | Real estate expenses | | 186,450 | | 235,331 | 1% | | 50,905 | | | | | 286,236 | 1% | | 90,812 | | | (7,990) | | 195,424 | | 82,822 | |
| 32 | Real estate taxes | | | | | 0% | | - | | | | | - | 0% | | - | | | - | | - | | - | |
| 33 | Taxes, Licenses and Fees: | | | | | 0% | | - | | | | | - | 0% | | - | | | - | | 4,534,112 | | - | |
| 34 | 23.1 State and local insurance taxes | | - | | 3,887,044 | 7% | | 469,133 | | | U7 | 177,935 | 4,534,112 | 0% | | - | | | - | | - | | - | |
| 35 | 23.2 State premium taxes | | | | - | 0% | | - | | | | | - | 0% | | 1,165 | | | (164) | | 111,921 | | 1,081 | |
| 36 | 23.3 Regulatory authority licenses and fee | | 2,433 | | 100,663 | 0% | | 12,443 | | | | | 113,106 | 4% | | 300,673 | | | (26,455) | | 1,353,255 | | 274,218 | |
| 37 | 23.4 Payroll taxes | | 617,324 | | 1,409,328 | 4% | | 244,600 | | | | | 1,653,928 | 0% | | - | | | - | | - | | - | |
| 38 | 23.5 Other (excluding federal income and real estate taxes) | | | | | 0% | | - | | | | | - | 0% | | - | | | - | | - | | - | |
| 39 | Investment expenses not included elsewhere | | | | | 0% | | - | | | | | - | 0% | | - | | | - | | - | | - | |
| 40 | Aggregate write-ins for expenses: | | | | | 0% | | - | | | | | - | 0% | | 2,359 | | | (206) | | 50,789 | | 2,151 | |
| 41 | 25.1 Seminars & Training | | 4,843 | | 48,903 | 0% | | 5,245 | | | | | 53,148 | 0% | | 5,774 | | | (508) | | 45,642 | | 5,268 | |
| 42 | 25.2 Recruitment | | 11,854 | | 44,602 | 0% | | 6,814 | | | | | 51,416 | 0% | | 612 | | | (55) | | 61,788 | | 597 | |
| 43 | 25.3 Contributions | | 1,254 | | 55,545 | 0% | | 6,855 | | | | | 62,400 | 0% | | - | | | - | | 316,370 | | - | |
| 44 | 25.4 Bad Debt Expense | | | | 282,299 | 1% | | 34,071 | | | | | 316,370 | 2% | | 144,691 | | | (12,731) | | 2,294,848 | | 131,980 | |
| 45 | 25.5 Other | | 287,071 | | (170,733) | 0% | | 15,248 | U5 | 2,595,024 | | Amort of goodwill & restructure exp | 2,430,539 | | | | | | | | 9,539,984 | | - | |
| 46 | 25.6 Corporate Charge Back | | | | | | | | U5 | 9,539,984 | | WA's allocation of corp expense | 9,539,984 | | | | | | | | | | | |
| 47 | | | | | | | | | | | | | | | | | | | | | | | | |
| 48 | Total general expenses incurred (line 1 to 25) | | 16,615,427 | X | 35,808,046 | 100% | | 6,327,069 | | 17,592,965 | | 177,935 | 59,906,014 | 100% | | 8,092,701 | | | (712,057) | | 51,813,313 | | 7,380,644 | |
| 49 | | | | ZZ | | | | | ZZ | | ZZ | | 59,906,015 | | XX | | | XX | | | | | | |
| 50 | | | | | 52,423,473 | Z | | | | | | | | | | | | | | | | | | |
| 51 | Agreed to Company's source document | | | | | | | | | | | | | | | | | | | | | | | |
| 52 | | | | | | | | | | | | | | | | | | | | | | | | |
| 53 | Note to Line 25.6: | | | | | | | | | | | | | | | | | | | | | | | |
| 54 | Corporate Charge Back is defined as corporate expense allocated to Washington. | | | | | | | | | | | | | | | | | | | | | | | |
| 55 | Note to Line 25.5: | | | | | | | | | | | | | | | | | | | | | | | |
| 56 | Other is defined as amortization goodwill and any restructure charges allocated to Washington. | | | | | | | | | | | | | | | | | | | | | | | |
| 57 | Per SSAP No. 68, paragraph 7, amortization of goodwill in a health company should be expensed to operations. Appropriately expensed. | | | | | | | | | | | | | | | | | | | | | | | |
| 58 | | | | | | | | | | | | | | | | | | | | | | | | |
| 59 | Note to Line 2: | | | | | | | | | | | | | | | | | | | | | | | |
| 60 | Calculations and sources used by the company for amounts in the U&I report. | | | | | | | | | | | | | | | | | | | | | | | |
| 61 | Direct expense for WA (GL report) | | $ 18,226,974.00 | | | | | | | | | | | | | | | | | | | | | |
| 62 | Derived allocation of 49% is based on total of NW customer | | 3,077,402 | | | | | | | | | | | | | | | | | | | | | |
| 63 | service & WA expense general ledger report. The amount of $6,327,069 | | | | | | | | | | | | | | | | | | | | | | | |
| 64 | for company support service expenses is based on derived % allocation. | | | | | | | | | | | | | | | | | | | | | | | |
| 65 | Subtotal | | 21,304,376 | | | | | | | | | | | | | | | | | | | | | |

