

REPORT ON EXAMINATION
OF THE
PREFERRED ASSURANCE COMPANY, INC.
AS OF
DECEMBER 31, 2000

DATE OF REPORT

MAY 30, 2002

EXAMINER

JOSEPH S. KRUG

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STATE OF NEW YORK
INSURANCE DEPARTMENT
25 BEAVER STREET
NEW YORK, NEW YORK 10004

May 30, 2002

Honorable Gregory V. Serio
Superintendent of Insurance
Albany, New York 12257

Sir:

Pursuant to the provisions of the New York Insurance Law and acting in compliance with the instructions contained in Appointment Number 21727, dated April 10, 2001, annexed hereto, I have made an examination into the financial condition and affairs of Preferred Assurance Company, Inc. at its home office located at 259 Monroe Avenue, Rochester, New York 14607.

Whenever the terms "Plan" or "PAC" appear in this report, they refer to Preferred Assurance Company, Inc.

1. SCOPE OF EXAMINATION

The Plan was previously examined as of December 31, 1994. This examination covered the period from January 1, 1995 through December 31, 2000. Transactions subsequent to the date of examination were reviewed where deemed appropriate by the examiner.

The examination comprised a complete verification of assets and liabilities as of December 31, 2000, a review of income and disbursements deemed necessary to accomplish such verification and utilized, to the extent considered appropriate, work performed by the Plan's independent certified public accountants. A review or audit was also made of the following items:

- History of the Plan
- Management and control
- Corporate records
- Fidelity bonds and other insurance
- Employee relations and welfare
- Territory and plan of operation
- Accounts and records
- Reinsurance
- Growth of the Plan
- Market conduct activities

A review was also made to ascertain what action was taken by the Plan with regard to comments in the prior report on examination. This report on examination is confined to financial statements and comments on those matters that involve departures from laws, regulations or rules, or which are deemed to require explanation or description.

2. DESCRIPTION OF PLAN

Preferred Assurance Company was incorporated under Section 402 of the Not-For-Profit Corporation Law on June 2, 1992. A license to do business within New York State as a non-profit Health Service Corporation pursuant to the provisions of Article 43 of the New York Insurance Law was obtained on August 6, 1992. The Plan commenced the issuance of insurance contracts early in 1993.

The Plan is a membership corporation as defined in the not-for-profit corporation law. Pursuant to Article I of its by-laws the Plan has one member only, which is Preferred Care, Inc.

A. Management

The by-laws of the Plan provide for management to be vested in a Board of Directors to consist of not less than four directors. The exact number of directors shall be determined from time to time by a resolution of a majority of the directors of the Corporation. In the event of a vacancy on the Board of Directors, a new director shall be appointed to fill such vacancy for the balance of the term by a majority vote of the remaining directors.

The by-laws of the Plan provide that directors shall be elected for a term of three years and that the board, by resolution, may stagger the terms of directors so as to provide that the terms of one-third of the directors shall expire each year. Until a system of staggered terms is established, all directors shall serve a term of one year.

During the period under review, directors were elected to one-year terms. No system of staggered terms has yet been established.

It is recommended that the Plan set up a system of staggered terms.

As of December 31, 2000, the board of directors was comprised of seven (7) members as set forth below:

	<u>Name and Residence</u>	<u>Principal Business Affiliation</u>
(a)	<u>Provider Representative</u> (1)	
	Robert Oppenheimer Pittsford, NY	Attorney. Chamberlain, D'Amada, Oppenheimer and Greenfield
(b)	<u>Public Members</u> (3)	
	Rivka Chatman Pittsford, NY	Director, Continental Dental Assistant School
	Michael Copeland Rochester, NY	Manager, Industrial Relations, Alstom Signaling, Inc.
	Anthony J. Costanza Rochester, NY	Retired
(c)	<u>Subscriber Members</u> (2)	
	Julian Gordon Rochester, NY	Retired
	Michael C. Dwyer Rochester, NY	Attorney, Underberg and Kessler
(d)	<u>Officer-Employee</u> (1)	
	John Urban Rochester, NY	President, Rochester Area Health Maintenance Organization, Inc.

The board meets at times as fixed by the board of directors or at special meetings as may be called by the Chairperson or by any two of the board members.

