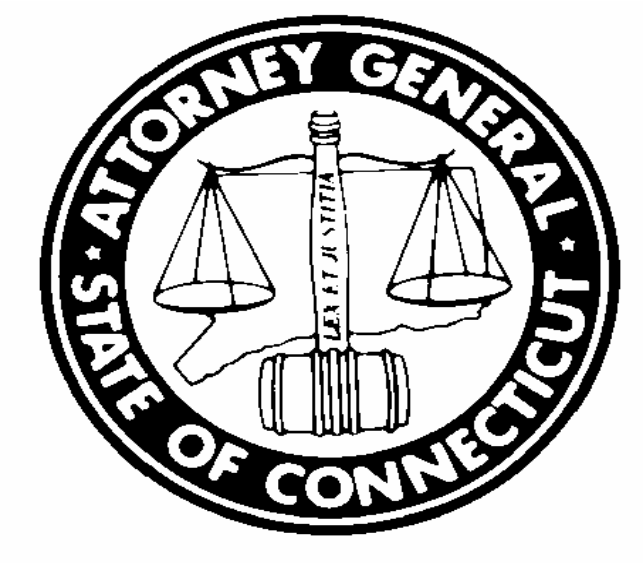

REPORT OF THE OFFICE OF THE

ATTORNEY GENERAL ON THE INVESTIGATION CONDUCTED PURSUANT TO SECTION 4-61dd OF THE CONNECTICUT GENERAL STATUTES

LOSS PORTFOLIO ARRANGEMENT

January 31, 2008

EXECUTIVE SUMMARY

This report by the Office of the Attorney General summarizes an intensive investigation of a complaint filed pursuant to Connecticut's Whistleblower Statute regarding the Department of Administrative Services' ("DAS") Loss Portfolio Arrangement ("LPA") with ACE Financial Solutions ("ACE"). In 2001, DAS was deeply concerned about rising costs relating to its self-insured workers' compensation program for the State's own injured workers and lack of any money to settle cases itself. As a result, it entered into an LPA contract funded primarily with bond money that paid ACE $80 million to assume the financial liability for 660 of the State's workers' compensation files. The DAS decision to initiate an LPA was based on highly questionable advice from the DAS consultant, MRM Consulting, Inc. ("MRM"), hired by DAS without competitive bidding.

Relying on assumptions from its consultant, DAS envisioned a lump sum payment of an $80 million premium to ACE in exchange for turning over to ACE up to $150 million in potential liability from 660 existing Workers Compensation claims. Additionally, by reducing the Workers Compensation claims handled by the State, it was projected that the Workers Compensation budget would be reduced by $13.5 million in both 2002 and 2003.

Privatizing the cases enabled off-budget financing --supporting a perception of immediate gains at long term cost.

After an intensive and thorough examination of thousands of documents and testimony of more than a dozen key witnesses, we conclude that there is serious and significant reason to doubt that the State received fair value for its $80 million payment. If it did, it would be by coincidence rather than appropriate fiscal planning and calculation. There is also strong reason to question whether the State received even the short-term budgetary savings it projected.

The evidence developed by this investigation demonstrates numerous critical mistakes by DAS and highly questionable advice from MRM relating to the premium paid by the state and the value of the claims transferred to ACE. In fact, at the time the LPA was agreed upon, the State apparently had little or no reliable data on whether the State would receive any benefit from the transaction.

Among the findings in this report are the following:

- By 1999, Workers Compensation costs were rapidly increasing and DAS was ordered by OPM to keep those costs under control.
- In seeking advice on how to reduce its Workers Compensation costs, DAS hired MRM Consulting without competitively bidding for a consultant, thereby missing the opportunity to obtain a consultant with more experience and expertise in evaluating the use, design and pricing for an LPA.
- On the advice of MRM, DAS decided to utilize an LPA to reduce its Workers Compensation costs. Although the LPA required the immediate payment of $80 million to a private company willing to assume the state's liability in specific Workers Compensation claims, it provided no guarantee of finality to the State because the State was responsible for each claim that exceeded $1.5 million. While an LPA has significant economic advantages for a private company, the benefits to a public entity are fewer and far less certain. See Appendix I.
- DAS was advised to create an LPA by MRM, a company with little experience in LPAs.
- MRM's analysis and advice to DAS was seriously flawed.

- The LPA was structured around claims not claimants, thereby allowing multiple claims by an individual to remain with the State even if one of the individual's claims went to the LPA. Everyone, including MRM, agrees that this egregious, misstep should never have happened. Well established and long-standing experience teaches that Workers Compensation cases are most economically resolved when all of an individual's claims are settled at the same time.
- The number and the specific claims included in the LPA continually changed. MRM originally selected 726 claims to be included for the $80 million premium. However, hundreds of the claims included were actually closed or of no value and hence were removed from the LPA. As a result DAS had to add several hundred claims of a different type to the LPA at the last minute without appropriate analysis or consideration.
- Major last minute deletions and additions reduced from 726 to 660 the number of cases being transferred by the state in the LPA, but no adjustment was made to lower the premium price to account for the lower number of claims being transferred. The premium remained at $80 million.
- Essential to appropriately pricing an LPA is estimating as accurately as possible the reserves on the cases to be assumed. "Reserves" are the estimated total liabilities for future benefit payments anticipated to be incurred over the course of the claim. The State's determination of the appropriate reserves to be included in determining the premium to pay for the LPA was marred by inaccurate, inept estimates -- the result in part, of MRM's use of college students who were friends of the son of the owner of MRM to do the underlying fact-finding work. While

the owner of MRM claimed that what they were doing was not "rocket science," people knowledgeable about LPA's were unanimous in their view that developing the appropriate reserves for use in determining the pricing of an LPA should only be done by personnel with extensive experience in calculating appropriate reserves for claims.