EX. 6

See also "Analysis" tab in this file.
Allocation of charge back not consistent between years to line items.
See excel file, "States Analysis" tab for comparison between states.
See e-mail from Susan Harvey for corp. charge back allocations explanation.

O.3.1
NS.11

This amount traces to U&I statement.
N.SI.5

Note

SEE ATTACHED PAGE FOR CORPORATE CHARGE BACK SCHEDULE PREPARED BY COMPANY

SEE ATTACHED SCH FOR BREAKOUT COST FOR $9,539,964

Exhibit C-4 Page2

This was prepared by Susan Harvey to document the allocation method used in 2002 if the corporate chargeback was allocated as it was in 2001. jt 3/25/04

Total Corporate Chargeback 9,539,984

| | % allocation | Allocation of Corp Charge 2002 | 2002 G&A w/o Corp Charge | (Ties to filing) 2002 Total | (Ties to filing) 2001 Total | Difference |
|---|---|---|---|---|---|---|
| Rent ($0 for occupancy of own building) | 5% | 451,093 | 1,665,600 | 2,116,693 | 2,526,607 | (409,914) |
| Salaries, wages and other benefits | 49% | 4,640,121 | 17,762,917 | 22,403,038 | 22,789,551 | (386,513) |
| Commissions | 0% | - | 1,995,154 | 1,995,154 | 1,815,083 | 180,071 |
| Legal fees and expenses | 1% | 124,874 | 743,307 | 868,181 | 142,982 | 725,199 |
| Certifications and accreditation fees | 0% | - | - | - | 199,199 | (199,199) |
| Auditing, actuarial and other consulting services | 0% | - | - | - | 866,558 | (866,558) |
| Traveling expenses | 1% | 124,855 | 612,304 | 737,159 | 771,782 | (34,623) |
| Marketing and advertising | 0% | - | 3,462,803 | 3,462,803 | 3,677,865 | (215,062) |
| Postage, express, and telephone | 2% | 199,256 | 749,030 | 948,286 | 1,656,900 | (708,614) |
| Printing and office supplies | 0% | 34,268 | 136,322 | 170,590 | 347,816 | (177,226) |
| Occupancy, depreciation and amortization | 1% | 56,204 | 257,837 | 314,041 | - | 314,041 |
| Equipment | 0% | (1,703) | (11,105) | (12,808) | 559,208 | (572,016) |
| Cost of depreciation of EDP Equip and software (no | 0% | - | - | - | 761,567 | (761,567) |
| Outsourced svcs including EDP, claims, and other s | 0% | - | - | - | 742,331 | (742,331) |
| Boards, bureaus and association fees | 0% | 17,452 | 93,049 | 110,501 | 87,760 | 22,741 |
| Insurance, except on real estate | 1% | 104,723 | 634,122 | 738,845 | 1,046,824 | (307,979) |
| Collection and bank service charges | 0% | - | - | - | 3,973 | (3,973) |
| Group service and administration fees | 0% | - | - | - | 1,774,134 | (1,774,134) |
| Reimbursements by uninsured accident and health | 0% | - | - | - | - | - |
| Reimbursements from fiscal intermediaries | 26% | 2,512,764 | 5,207,840 | 7,720,604 | - | 7,720,604 |
| Real estate expenses | 1% | 76,755 | 195,424 | 272,179 | - | 272,179 |
| Real estate taxes | 0% | - | - | - | - | - |
| Taxes, Licenses and Fees: | 0% | - | - | - | - | - |
| 23.1 State and local insurance taxes | 7% | 707,361 | 4,534,112 | 5,241,473 | 5,087,226 | 154,247 |
| 23.2 State premium taxes | 0% | - | - | - | - | - |
| 23.3 Regulatory authority licenses and fee | 0% | 18,761 | 111,921 | 130,682 | 51,859 | 78,823 |