The minutes of all of the Board of Directors' meetings and committees thereof held during the examination period were reviewed. The review indicated that all meetings were well attended.

At December 31, 2000, the non-salaried corporate officer of the Plan was as follows:

<u>Title</u>	<u>Name</u>
Secretary	Robert Oppenheimer

The Plan's principal salaried officers as of December 31, 2000 were as follows:

<u>Title</u>	<u>Name</u>
President	John Urban
Treasurer	Thomas Combs

B. Territory and Plan of Operation

Preferred Assurance Company, Inc. is licensed to do business throughout the state of New York, as a non-profit health service corporation, pursuant to the provisions of Article 43 of the New York Insurance Law. The Plan provides hospital, medical and other health services through indemnity contracts or preferred provider arrangements. Indemnity contracts are issued to small groups and individuals on a community rated basis and to large groups on an experience rated basis. Contracts providing managed care coverage, based on a preferred provider organization (PPO) are offered. Administrative service contracts (ASC), provide indemnity or preferred provider contracts, to certain large self-insured groups who reimburse the Plan for the cost of claims plus administrative charges. However, during the examination period, PAC only provided coverage of hospital, medical and other health services for the out of network component of

Rochester Area Health Maintenance Organization Inc.'s (a sister corporation) point of service product in the Rochester metropolitan area.

The Plan commenced business early in 1993 in both the Rochester and Albany areas. Contracts issued in the Rochester area consist mainly of a point of service indemnity contract that complements the basic benefit package offered by affiliated Rochester Area Health Maintenance Organization (RAHMO). The contract covers health maintenance organization subscribers who elect to seek services outside RAHMO's provider network. Enrollment in the Rochester area is minimal. The major portion of the Plan's business activity was conducted in the Albany area, where it maintained a regional office. However, on December 12, 1994, PAC implemented a plan to discontinue its operations in the Albany area. In accordance with Section 4304(c)(4)(D) of the New York Insurance Law, the Plan notified all of its community rated subscribers in the Albany area, of its intention to withdraw from the Albany market and that contracts would terminate effective May 31, 1995. Experience rated and ASC contract holders were notified that contracts would not be renewed at the expiration date. The last contract in the Albany area expired December 31, 1995. This withdrawal from the Albany area had a significant impact on the Plan's net premiums written as evidenced in the following schedule:

	<u>1995</u>	<u>1996</u>	<u>1997</u>	<u>1998</u>	<u>1999</u>	<u>2000</u>
Net Premiums Written	\$10,433,478	\$741,240	\$256,750	\$38,525	\$123,879	\$114,435

At December 31, 1994, the Plan had 22,215 contracts with 41,859 participants. At December 31, 2000 there were 6,376 contracts with 13,719 participants.

C. Reinsurance

Following is a description of the HMO's ceded reinsurance program in effect at December 31, 2000:

<u>Lines of Business Covered</u>	<u>Type of Cession</u>	<u>Limits</u>
<u>Commercial & Medicare</u>		
Eligible hospital services (authorized reinsurer)	Excess of Loss	<p>90% excess of \$100,000 of loss per member, per contract year if paid at a "Fixed Fee" or at any other hospital located in the State of New York</p> <p>80% excess of \$100,000 of loss per member, per contract year if not paid at a "Fixed Fee" or at any other hospital located outside the State of New York</p> <p>50% excess of \$100,000 of loss per member, per contract year if non-emergency admissions into the following Pennsylvania Hospitals:</p> <ul style="list-style-type: none"> ▪ Presbyterian Medical Center in Pittsburgh, PA ▪ Hospital and Medical Center of University of PA in Philadelphia, PA ▪ Thomas Jefferson Hospital in Philadelphia, PA ▪ Children's Hospital in Philadelphia, PA
Eligible hospital services related to organ and bone marrow transplant or peripheral stem cell transplant(s) for the period of confinement in which the transplant occurs (authorized reinsurer)	Excess of Loss	<p>90% excess of \$100,000 of loss per member, per contract year if paid at an Approved LifeTrac Transplant Rate</p> <p>80% excess of \$100,000 of loss per member, per contract year if paid at an Approved Non-LifeTrac Transplant Rate</p>