- DAS expressed no concern with the lack of qualifications or experience of the college students used by MRM. Instead, DAS was concerned with the identification in MRM's billing statements showing that it was charging $105 per hour for "interns". Rather than instructing MRM to hire experienced professionals, DAS instructed MRM to refer to them in their invoices as "junior staff."
- The formula MRM used in determining the actual pricing of the LPA assumed that the LPA holder would be required to continue paying for 40 years or more on the claims included in the LPA. No assumptions based on settlement of these claims were developed. As a result, the State paid a premium that was substantially higher than it could have been because MRM's formula assumed many more years of payouts than actually occurred.
- Thus, MRM projected that it would take 40 plus years for the LPA holder to settle 600 of the 662 claims. In reality, according to one of ACE's documents, 160 of the cases were closed immediately after the LPA started. While the cases theoretically can reopen, testimony was presented indicating that MRM was erroneous in ascribing a high value to the liability of those cases.

- Within three years after the start of the LPA, 545 of the original 660 claims were settled or closed rather than the 40 plus years of payouts MRM had assumed.
- There is no way to know at this time how much the remaining claims will cost ACE, and how much ACE will profit from this deal. ACE retains all that may be left from the $80 million premium after all the claims are closed, but also had full investment use of the $80 million -- collecting additional revenue from the investment proceeds from the first day of the LPA.
- The whole LPA arrangement was compromised by DAS' lack of scrutiny and oversight, cooperation or collaboration with agencies such as the Insurance Department or the Office of the Attorney General that might have improved the process and the result. Neither were consulted.
- Although staff from the Legislative Office of Fiscal Analysis reviewed the proposed loan portfolio arrangement and raised significant questions about its possibly providing the estimated savings, the decision was made to place the funding in the Bond Act, meaning that the Appropriations Committee, which reviews agency budgets, had no opportunity to examine the details of the proposal.
- A plausible conclusion is that the State saved no money from the LPA. The predicted short term budget savings, if they occurred, were likely more than off set by rising medical costs and other factors. The long term savings, if any, could have been achieved by the state itself, probably at lower cost.
- Misguided decisions and missteps led to inaccurate and incomplete information used by state officials in creating the LPA.

Recommendations

1. The State should study and consider establishing a possible separate "settlement fund" and develop an organized and systematic program to settle Workers' Compensation cases "in-house." The evaluation should focus on whether a properly managed settlement program could save the State significant amounts of money in administering its Workers Compensation system without using financing vehicles like LPAs.

2. The provisions of Public Act No. 07-01 Sept. Spec. Sess. which we advocated and the Legislature passed, needs to be carefully monitored to ensure that its terms are complied with and to see whether further legislation is necessary. It can help assure appropriate limits to the use of "privatization" through the §16 cost benefit analysis.

3. The State should consider whether and how MRM can be held accountable for its highly troubling performance. By following their faulty reserve numbers and premium pricing, the State proceeded with a project of highly suspect and challengeable value and appears to have overpaid for the LPA, although the ultimate outcome cannot be known with certainty.

Report

1. Worker's Compensation Costs Were Escalating Through The 1990's

The Department of Administrative Services ("DAS") of the State of Connecticut, which had always maintained a self-insured workers' compensation program for the State's injured workers, entered into a loss portfolio arrangement with ACE Financial Solutions ("ACE") to sell off 660 worker's compensation claims. These claims represented liability to the state, according to DAS's consultant on the project, MRM Consulting Inc. ("MRM"), anywhere from $127 -

$150 million (a figure later amended by MRM to be approximately $195 million). The State of Connecticut relied on MRM in the claim selection and pricing of the loss portfolio arrangement ("LPA") and Marsh & McLennan Companies ("Marsh") on the brokerage of this arrangement. MRM determined the LPA could be sold to an insurance company for $80 million, and Marsh brought the insurance company ACE Financial Solutions to DAS. DAS and ACE Financial Solutions thereafter negotiated a deal for $80 million.

During the 1990's, the State's workers' compensation program was comprised of large agency programs of the six biggest agencies with oversight by DAS and smaller agency programs being fully administered by DAS. The program experienced increasing costs over the decade. Berkley Administrators of CT, Inc. ("Berkley") was the third party administrator for the program beginning in 1997.

OPM issued a memorandum November 16, 1999 highlighting the need to stop the escalating costs. The Commissioner of DAS, Barbara Waters, testified that she had proposed to OPM that funds be made available for in-house settlements to control costs in workers' compensation, but her requests were denied and costs continued to rise. Former Commissioner Waters was further embarrassed in December, 1999 when she presented medical expenditure data to the legislature which was underestimated by Berkley. From the end of 1999 onward, DAS was looking for quick answers to the problems which had taken years to develop. The Attorney General's Office, which routinely litigated and settled workers' compensation cases for DAS and had made recommendations regarding methods to curtail costs, including a separate pool of money for settlements, was never consulted.

Jeffrey Drake at Berkley testified that the state had led Berkley to believe that the 1997 third party administrator (TPA) contract that it bid for initially was for 2,500 workers

compensation cases. After being awarded the contract, Berkley felt it was significantly underpaid because they found the actual number of open files to be 4000 plus. As a result, the case loads of the adjusters were very heavy at about 250 cases per adjuster. Berkley's staff had to prioritize claim payment rather than reserve setting which only further exacerbated the reserves issue. Reserving came up in adjuster reviews and the situation slowly improved, particularly with new cases. Generally, "reserves" are estimated total liabilities for future benefit payments anticipated to be incurred over the course of the claim. According to the experts, this number is calculated using historical loss emergence patterns as predictive of future developments. Mr. Drake made it clear, however, that reserving is a very complex issue involving detailed professional knowledge of medical histories, lost time analysis, permanency, pre-existing conditions and recovery times and future exposure. Mr. Drake explained that reserve setting was a task requiring years, if not decades of experience, a fact confirmed by Joanne Wood at ACE.