| 23.4 Payroll taxes | 4% | 368,809 | 1,353,255 | 1,722,064 | 1,647,664 | 74,400 |
| 23.5 Other (excluding federal income and real estat | 0% | - | - | - | 20,521 | (20,521) |
| Investment expenses not included elsewhere | 0% | - | - | - | - | - |
| Aggregate write-ins for expenses: | 0% | - | - | - | - | - |
| 25.1 Seminars & Training | 0% | 9,417 | 50,789 | 60,206 | 142,566 | (82,360) |
| 25.2 Recruitment | 0% | 10,274 | 45,642 | 55,916 | 421,441 | (365,525) |
| 25.3 Contributions | 0% | 10,336 | 61,788 | 72,124 | 213,044 | (140,920) |
| 25.4 Bad Debt Expense | 1% | 51,373 | 316,370 | 367,743 | 809,465 | (441,722) |
| 25.5 Other (Primarily Amortization of Goodwill & Re | 0% | 22,991 | 2,294,848 | 2,317,839 | 2,872,928 | (555,089) |
| 25.6 Corporate Charge Back | | - | | - | 445,092 | (445,092) |
| 25.7 Repairs and Maintenance | | | | | 60,147 | (60,147) |
| 25.8 Utilities | | | | | (294,831) | 294,831 |
| 25.9 Intercompany reallocations | | | | | - | - |
| Total general expenses incurred (line 1 to 25) | 1 | 9,539,984 | 42,273,329 | 51,813,313 | 51,247,262 | 566,051 |

↳ THIS IS REALLY ROYALTY FEE'S

Exhibit C-4 Page3

# EXHIBIT C-5

| PacifiCare of Washington, Inc. | Request for Information (RFI) |
|---|---|

Company provided on 08-17-07. It explains why it paid royalty fees. Since the fees are not allowed per state statutes, Royalty Fees Paid Exception 15, EX.15 , will be written up in the Related Party Cycle, Q.4.PS, Exam 4. Q.4.PS
Contact information is at Q.5.61. Q.5.61

KLWH 08-20-07.

## Request No. RFI—K028

**Date and Time Requested: August 16, 2007**
**Request Due by: The Company will send over items as they are completed. It realizes the need to expedite the request.**

**To: Andrea Dawson and Tom Lindquist**
**Cc: Lori Cottingham and Rebeca de la Torre**

**From: Kathy Hicks**

**Subject: PCW Other Expenses – Royalty Fees**

Dear Andrea and Tom,

By August 13th, the Company provided the *Comparison of Actual Expenses on Contract Company vs. Management Fees Paid* for 2003-2006. At the bottom of each spreadsheet, it provided the calculation for the *Management Contract Fees.* The Company explained that these were royalty fees calculated as 1.75% of premiums.

The *Master License Agreement* effective October 1, 1998, #3 states;

> *...Licensee and Licensor acknowledge and agree that the Washington Department of Insurance has determined, as of the Effective Date, that Licensee is precluded from paying any license fee to Licensor under the Laws and Regulatory Requirements applicable to Licensee. In view of the foregoing and during such time period as the direct payment of the license fee to Licensor by Licensee is precluded, Licensee and Licensor acknowledge and agree that Licensee's parent company may make payment of the license fee to Licensor on Licensee's behalf. ...*

1.) According to the *Master License Agreement*, PCW should not be paying any royalty fees. Why are royalty fees being charged to PCW during 2003 through 2006?