<u>Lines of Business Covered</u>	<u>Type of Cession</u>	<u>Limits</u>
<u>Commercial & Medicare</u>		50% excess of \$100,000 of loss per member, per contract year if paid at other than above 50% excess of \$100,000 of loss per member, per contract year if related to retransplantation of same tissue type performed within one year of the date of the initial transplant
Emergency Out of Area Services (authorized reinsurer)	Excess of Loss	80% excess of \$100,000 of loss per member, per contract year

The maximum lifetime reinsurance indemnity payable under this agreement for eligible hospital services for each member is \$2,000,000. The monthly premium for the above reinsurance coverage is \$0.74 per commercial member and \$1.60 per Medicare member.

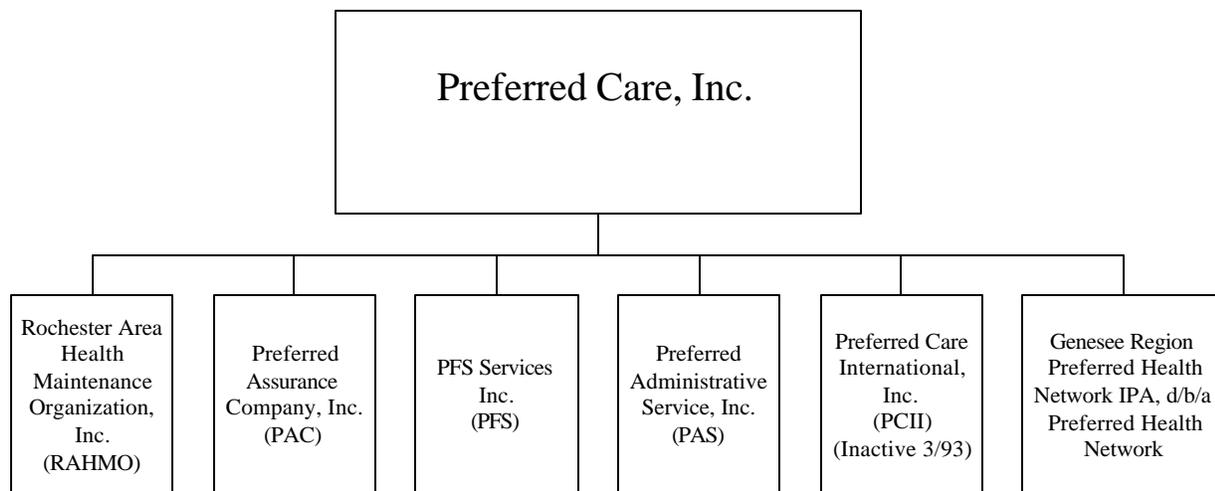
The reinsurer will continue Plan Benefits for Members from the date of Plan Insolvency through the contract period after Plan insolvency for which premium had been paid to the Plan, but for not more than 60 days, if such premium is paid prior to the date of Plan insolvency.

D. Holding Company System

Preferred Assurance Company of New York is controlled by its sole member, Preferred Care, Inc. and, accordingly, is subject to the holding company requirements of Article 15 of the New York Insurance Law. The holding company reports annually to the Superintendent on behalf of PAC and the entire holding company system.

The holding company is a corporation as defined in subparagraph (a)(5) of Section 402 of the Not-for-Profit Corporation Law. The holding company does not conduct any revenue-producing business, generates no funds and has no employees of its own. Its function is to provide common control to its wholly owned subsidiaries.

Preferred Care, Inc, a corporation formed under Section 402 of the Not-For-Profit Corporation Law as a holding company, provides common control to its wholly owned subsidiaries. The following chart depicts the Plan and its relationship to affiliates, as of December 31, 2000:



As indicated in the organizational chart, the holding company controls PAC plus the following entities described below:

Rochester Area Health Maintenance Organization, Inc. conducts business in nine counties. It is a health maintenance organization on the individual practice association model. With approximately 163,923 members this health maintenance organization has been in business since 1979.

Preferred Financial Services, Inc. (PFS) is a for profit corporation which operates as an insurance agency/broker. PFS offers life, disability and 401K administrative services to groups and individuals.