Settlement was a very important issue for Berkley and the state because the state had a moratorium on settlements in effect through significant portions of the contract. Commissioner Waters was responsible for the freezes on settlements, she says because of budgetary considerations. We received conflicting testimony as to the exact dates of each moratorium. Mr. Barletta, in charge of the workers compensation program at DAS, acknowledged settlement was an essential aspect of properly handling claims and reducing overall liability. Mr. Barletta indicated that settlements were usually 50¢ on the $1.00 and reflected a discount to net present value. Mr. Drake felt that while some cases could be settled for as low as 35 – 45% of present value, other very severe cases might settle for as high as 65%. Because of the importance of settlement, Drake was aware that there was serious discussion about setting aside sums for a

settlement budget, since the system in place at that time allowed settlements (if a moratorium was not in place) only when money was left over in the budget after payment on all open claims was satisfied. Mr. Drake met with Alan Mazzola and Commissioner Barbara Waters several times on the issue of creating a settlement budget, and Berkley developed a list of cases which would be able to be settled at significant savings to the state. This plan was not, however, put into place.

Mr. Drake testified that without a loss control program and with each agency determining its own use of budgets, and with no tools to settle claims and high reoccurrence rates, the state's costs were bound to increase, which they did. Rather than attempt to address these issues with implementation of a settlement program or proper loss control program, the state, in Mr. Drake's view, panicked at the end of 1999 because of increased medical expenditures. Drake claimed the increased medical costs were falsely inflated due to payment of old medical claims, but the Commissioner, according to Mr. Drake, was very distressed when Berkley missed the forecast for expenditures during budget time at the Legislature. Although an apology and explanation were given to the Commissioner on December 15, 1999, in Mr. Drake's view, the state saw a crisis.

2. The State Hired MRM To Study The Worker's Compensation System

In response to the mounting concerns, DAS executed an amendment in December 1999 to an existing Personal Service Agreement ("PSA") with consultant MRM to extend the scope of services in that contract to include researching and gathering information on the worker's compensation program's safety and loss control and prevention initiatives, to identify the factors for rising worker's compensation costs, and to devise and implement a plan to control such costs.

In January 1999, DAS had signed the first original PSA with MRM for consulting related to the use of Owner Controlled Insurance Programs ("OCIP's") for State owned construction projects. In November 1999, DAS and MRM signed a second PSA to implement an OCIP for Adriaen's Landing. Subsequently, former Commissioner Waters approved amending the MRM contract to include the LPA because, she indicated, all the work related to workers' compensation. OCIP's, however, are highly specialized insurance programs totally unrelated to LPA's. In an OCIP, the owner of a construction project retains total control of the workers' compensation piece, while in an LPA the liability is sold off to a third party. By amending the existing contract with MRM to include an evaluation of the worker's compensation program and exploration of possible solutions such as an LPA, DAS chose not to use competitive bidding thereby losing the opportunity to evaluate the experience and expertise of other entities to advise the State on the complex issue of how the State could best control rising costs in workers' compensation.

The December amendment with MRM adding the new workers' compensation consulting services stipulated that costs not exceed $18,000 and that the total contract not exceed $48,000. In April and May, 2000, MRM studied the feasibility of utilizing a loss portfolio arrangement as a means to contain workers' compensation costs.

From 1999 to 2001, the contract between DAS and MRM was amended six times. The scope of MRM's services continued to expand under the terms of the amendments. MRM's duties under the second amendment were to research and collect information on the worker's compensation program's loss control and prevention initiatives, present the findings to the Commissioner, and to identify factors for rising claims and devise and implement a plan to control such costs. The LPA was the only plan ever presented to DAS, and there is no evidence that any alternative other than an LPA was seriously considered at that time. Under the terms of

an additional amendment in May 2001, MRM's duties were expanded to include assisting DAS in the administration of the worker's compensation plan. By the last contract amendment, the contract had grown to $702,000, the majority of which was related to the LPA.

3. MRM Had Little Or No Experience in Developing LPA'S

MRM Consulting was established by Adrien Theriault. According to Mr. Theriault, MRM specializes in helping organizations evaluate, develop, and implement owner-controlled insurance programs ("OCIPs"), also called "wrap-ups." MRM's major clients have included the states of Connecticut, Rhode Island, New Jersey, Texas, and Florida as well as the New York City Department of Environmental Protection, the Narragansett Bay Commission, the Houston Rockets, and the cities of Bridgeport, New Haven, and Raleigh. With respect to loss portfolio arrangements, MRM had little experience. MRM claimed to have worked with the cities of New Haven, Bridgeport, and Darien. However, Mr. Theriault indicated that the "dynamics" of the workers' compensation portfolios in Darien and Bridgeport "did not come together."

Mr. Theriault is founder and president of the company. He received a Bachelor of Arts in Economics at Catholic University. He began his career at Marsh McLennan as an associate consultant for three or four years and was trained in employee benefits at the College of Insurance during that time. According to Adrien Theriault, Marsh is so large that it is not uncommon that people in the insurance business have spent time working for Marsh, and, in fact, most of his employees worked for Marsh at one time. Mr. Theriault then worked at Price Waterhouse as an independent consultant, specializing in life, medical, disability and workers' compensation. His experience before establishing MRM also included working at the firms of Touche Ross, Mercer, and Alexander Services, Inc.

In connection with the OCIP work he was doing, Adrien Theriault was introduced to Commissioner Barbara Waters at DAS. Soon thereafter MRM obtained a contract with DAS to work on an OCIP for state construction projects. Commissioner Waters subsequently asked MRM to look into the overall management structure of the workers' compensation system, TPA issues, and finally an LPA for the state. The latter three areas of work were undertaken as an amendment to the original contract MRM had with the state related to OCIP's.

MRM's initial evaluation of the state's workers compensation program found that the state's system was actually four multiple systems including the payroll and pension system, none of which communicated with each other. Adrien Theriault found there was no cooperation or communication between the agencies and DAS. The program was in a vulnerable state.