AUGUST 16

Company Response:

These Royalty Fees are not paid directly by PC WA. The Royalty Fees are being paid by PHPA on behalf of PC WA, as allowed per the Master License Agreement between PLHIC and PC WA, in section 3, quoted above.

The *Comparison of Actual Expenses on Contract Company vs. Management Fees Paid* files represent the expenses that PHPA incurred during the years 2003-2006, on behalf of PC WA, per the *Management and Administrative Service Agreement*, as compared to the Management Fee paid in those years.

The *Management and Administrative Service Agreement* between PHPA and PC WA, Exhibit A, Marketing, Marketing Administration states:

> *"PHPA, subject to the ultimate authority and control of PCW, shall direc the marketing of PCW's products in compliance with Regulatory Requirements and shall incur all costs related to marketing..."*

It is the Company's position that the use of PacifiCare Intellectual Property is integral to the marketing of PC WA's products. Therefore, the Royalty Fees incurred related to the use of PacifiCare Intellectual Property would be a reasonable charge included in the reconciliation of actual expenses to Management Fees paid.

2.) Is PCW being reimbursed for the fees? Are the fees being reversed out of the accounting records in some other general ledger account? If yes, please explain.

Company Response:

As stated above, PC WA is not paying these fees. They are being paid by PHPA on behalf of PC WA.

I can be reached by phone at 206-230-7192 if you have questions.

Thank you,

Kathy Hicks
Insurance Examiner
State of Washington
Office of Insurance Commissioner

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NOV 16 2009
OAH - Olympia

| | |
|---|---|
| IN THE MATTER OF<br><br>PacifiCare of Washington, Inc.,<br><br>Authorized Health Care Service Contractor. | OAH DOCKET NO. 2009-INS-0001<br>OIC ORDER NO. 09-0010<br><br>DECLARATION OF DENNIS EDWARD JULNES IN SUPPORT OF OIC'S RESPONSE TO MOTION FOR SUMMARY JUDGMENT RE: STATUTE OF LIMITATIONS |

I, Dennis Julnes, make the following declaration based upon my own personal knowledge:

1. I am over the age of eighteen years and am competent to testify to the facts and matters contained herein. I am the Chief Financial Analyst for the Washington State Office of the Insurance Commissioner ("OIC"). I have held that position throughout the events at issue in this matter. I am a Certified Public Accountant and have been a regulator financial examiner for over twenty-five years.

2. Exhibit C-6 is a true and correct copy of SSAP #70 as it was codified in the NAIC Accounting Practices and Procedures Manual.

3. RCW 48.43.097(2) and WAC 284-07-050 require companies to follow the NAIC accounting practices and procedures.

4. On or about November 24, 1998, I received a faxed copy of a Master License Agreement and cover letter from Donald Costa, Chief Financial Officer of PacifiCare of Washington. That Master License Agreement contemplated the payment of a franchise fee for PacifiCare of Washington's ("PCW's") use of the PacifiCare name and PacifiCare intellectual property.

5. Exhibit C-7 is a true and correct copy of that cover letter.

6. As the cover letter indicates, I had previously notified PacifiCare that the payment of franchise fees was not allowed under Washington law.



COPY

7. On or about November 24, 1998, I reviewed this letter and the attached Master License Agreement, and called Mr. Costa to discuss it. I reiterated OIC's position that Washington law prohibits payment of royalties or franchise fees within a holding company system and would therefore not allow the company to utilize this agreement.

8. Mr. Costa told me that PacifiCare would not be moving forward with the Master Licensing Agreement.

9. I made the handwritten notation that is seen at the upper right of the cover letter to memorialize that conversation. The initials next to the notation are mine.

I declare under penalty of perjury under the laws of the State of Washington that the foregoing is true and correct.

Executed this 16 day of November, 2009 at Tumwater, Washington.