Preferred Administrative Services, Inc. (PAS) is a for profit corporation which provides management and information services related to health services to outside parties. PAS also provides administrative claims services as a third party administrator to groups.

Preferred Care International, Inc. (PCI) is a for profit corporation which was established in order to develop a Canadian subsidiary, Preferred Care, Inc. of Canada (Soins Privileges). Preferred Care Inc. of Canada was established to provide consulting and management services to Canadian managed care organizations. In 1993, Preferred Care, Inc. of Canada ceased operations. Since 1993, Preferred Care International, Inc. has remained dormant.

E. Administrative Services Agreement

In February of 1998 the Plan executed an Administrative Services Agreement with its affiliate, RAHMO. According to this agreement, various services are provided to the Plan by RAHMO including but not limited to the following:

- a) financial systems and services
- b) claims administration
- c) information services
- d) provider and member services and relations
- e) medical policies, utilization review and quality assurance
- f) underwriting services
- g) contracts for services
- h) purchase and leases
- i) reports to Board
- j) licensing
- k) marketing

This agreement was submitted to the Insurance Department and was approved.

F. Accounts and records

A review of the Plan's accounts and records revealed the following reporting inaccuracies in its filed statements to the Insurance Department:

1. Exhibit 2 – Reconciliation of Ledger Assets the Balance of ledger assets December 31 of current year did not agree to the Ledger Assets reported on the Assets page of the Balance Sheet.

2. Part 3 – Analysis of Expenses of the Underwriting and Investment Exhibit contained errors in both the total of General Expenses unpaid December 31, prior year and General Expenses paid during year.

It is recommended that the Plan exercise greater care in the preparation of its annual statement.

At December 31, 2000, PAC had Section 1307 loans outstanding that totaled \$7,998,461 from RAHMO.

Section 1307(c) of the New York Insurance Law requires a footnote, in all filed statements, showing the unpaid amounts. The Plan failed to show the required footnote any of its filed Annual or Quarterly Statements during the period under examination.

It is recommended that the HMO comply with Section 1307(c) of the New York Insurance Law which requires a footnote, in all filed statements, showing the unpaid amounts.

G. Disaster Recovery

It was noted that, at December 31, 2000, the Plan did not maintain a disaster recovery plan. A disaster recovery plan is essential to the maintenance of continuity of services to the Plan's subscribers in the event of a disaster.

It is recommended that the HMO develop and maintain a disaster recovery plan.

3. FINANCIAL STATEMENTS

A. Balance Sheet

The following shows the Plan's assets, liabilities and total reserves and unassigned funds as determined by this examination as of December 31, 2000, and as reported by the Plan.

Assets	EXAMINATION				PLAN	Surplus Increase (Decrease)
	Ledger Assets	Non-Ledger Assets	Assets Not Admitted	Net Admitted Assets	Admitted Assets	
Cash and short-term investments	315,276			315,276	315,276	
Interest and other investment income due and accrued	1,194			1,194	1,194	
Receivable from parent, subsidiaries and affiliates	<u>117,365</u>	<u>0</u>	<u>113,719</u>	<u>3,646</u>	<u>117,365</u>	<u>(113,719)</u>
Total Assets	<u>\$433,835</u>	<u>\$0</u>	<u>\$113,719</u>	<u>\$320,116</u>	<u>\$433,835</u>	<u>\$(113,719)</u>
 <u>Liabilities</u>						
Claims unpaid				\$ 15,465	\$ 15,465	\$ 0
Unpaid claims adjustment expenses				4,714	4,714	
Salary and trade accounts payable				<u>5,513</u>	<u>5,513</u>	
Total Liabilities				\$ 25,712	\$ 25,712	0
 <u>Reserves and Other Funds</u>						
Section 1307 loan				\$7,998,461	\$7,998,461	
Statutory reserves				14,304	14,304	
Unassigned funds				<u>(7,718,361)</u>	<u>(7,604,642)</u>	<u>\$ (113,719)</u>
Total reserves and unassigned funds				\$ 294,404	\$ 408,123	\$ (113,719)
Total liabilities, reserves and other funds				<u>\$ 320,116</u>	<u>\$ 433,834</u>	

Note 1: No liability appears in the examination balance sheet relative to a loan in the amount of \$7,998,461 and interest thereon in the amount of \$2,583,288. The loan was granted pursuant to the provisions of Section 1307 of the New York Insurance Law. As provided in Section 1307, repayment of principal and interest shall only be made out of free and divisible surplus, subject to the prior approval of the Superintendent of Insurance of the State of New York.