In addition to internal problems within the State and at DAS, MRM reported significant problems with TPA Berkley. Berkley was severely understaffed for the Connecticut project according to Mr. Theriault. Each adjuster had a double case load, and according to Adrien Theriault, Berkley was paying out on claims which were located in unopened boxes never examined by Berkley. MRM found Berkley's procedures grossly lacking and the overall allegedly appalling state of the files left MRM, according to Mr. Theriault, severely curtailed in its LPA work later, yet never caused it to question going forward with the project.

MRM issued several draft reports in relation to its initial analysis of the workers' compensation system. The reports were always in draft form because Adrien Theriault alleges that he was told in no uncertain terms that they were to be submitted in draft form only so they would not be made part of the public record while under discussion. Adrien Theriault thought they had submitted finals of the reports, but none were produced by DAS or MRM.

To better manage the state's Workers Compensation program, MRM recommended that either Berkley be assisted in processing the claims they had or that the number of files be reduced that Berkley would handle. Under this latter idea, the concept of an LPA, allegedly presented as a viable alternative if the factors were right, became the immediate focus. The LPA plan was in fact the only alternative ever presented to DAS by MRM according to all the DAS witnesses interviewed.

Joe Prevuznak appeared to Mr. Theriault to resist the idea of an LPA, believing the state could settle cases itself. Commissioner Waters wanted to make changes to the workers' compensation program to make it more cost effective. Although she would have preferred to obtain funds to do in-house settlements, she was convinced that money would be saved by doing the LPA and that in fact the LPA would be a "slam dunk" for the State.

Mr. Alan Mazzola, Deputy Commissioner at DAS, handled the procurement and negotiations phases of the LPA project, according to Mr. Theriault, but was not part of the initial group working with MRM. Attorney James Neil, counsel for DAS, was the point person for MRM for contract issues and advised the Commissioner. Mr. Theriault indicated that when they had billed out for almost the entire amendment amount they would be in contact with Mr. Neil who would see to it that another amendment was secured. In all, these amendments totaled over $700,000.

4. MRM'S Work On The LPA Was Seriously Flawed

Adrien Theriault described MRM as "one of a kind." For all their claimed uniqueness, MRM had no real expertise in LPA's. They only helped with one municipal LPA which went forward, New Haven. That LPA was no where near the magnitude of Connecticut's project. MRM never did another LPA after Connecticut and indicated they are out of the business

altogether of LPA's. Regardless of their lack of expertise, they were paid up to $702,000 for their services under the multiple contractual amendments.

Perhaps not surprisingly given their lack of experience in LPA, MRM had a very simplistic concept of the LPA line of business. For the hundreds of thousands of dollars paid to them, MRM saw the LPA as a simple matter involving only the correct mix of cases and good pricing in terms of the cost of tax free bonds. Mr. Theriault was under the impression that the state could not use bond monies itself but that those monies could only be paid to a third party. He did not know much about bonds and also had no understanding as to why or how the $80 million got off budget. He described himself as not being a person familiar with bonding issues and not up to date on accounting, two areas which might have been very useful, particularly since the LPA was to be funded in large part through state issued bonds.

Mr. Theriault's focus seemed to be to make the LPA as attractive as possible to the insurance company who stood to profit from the deal. The LPA placed a $150 million overall cap on liability for the insurer and a cap was placed on individual claims. Additionally, the LPA was designed to include only certain claimant groups such as widows which were very attractive to insurance companies because the only risk on that group was life expectancy. He included claimant groups that would be considered attractive to an insurance company rather than push for inclusion of the most serious cases. Curiously, Adrien Theriault got a significant amount of his information from the insurance companies who stood to profit from the deal. In terms of research, he suggested there were probably articles on the subject of LPA's but knew of none he relied upon.

Mr. Jeffrey Drake of Berkley noted that after the state started working with MRM on the LPA, individuals from MRM began coming on site at Berkley. Mr. Drake found that MRM staff

had many basic questions and were not familiar with the enhanced benefits of state workers. According to Mr. Drake, MRM staff appeared to have little expertise in LPA's or reserving to Drake's observances, and numerous puzzling issues began to arise. First, MRM began to use numerous college interns to compile data. During this time frame, Drake found he was spending a tremendous amount of time answering questions and explaining specific information in files and explaining what was meant by different terms. Further, once claims were chosen to be part of the LPA, Drake noticed many claims had zero reserves, meaning the cases had little or no value. He also saw that the LPA was being constructed by specific injury dates rather than by claimant with all dates of injury included. He brought this latter fact to the attention of DAS officials including Joe Prevuznak, but nothing was done to change this serious oversight. Up until that time, in Drake's experience, all claims of a person would be settled together, but with the LPA as designed by MRM, the state would still be stuck for all claims of a given individual except the one transferred to the LPA. When asked specifically about this, Adrien Theriault indicated that all claims were included for an individual, but this was simply not the case.

Mr. Drake indicated DAS had every opportunity to see that many claims being chosen for the LPA had zero reserves and/or were in fact closed because that information was located in the electronic files to which the state had access. MRM was apparently given the entire responsibility for selecting and valuing the claims. Mr. Drake at Berkley claimed his company was never given an opportunity to formally comment on any of MRM's work, and the state appeared to be relying on MRM for all aspects of the LPA. The only exception in Mr. Drake's view came when Joe Prevuznak got involved and added an extra 200 claims to the LPA. Although Drake thought that in theory the LPA could be useful in lowering the state's claim exposure, he noted that 660 claims out of more than 4000 was not that many to take off the

books. He could not comment therefore whether the deal made any sense financially, but he noted that the state could have done what ACE was doing, namely settling many of the cases for much less than the reserves on the cases.

After the LPA, Berkley was hired by ACE as its third party administrator. According to Mr. Drake, Berkley and ACE agreed upon a set fee for Berkley's services of approximately $40,000 per month. However, that fee was based on 500 claims rather than the 660 cases in the contract between the State and ACE because, according to Mr. Drake and the relevant documents, 160 of the LPA cases were closed claims when Berkley took over the LPA TPA contract. Berkley worked on the remaining 500 claims with no complaints from ACE and, Mr. Drake explained, just the general goal of settling claims. They attempted to beat the number of claims they settled from the month before. According to Joanne Wood of ACE, ACE actually had specific and aggressive goals regarding settlement.