Dennis Edward Julnes

Dennis Edward Julnes, CPA

# EXHIBIT C-6

*Debt Issue Costs in the*

# Statement of Statutory Accounting Principles No. 70

## Allocation of Expenses

STATUS

| | |
|---|---|
| Type of Issue: | Common Area |
| Issued: | Initial Draft |
| Effective Date: | January 1, 2001 |
| Affects: | No other pronouncements |
| Affected by: | No other pronouncements |
| Interpreted by: | No other pronouncements |


STATUS ..... 1

SCOPE OF STATEMENT ..... 3

SUMMARY CONCLUSION ..... 3

Effective Date and Transition ..... 4

AUTHORITATIVE LITERATURE ..... 4

Statutory Accounting ..... 4

RELEVANT ISSUE PAPERS ..... 4

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## Allocation of Expenses

### SCOPE OF STATEMENT

1. This statement establishes statutory accounting principles for presentation and allocation of certain expenses of reporting entities into general categories and the apportionment of shared expenses between members of a group of entities.

### SUMMARY CONCLUSION

2. This statement establishes uniform expense allocation rules to classify expenses within prescribed principal groupings. It is necessary to allocate those expenses which may contain characteristics of more than one classification, which this statement will refer to as allocable expenses.

3. Allocable expenses for property and casualty insurance companies shall be classified into one of three categories on the Underwriting and Investment Exhibit as follows:

a. Loss adjustment expenses—Expenses incurred in the adjusting, recording and paying of claims (including expenses associated with commutations);

b. Investment expenses—Expenses incurred in the investing of funds and pursuit of investment income. Such expenses include those specifically identifiable and allocated costs related to activities such as initiating and handling orders, researching and recommending investments (i.e., investment strategy), appraising, valuing, disbursing funds and collecting income, securities safekeeping, real estate taxes, records maintenance, data processing, support personnel, postage and supplies, office overhead, management and executive duties and all other functions reasonably associated with the investment of funds; or

c. Other underwriting expenses—Allocable expenses other than loss adjustment expenses and investment related expenses.

4. Similarly for life and accident and health insurers allocable expenses shall be categorized as general insurance expenses; insurance taxes, licenses and fees; or investment expenses which are netted against investment income on the Summary of Operations.

5. Allocable expenses for health insurers shall be classified as claim adjustment expenses; general administrative expenses; or investment expenses which are netted against investment income on the Statement of Revenue and Expenses.

6. Allocation to the above categories should be based on a method that yields the most accurate results. Specific identification of an expense with an activity that is represented by one of the categories above will generally be the most accurate method. Where specific identification is not feasible allocation of expenses should be based upon pertinent factors or ratios such as studies of employee activities, salary ratios or similar analyses.

7. Allocation may be entirely to one expense category based upon the type of expense incurred, for example, premium taxes would be 100% allocated to Other Underwriting Expenses for property and casualty companies. Other expenses may be allocated across several categories, such as salaries, which may be allocated to both general insurance expenses and net investment income of a life and accident and health company.

8. Many entities operate within a group where personnel and facilities are shared. Shared expenses, including expenses under the terms of a management contract, shall be apportioned to the entities


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incurring the expense as if the expense had been paid solely by the incurring entity. The apportionment shall be completed based upon specific identification to the entity incurring the expense. Where specific identification is not feasible apportionment shall be based upon pertinent factors or ratios.

98. Any basis adopted to apportion expenses shall be that which yields the most accurate results and may result from special studies of employee activities, salary ratios, premium ratios or similar analyses. Expenses that relate solely to the operations of a reporting entity, such as personnel costs associated with the adjusting and paying of claims, must be borne solely by the reporting entity and are not to be apportioned to other entities within a group.

109. Apportioned expenses are subject to presentation and allocation as provided in paragraphs 3 through 6.

1110. Any material individual component of the reported expense categories shall be presented either on the face of the Summary of Operations or within the footnotes or related eExhibits to the financial statements ~~(e.g., Exhibits 5 and 6~~ of the Life and Accident and Health annual statement, ~~and Underwriting and Investment Exhibit, Part 4—Expenses of~~ the Property and Casualty annual statement~~)~~ ~~and~~or the Health annual statement ~~to the financial statements~~.