Note 2: The Internal Revenue Service has not made any audits the Plan. The examiner is unaware of any potential exposure of the Plan to any tax assessment and no liability has been established herein relative to any contingency.

B. Statement of Revenues and Expenses

Net worth increased \$966,948 during the period under examination, January 1, 1995 through December 31, 2000, detailed as follows:

Revenues

Premiums earned	\$11,563,010	
Interest income	<u>232,517</u>	
Total revenues		\$11,795,527

Expenses

Losses incurred	\$10,144,249	
Loss expenses incurred	1,036,367	
Other underwriting expenses incurred	<u>2,271,161</u>	
Total expenses		\$13,451,777
Net income (loss) from operations		<u>\$(1,656,250)</u>

C. Reserves and unassigned funds

Reserves and unassigned funds per report on examination as of December 31, 1994 \$ (558,825)

	Gains in Reserves and <u>Unassigned Funds</u>	Losses in Reserves and Unassigned Funds	
Net loss from operations		\$(1,656,250)	
Change in non-admitted assets	1,759,479		
Section 1307 loan	<u>750,000</u>		
Total gains and losses	2,509,479	(1,656,250)	
Net increase in reserves and unassigned funds for the period			<u>853,229</u>
Reserves and unassigned funds per report on examination as of December 31, 2000			<u>\$ 294,404</u>

4. RECEIVABLE FROM PARENT, SUBSIDIARIES AND AFFILIATES

The examination admitted asset of \$3,646 is \$113,719 less than the \$117,365 reported by the Plan as of December 31, 2000

A review of the Plan's records and billings, plus an analysis of the various outstanding premium accounts determined the decrease. The Plan had a receivable from RAHMO at December 31, 2000 for \$113,719 that still was not paid in April of 2002. Amounts due from affiliates are to be received within 90 days in order to be admitted assets.

5. MARKET CONDUCT ACTIVITIES

In the course of this examination, a review was made of the manner in which the Plan conducts its business practices and fulfills its contractual obligations to subscribers and claimants. The review was general in nature and is not to be construed to encompass the more precise scope of a market conduct examination.

The general review was directed at practices of the Plan in the following major areas:

- A) Sales and advertising
- B) Underwriting and rating
- C) Treatment of policyholders and claimants

No problem areas were encountered during the review.

6. COMPLIANCE WITH PRIOR REPORT ON EXAMINATION

The prior report on examination included twenty-one recommendations detailed as follows (page number refers to the prior report on examination):

<u>ITEM</u>	<u>PAGE NO.</u>
<p>A. <u>Number of Directors</u></p> <p>It is recommended that the Plan abide by its by-laws and set the exact number of directors by resolution.</p> <p>The HMO has complied with this recommendation.</p>	<p>4</p>
<p>B <u>Executive Committee</u></p> <p>It is recommended that the Executive Committee hold meetings in order to discharge its responsibilities as set forth in the Plan's by-laws.</p> <p>The HMO has complied with this recommendation.</p>	<p>5-6</p>
<p>C. <u>Election of Officers</u></p> <p>It is recommended that the Plan abide by its by-laws in the election of officers.</p> <p>The HMO has complied with this recommendation.</p>	<p>6</p>
<p>D. <u>Holding Company System</u></p> <p>It is recommended that the Plan obtain the approvals required by Section 1505 before entering into any transaction with a member of its holding company system.</p> <p>The HMO has complied with this recommendation.</p>	<p>12</p>