Mr. Drake was surprised that the LPA claims did not include all open cases of a given claimant. Having multiple injuries is not unusual, and up until that point a settlement would include all prior claims of a person along with the primary claim being settled. Mr. Drake was very surprised that the state would enter into a deal whereby certain claims of a person would remain with the state (with GAB Robbins as the TPA) while one or more claims went to ACE. In fact, there is evidence from DAS that this has led to confusion and expense. Drake and DAS witnesses have indicated that there have been numerous instances where a representative of both Berkley for ACE and GAB for the State must attend the same workers' compensation matter because the claimant has one claim in the LPA and multiple claims left with the State. Douglas Rinaldi, the current head of the workers' compensation program, also claimed that he attempted to contact Mr. Theriault at MRM to ask whether a specific claim was intended by MRM to be

included or not in the LPA after ACE denied the claim on the basis that it was not included in the LPA.

Similarly puzzling to Mr. Drake was the lack of involvement of the AGO in the LPA discussions. Mr. Drake worked well with the AGO and found them to be extremely competent, so he had no idea why the AGO was being left out of the LPA.

Based on the evidence presented during this investigation, the flaws in the methodology used by MRM in its calculations related to the LPA include the following:

1. Although representations to the Legislature had been made that the reason the LPA was necessary was that 23% of the cost of the program was related to claims eight years and older, MRM switched its focus from that age claim to those five years and older and subsequently to claims just three years and older with no apparent explanation.
2. In selecting claimant groups, Mr. Theriault stressed the importance of the claimant being separated from state service so the person could not come back with other claims later. Yet, he designed the LPA as claim rather than claimant based which had the effect of leaving multiple claims of a person with the State while one claim went to the LPA. Commissioner Waters indicated it "wouldn't make a lot of sense" not to include all of person's claims in the LPA, but that in fact did happen.
3. MRM used college students to do much of the work associated with the individual claim review. Friends of Mr. Theriault's college aged son from the son's high school years in Westport with no experience whatsoever in the insurance industry performed critical tasks in developing the reserves and setting the liability on the cases.

In Adrien Theriault's opinion, the claim review was "not rocket science" and the students got "some" training. He claimed senior people set the actual reserves, but the critical data they were working with came from the summer interns. Individuals at DAS were nervous about these summer interns being billed as professionals. Joe Prevuznak said using the term "interns" on the invoices could raise a lot of questions. Adrien Theriault was told by him to call them 'junior staff', and Mr. Theriault changed that invoice and future references to the college students. The 'junior staff' was billed at $105/hour.

4. The summer interns worked with only the paper files although Berkley indicated that the most up to date information was electronic. The interns compiled data from paper files which, according to Adrien Theriault, were in horrible condition. This extracted information was the basis for the calculations underpinning the LPA, and not even that information was fully available for a large group of claims. The paper files on many of the claimants from the "separated from state service" group and the "retiree" group were not available.
5. MRM applied a 35% and an additional 20% risk factor to Berkley's reserve figures on the cases selected with little or no industry standard to point to.
6. MRM claimed $2.5 million could be saved on administrative costs with the TPA by having certain types of claims removed from the state system, but in reality, the TPA was paid a flat fee and there was no difference in the amount paid for different types of claims.
7. MRM believed 65¢ on $1.00 of liability was a reasonable estimate of what a company would pay for the LPA and then was reassured that the market "agreed"

when they were asked what they would pay. MRM made key calculations by using, without question or any adjustment, the information provided by the companies who sought to profit from the deal.

8. MRM did not factor in settlements to arrive at the 65¢ on a $1.00 figure because Mr. Theriault testified that he believed settlements may in fact be at rates higher than the predicted liability to avoid the upside risk of a long payout period for a claim. Not one other professional we spoke to agreed that cases settle for more than present value. The failure to consider that claims could be settled for less than their claimed liability was an enormous oversight in pricing the LPA.
9. The 65¢ on a $1.00 reflected MRM's limited understanding of the accounting treatment of the company taking on the liability. The fact that the company would have $80 million to invest from the first day of the LPA was ignored in his calculations. There was no complete analysis of what this LPA might be worth to a company, an estimation essential to pricing the premium.
10. The 'trail out', or time period during which a claim would be presumed to be open and potentially active, for most of the claims was assumed by MRM to be 35-56 years. Because a long trail out would translate into years and years of costs for each claim, this kind of prediction considerably increased the numbers MRM calculated for the claim liability. In fact, the vast majority of the LPA claims were predictably closed after only five years, since companies typically want to aggressively settle cases, not manage claims for the life expectancy of the claimant.
11. MRM did not discount to net present value in its liability calculations or premium pricing, making the oversimplified assumption that Cost of Living Adjustments

(COLA's) would offset the discount to present value in an exact 1:1 ratio. Mr. Theriault could cite no authority for this supposition which potentially drove up the liability figures.

12. MRM's procedures led to very questionable accounting of the claims in the LPA. For example, the sheets of claimants MRM developed included pages and pages of claimants with an age listed as 100. Adrien Theriault claimed this was Berkley's fault, but the analysis for those claimants was compromised by not having the correct age and life expectancy data. Moreover, MRM originally selected 726 claims which were represented as having significant liability to be part of the LPA, but the number decreased by hundreds of claims when it turned out many of MRM's selected cases could be closed. As Mr. Theriault stated, "Everything was such a goddamn mess." MRM blamed Berkley, but MRM was charged with selecting the claims and had every opportunity to do so properly.