1211. Refer to the preamble for further discussion regarding disclosure requirements.

**Effective Date and Transition**

1312. This statement is effective for years beginning January 1, 2001. A change resulting from the adoption of this statement shall be accounted for as a change in accounting principle in accordance with *SSAP No. 3—Accounting Changes and Corrections of Errors*.

## AUTHORITATIVE LITERATURE

**Statutory Accounting**

- NAIC *Annual Statement Instructions for Property and Casualty Insurance Companies*, "Underwriting and Investment Exhibit"
- NAIC *Annual Statement Instructions for Life and Accident and Health Insurance Companies*, "Exhibit 5—General Expenses"

## RELEVANT ISSUE PAPERS

- Issue Paper No. 94—Allocation of Expenses



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# Exhibit C-7

**PacifiCare®**
*of Washington*

7525 S.E. 24th
P.O. Box 9005
Mercer Island, WA 98040-9005
Administration: 206-236-2500
Member Service: 206-340-1510
Fax: 206-232-3099

Per Don Costa this agreement will not be move forward at this time.

November 24, 1998

Mr. Dennis Julnes, CPA
Chief Financial Analyst, Company Supervision
Office of the Insurance Commissioner
P.O. Box 40259
Olympia, WA 98504-0259

Re: Master License Agreement

Dear Mr. Julnes:

The purpose of this letter is to provide you with a copy of the Master License Agreement (the "License Agreement") that PacifiCare of Washington proposes to enter into with its affiliate, PacifiCare Life and Health Insurance Company ("PLHIC"), effective October 1, 1998. Several weeks ago, you indicated that the OIC would likely not permit PacifiCare of Washington to enter into the License Agreement because it amounted to a franchise fee, which is not permitted under Washington law. Based upon your comments, we reviewed the statutes and regulations applicable to PacifiCare of Washington and could not find a specific prohibition of the relationship created by the proposed License Agreement. Accordingly, we thought it would be helpful to provide you with a copy of the License Agreement so that you could review the specifics of the proposed relationship between PLHIC and PacifiCare of Washington. We believe that the License Agreement is consistent with Washington law and contains adequate protections to ensure the continued solvency of PacifiCare of Washington.

Pursuant to the License Agreement, PLHIC is extending to PacifiCare of Washington a license and right to use the trademarks, service marks and other intellectual property identified in Exhibit A to the License Agreement (the "PacifiCare Intellectual Property") in common with the other PacifiCare-owned licensees. In consideration of this license, PacifiCare of Washington will pay PLHIC a license fee based upon a percentage of PacifiCare of Washington's adjusted gross revenue. PacifiCare of Washington's payment of the license fee is subordinated to the payment of its normal creditors. In addition, payment of the license fee may be deferred to the extent necessary to satisfy applicable regulatory laws or requirements which impose restrictions on PacifiCare of Washington's ability to make such payments.

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The License Agreement is a means for the PacifiCare system to gain greater control and protection over the PacifiCare Intellectual Property. Because of the goodwill associated with the businesses represented by the PacifiCare Intellectual Property, PacifiCare has recognized that any health plan or other operation which utilizes the "PacifiCare" or "Secure Horizons" marks derives a value from such use, even when the licensee is an affiliate. Charging an appropriate license fee for the use of the PacifiCare Intellectual Property both (i) preserves and enhances the value of the property, and (ii) creates a fair mechanism to compensate the PacifiCare system for its use where, in the past, this compensation may have been derived from other service relationships or corporate dividends. The license fee formula has been determined based upon a comparative analysis of what similarly-situated companies are doing in the marketplace and the license fees being charged by PacifiCare's Secure Horizons USA subsidiary under its licensing relationships with third parties.

We are hoping to resolve any questions or concerns you might have regarding the License Agreement so that it may be implemented with an effective date of October 1, 1998. Accordingly, we will be contacting you to schedule a telephone call to discuss your questions and concerns. In the meantime, if you need any additional information, please contact me at 206-230-7111 or Mimi Haley at 206-230-7171.

Very truly yours,

Donald E. Costa, CPA
Chief Financial Officer

Enclosure

cc: Mimi Haley, Director, Regulatory Services
Valerie Blomquist, PacifiCare Life and Health
Peter Mason, Konowiecki & Rank



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