<u>ITEM</u>	<u>PAGE NO.</u>
E. <u>Administrative Services Agreement</u>	
It is recommended that the Plan comply with the provisions of its administrative services agreement or amend the agreement in accordance with section 7.17 of said agreement.	11
The HMO has complied with this recommendation.	
F. <u>Section 1307 Loans</u>	
It is recommended that the Plan obtain prior approval, as required by Section 1307(d), for any future Section 1307 loans it may need.	13
The HMO has complied with this recommendation.	
G. <u>Fidelity Bond</u>	
It is recommended that PAC obtain fidelity bond coverage on its employees.	14-15
The HMO has complied with this recommendation.	
H. <u>Abandoned Property</u>	
It is recommended that the Plan comply with the reporting requirements of Section 1316 of the New York State Abandoned Property Law.	15
The HMO has complied with this recommendation.	
I. <u>Accounts and Records</u>	
It is recommended that the Plan comply with the provisions of Section 4310(a) of the New York Insurance Law and the Annual Statement instructions and exercise greater care in the preparation of its future filed financial statements.	15-16
The HMO has not complied with this recommendation. A similar comment is repeated in this report.	

<u>ITEM</u>	<u>PAGE NO.</u>
J. <u>Allocation of Expenses</u>	
It is recommended that the Plan abide by the requirements of Regulation 30 in allocating and reporting its operating expenses.	17
The HMO has complied with this recommendation.	
K. <u>Approval of Investments</u>	
It is recommended that the Board of Directors review and approve investments as required by Section 1411(a).	18
The HMO has complied with this recommendation.	
L. <u>Excess Investments</u>	
It is recommended that the Plan closely monitor its investment activity in order to maintain compliance with the applicable sections of Article 14 of the New York Insurance Law.	25
The HMO has complied with this recommendation.	
M. <u>Reinsurance Recoverable on Paid Losses</u>	
It is recommended that the Plan include in its asset "Reinsurance recoverable on paid losses", all funds due from its reinsurer and if necessary set up a liability for the portion that is payable to ASC groups.	27
The HMO has complied with this recommendation.	
N. <u>Unpaid Claims Adjustment Expense</u>	
It is recommended that the Plan, provide the proper required statutory reserve for claims adjustment expense in its future filed statements.	29
The HMO has complied with this recommendation.	

ITEMPAGE NO.O. Salary and Trade Accounts Payable

It is recommended that the Plan properly classify its liabilities in future statement filings.

30

The HMO has complied with this recommendation.

P. Claims Settlement Practices

It is recommended that the Plan institute procedures to correct the inadequacies of its claims processing system and to set up procedures to detect fraudulent claims.

32

The HMO has complied with this recommendation.

7. SUMMARY OF COMMENTS AND RECOMMENDATIONS

<u>ITEM</u>	<u>PAGE NO.</u>
<p>A. <u>Board of Directors</u></p> <p>It is recommended that the Plan set up a system of staggered terms</p>	<p>4</p>
<p>B. <u>Accounts and records</u></p> <p>1. It is recommended that the Plan exercise greater care in the preparation of its annual statement.</p> <p>2. It is recommended that the HMO comply with Section 1307(c) of the New York Insurance Law which requires a footnote, in all filed statements, showing the unpaid amounts</p>	<p>12</p> <p>12</p>
<p>C. <u>Disaster recovery</u></p> <p>It is recommended that the Plan develop and maintain a disaster recovery plan.</p>	<p>12</p>

Respectfully submitted,

Joseph S. Krug
Associate Insurance Examiner

STATE OF NEW YORK)
)SS.
)
COUNTY OF NEW YORK)

JOSEPH S. KRUG, being duly sworn, deposes and says that the foregoing report submitted by him is true to the best of his knowledge and belief.

Joseph S. Krug

Subscribed and sworn to before me
this day of 2002.

Appointment No. 21727

STATE OF NEW YORK ^{RR}
INSURANCE DEPARTMENT

I, GREGORY SERIO, Acting Superintendent of Insurance of the State of New York,
pursuant to the provisions of the Insurance Law, do hereby appoint:

Joseph Krug

as a proper person to examine into the affairs of the

PREFERRED ASSURANCE COMPANY

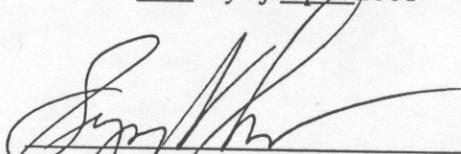
and to make a report to me in writing of the said

Company

with such information as he shall deem requisite.

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

this 10th day of April 2001


(by) Gregory Serio
Acting Superintendent