13. After the number of claims dropped by hundreds, Joe Prevuznak insisted that an additional more than 200 claims be added to the LPA for a final number of 660 claims. Mr. Theriault claimed that Mr. Prevuznak did this because he made an error in the pay as you go budget numbers submitted to the legislature which led him to add the additional cases, but regardless, because $80 million was earmarked to go into the LPA deal, the inclusion of the 200 extra cases seemed to be necessary due to MRM's failure to insure that the cases selected all had actual liability.

14. When asked about the changing numbers of claims, Adrien Theriault was not sure why the projected liability of the claims transferred didn't go down when the number of cases started at 726 and ended at 660. He never made adjustments to his figures

despite the changes occurring in the LPA claims. Individuals including Mr. Prevuznak and former Commissioner Waters reportedly lost confidence in MRM and Mr. Theriault by the end of the process. Commissioner Waters indicated questions developed, but she never "pulled the plug" on the project.

15. $126 million - $151 million was what Mr. Theriault claimed was his "reasonable" liability estimate (as opposed to his worst case scenario) for the LPA claims. In fact, he felt the liability could go much higher than $151 million, and in fact after the two hundred new cases were added by Mr. Prevuznak, Mr. Theriault brought his liability estimate closer to $200 million. This estimate, given that cases settled quickly for far less than the reserve amount, appears to be extremely overstated. Although settlements seemed quite predictable, MRM appeared oblivious to that possibility.

16. Adrien Theriault ultimately thought ACE's $80 million number was "a hell of a number" when the rest of the marketplace was coming in higher (he claimed $115 million - $140 million.) He continued to derive his calculations from the industry which stood to profit from the deal.

5. <u>After MRM Completed Its Analysis, DAS Proceeded To Finalize The LPA</u>

On December 19, 2000, MRM issued its Consulting Report (in draft form, no final having ever been issued) regarding the Loss Portfolio Arrangement. In its report, MRM chose specific categories of claimants, set forth liability determinations for 726 claims in the range of $126 to $151.9 million and established estimates of annual costs from 2001 to 2057. In its evaluation of the claims, MRM did not consider the probability of settling the claims, which,

according to the testimony of knowledgeable people in the area of LPA's, is crucial to calculating a reasonable cost of an LPA contract.

After receiving the draft report, DAS proceeded with preliminary inquiries into insurance company interest in submitting pricing estimates for an LPA with twenty-one companies including American Intl Group, The Hartford, Cologne Re, Max Re, Discover Re, ACE Financial, Travelers, AXA, Atlantic Mutual, Centre Re, Kemper, American Re, CNA, Swiss Re, Safety National, Chubb, Alliance, XL Nac Re, Zurich, MetLife, and Prudential. In so doing, DAS did not avail itself of the expertise of other agencies such as the Office of the Attorney General or the Department of Insurance.

In response to the requests to the insurance companies to provide pro bono preliminary pricing for the loss portfolio, using the claims as presented in MRM's report, numerous companies responded to various degrees. On January 2, 2001 AIG, The Hartford, and Cologne Re, among other companies, submitted preliminary pricing. A summary document was created on January 17, 2001 indicating AIG's suggested premium ranging from $76.0 to $77.75 million for liability limits of $90 to $140 million respectively; The Hartford's suggested premium of $78.84 to $88.5 million was for liability limits of $90 to $115 million respectively; Max Re's suggested premium of $93 million was for a liability limit of $115 million; and Cologne Re's suggested premium ranging from $91 to $107 million for a liability limit of $130 million. ACE submitted pricing of $50 to $70 million only for widows and permanent total disability claims with a projected liability of $150 million (but with no determination of liability limits). Because ACE Financial Solutions' preliminary pricing for the LPA was considered incomplete, DAS claims it was not initially considered. Likewise, Discover Re's suggested premium of $200 million and projected liability of $300 million (with no stated liability limit) was determined to

be incomplete. Kemper, Swiss Re and XLNac Re indicated they had no interest in submitting pricing.

After signing confidentiality agreements in December, 2000, the insurance companies who had submitted full preliminary pricing were permitted to conduct an on-site review of claimant files for more detailed pricing purposes at the offices of the third party administrator for the state, Berkley. Site reviews for AIG were performed on January 29, 2001 through February 2, 2001. Cologne conducted reviews on February 5-7, 2001, and The Hartford went on-site at Berkley on February 12, 2001.

Also in February 2001, the Governor's budget was introduced and included $80 million for the loss portfolio arrangement, $20 million dollars (which was later increased to $27 million) designated from surplus and $60 million (which was later decreased to $53 million) from bonding.

In March, 2001, Commissioner Waters submitted to the Finance, Revenue and Bonding Committee of the legislature a document dated February 22, 2001 asking for

> [a] new $60 million bond authorization for the purpose of effecting a Loss Portfolio Arrangement (LPA) that will enable the state to [sic] certain workers' compensation liabilities to a private insurer. The bond authorization will be combined with a $20 million appropriation from surplus funds will bring the total LPA financing package to $80 million…The financing of the LPA will allow the State to transfer liability for older and risky open claims to an insurer who will assume full liability for all claim payments, administration of the claims, and future liability. It has been calculated that through the $80 million LPA the State will transfer a minimum of $150 to $160 million in future liability and will realize an immediate impact of up to $13 million in annual savings on workers compensation claim expenditures. This impact affects claims in all budgeted state agencies…The LPA will enable the State to more effectively manage its workers compensation program through the sale of these older and costly claims.[1]

[1] This testimony should be considered along with that of former Commissioner Waters and Joe Prevuznak on February 18, 2000, which, although not related to the LPA, was when the legislature was informed that 23% of the current costs of the program were for the cases in the system eight years and older. At that time, a settlement program was suggested to address these older and costly cases, but there was no mention of an LPA.

MRM advised the state (essentially because the insurance companies insisted on it) to use a Request For Qualification ("RFQ") process to identify brokers to assist the state in finding the most financially sound and qualified insurers for the LPA. DAS issued an RFQ on March 13, 2001 to obtain a broker for the LPA and set the due date for April 10, 2001. The RFQ sought detailed disclosure of commission information. Brokers Hagedorn & Co. and Marsh USA both submitted responses to the RFQ. Marsh initially sought more than $1,000,000 in commissions but later agreed to a flat fee of $100,000. DAS scheduled April 20, 2001 as the date on which the appropriate RFQ candidate/s would be selected. In fact, both Marsh and Hagedorn performed work on the project, but only Marsh was actually paid the commission of $100,000 for securing the insurance company ultimately chosen for the LPA.

On June 28, 2001, the Bond Act was enacted in the June Special Session by Public Act 01-07 with an effective date of July 1, 2001. On June 30, 2001, the budget package was passed, allocating to the LPA $30 million in state surplus funds and $53 million in bonding.

It was not until August 17, 2001 that the Attorney General's Office was officially informed of the LPA.

On August 29, 2001 DAS issued its Request For Proposal ("RFP") for the LPA, and in September, 2001, ACE did an on-site claim review at Berkley. In October 2001, AIG, The Hartford, and ACE responded to the RFP via brokers Marsh and Hagedorn. The responses were all in excess of $90 million. After negotiation, ACE submitted a Term Sheet on October 31, 2001 and again on November 7, 2001 the latter of which provided that it would assume $150 million in liability for a premium of $80 million. In November 2001, DAS finalized its contract with ACE for $80 million.[2] The policy became effective November 16, 2001.

[2] Additionally, at or around this time, the broker, Marsh McLennan ("Marsh"), received a secret $50,000 kickback or "contingency fee" from ACE in addition to the $100,000 commission for having brought the successful bidder to

6. The LPA Process Was Rushed To Completion Despite The Misgivings Of Some DAS Staff And Others

The process was rushed according to Adrien Theriault and others after the RFP went out. The September 11, 2001 terrorist attacks caused grave concern among those at MRM that ACE, who, according to Mr. Theriault had been put on a credit watch after September 11, 2001, might not remain solvent. The selection of bond counsel was so rushed that Mr. Theriault did not know who was selected. He indicated there was hardly time to properly review the documents. The process went through with only minimal delays despite the catastrophic losses in the insurance industry. If the $80 million went to a company which went bankrupt, the State would have remained fully liable for all the LPA claims, but former Commissioner Waters did not recall being concerned or even informed of such a possibility.

Michael Barletta, who was the DAS administrator of the state's workers compensation program, immediately prior to the LPA deal, admitted he did not have a financial background and was not strong in that area. He was asked to step down and sent to do more technical agency work and was at DOC when the decision was made to go forward with the LPA. Joe Prevuznak took over as administrator of the program, but Mr. Barletta remained aware of aspects of the program, including the LPA. He heard that MRM was consulting with the state and knew Russ Partridge, who was working with MRM, to be a knowledgeable person from Travelers. He had concerns though about MRM sending college students to do the work at Berkley and of multiple claims for a person not being included in the LPA. His overall impression of the LPA was that it was a decision from the top down with little input from those below.

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the State. This conduct on the part of Marsh was the subject, in part, of a lawsuit brought by Attorney General Richard Blumenthal on January 21, 2005 which has been successfully resolved.

That impression (that LPA was top down decision) was seconded by Carl Hosmer who was an accountant in the workers compensation unit from 1980 – 2002. Mr. Hosmer certainly had a good deal of experience with fiscal matters involving workers compensation, having done the bank reconciliations for the program for many years. Once he heard about the LPA he thought it was a terrible idea. Going to a third party would be far too costly in his view, and he considered the amount of money going into the deal to be "astronomical." He never heard anyone suggest even considering a smaller, less expensive program. He was, however, aware that Joe Prevuznak was in favor of the state settling claims and that the agency wanted desperately to cut costs which were trending upwards. He never heard of a substantive matter of this magnitude being brought in a bond act.

Mr. Robert Wallace was the head of the internal audit department at DAS, and he had 18 years of experience in insurance auditing. He was not made aware of the LPA project until after MRM had made its draft report. There was no final report, Mr. Wallace noted, when Joe Prevuznak gave him the report in April 2001, and he told Mr. Prevuznak he was concerned about multiple claims of a person not being included in the LPA. He wrote a memo detailing other concerns in April 2001.

Mr. Wallace heard about college interns performing work for MRM on site at Berkley, and he was very concerned because in his view experience was a critical factor in looking at workers compensation claims. He was also of the opinion that $80 million was too much money for 660 claims and had heard Mr. Barletta say that these cases could be settled for far less. Mr. Barletta told him that he had tried to get additional funds to do "in-house" settlements but that that never happened. Much to Mr. Wallace's surprise, his internal audit department was disbanded early in 2003. He was told the staff and money were needed elsewhere. He went to

collection services where he said there appeared to be little or no need for his services. He had his unit look into various aspects of the LPA prior to this occurrence.

Susan DeMauro worked under Mr. Wallace in the internal audit department and was equally surprised when the unit was disbanded. She indicated they were looking into the LPA in 2002 and felt that may have been why the sudden change came about in 2003.

Ms. DeMauro's exposure to the LPA was limited to her concerns about MRM regarding its use of summer interns with no workers compensation background doing estimates and reserves work on claims. She felt they did not have the expertise for this task and that learning to estimate reserves was very difficult and time consuming. Once the deal was done, her unit began an examination of the claims because Mr. Wallace questioned that there were claims with zero balances. The concern was that they had been led to believe that the LPA was to be comprised of catastrophic high money cases but that there were in fact cases worth little or nothing. There was also concern about only one claim of a person being on the LPA, leaving the state with the other workers compensation claims for the same person.

7. The LPA Continued To Raise Questions After Its Implementation

A series of legal letters were issued at the time of the inception of the policy and shortly thereafter. By letter dated November 16, 2001 to the State of Connecticut, Office of the Treasurer and Robinson & Cole, Deborah Ashheim, Legal Counsel to ACE, provided the legal opinion that the policy was legally binding on the Illinois Union Insurance Company. Bingham Dana, Special Counsel to the Illinois Union Insurance Company, also opined on that same date that the Workers' Compensation Self-Insurers Indemnity Policy was enforceable. On January 2, 2002, Attorney James Neil of DAS provided a letter to ACE ostensibly providing the legal

authority for the state to enter into this policy. The Attorney General's Office was not consulted on the issuance of the legal authority binding the State to the $80 million policy. Because of the AGO involvement with workers' compensation cases, including any number of cases in the LPA, the Attorney General issued a letter November 29, 2001 to DAS Commissioner Waters seeking confirmation that 660 cases had been officially transferred to ACE. DAS Commissioner Waters responded in the affirmative to this question in correspondence on December 21, 2001 and provided contact persons for Berkley and ACE.

On January 1, 2002, the contract for the State's new workers' compensation TPA, GAB Robins North America ("GAB"), took effect covering the period through December 31, 2004. Berkley, who had been the TPA for the State on all its workers compensation cases up until January 1, 2002, was chosen by ACE to administer the claims in the LPA and thus was acting as both the State's and ACE's TPA for the period from November 16, 2001 until December 31, 2001.

On January 22, 2002 the Attorney General submitted testimony before the Labor and Public Employees Committee that the AGO had not been involved in drafting the legislation for the LPA, selecting cases, or writing or reviewing the contract. The Attorney General's submission included the following:

> My office has not previously addressed these issues since we have not been involved in drafting the legislation, writing or revealing [sic] the contract, or selecting the cases for transfer…My office was not involved in the drafting or approving the contract. In fact, we never saw the contract until after the transfer of the cases to ACE…The contract apparently is an insurance contract that does not completely eliminate state liability for the transferred claims. The state must pay any aggregate claims and administrative costs exceeding $150 million or any individual claim, including administrative costs exceeding $1.5 million….In addition the state remains liable for any medical insurance costs related to any claimant, even after a claim is transferred….In addition, the statute seems to provide for the third party to assume liability for the transferred cases. Under state law, an employer cannot transfer liability for a workers' compensation claim to

> another entity. The question is whether this language provides an exception to the employer's statutory duty regarding the transferred state employee cases. If the third party goes bankrupt and ceases payments, is the state still liable for such payments?...The Committee may wish to review the criteria of process for selecting the transferred cases. Some state employees, for example, have multiple claims but the transfer does not include all of them. One employee with 14 claims and only one was transferred, meaning the claims involving the same person cannot be resolved simultaneously. If the intent of transferring the claim is fully and finally settle claims, all should be addressed together.

On January 24, 2002, Deputy Commissioner Alan Mazzola testified before the same Committee that two months prior to signing the contract, he contacted the Attorney General's Office but he claimed the Office did not respond with any "input" on the deal. He also testified that the AGO only "sometimes" reviews DAS contracts. Adrien Theriault testified about the categories of claimants in the LPA and that he believed his fees to be approximately $100,000, notwithstanding that at that time the contract had been amended numerous times and the total approached $700,000.

Since ACE has taken over the 660 claims, the vast majority of cases have settled. Approximately one hundred cases remain open according to Berkley, and an equal number are closed without settlement with no apparent value. The company has submitted annual reports as part of its contractual obligation to DAS, and DAS has indicated that its understanding of the November, 2007 report is that $154,008,754.59 has been spent by ACE and the State on all the cases. Numerous witnesses testified that as of November 16, 2001, the State had spent $96,727,329.73 on the cases. Subtracting that amount from the total spent results in a difference of $57,281,424.86 which represents the amount spent by ACE since November 16, 2001.[3] The $57,281,424.86 amount does not include other costs that ACE incurs on the LPA, including TPA and personnel costs. Substantially adding to ACE's bottom line is the investment income from

[3] There is a dispute between DAS and ACE as to the total amount spent as reported to DAS for 2007. ACE has indicated that they believe the correct total figure for the 2007 report is $157,680,080.92 which results in ACE having spent $60,952,751.19.

the $80 million it received on the first day of the contract and which continues to be derived from the remaining funds.

8. <u>The Legislature Was Never Given The Opportunity To Fully Evaluate The LPA</u>

The proposed LPA, whereby DAS proposed spending $80,000,000 for an LPA under a bonding act, was introduced in the February 2001 budget. This budgetary proposal was examined by Michael Wambolt at the Office of Fiscal Analysis ("OFA").[4] Mr. Wambolt worked at OFA from 1980 until August 2002 as a budget analyst.

Mr. Wambolt's job as a non-partisan budget analyst was to make inquiries into the costs and benefits of the proposal. He had been involved with worker's compensation issues since the early 1980's and worked on the worker's compensation legislative reforms of the 1990's through 2002. Former Commissioner Waters indicated Mr. Wambolt did a very thorough job for OFA. Mr. Wambolt had little experience with LPA-type arrangements prior to the one in question because, to his knowledge, this was the first LPA undertaken by the state. He first heard about the LPA when the budget was introduced in February 2001. He compared it to the state experience with securing a Third Party Administrator (TPA) for worker's compensation cases, but this was the first time that there was an actual sell-off of cases.

<u>Mr. Wambolt's Analysis of the LPA Raised Significant Concerns</u>

In Mr. Wambolt's analysis of the LPA, he immediately noticed that there was an emphasis at the legislature on the proposed $13.5 million reduction in the 2002 and 2003 Workers Compensation budgets rather than the $80 million premium. This reduction was

[4] Mr. Wambolt has a Bachelor of Arts from the University of Connecticut and a Masters Degree in Public Administration from the University of Hartford.

attributed to a projected 22 % savings in worker's compensation expenses due to the sell-off of the LPA cases. The document titled, *A Summary of Revenue Appropriations and Bonds Authorized by the General Assembly, October 2001* states:

> About 700 of the oldest and most expensive State employee WC cases, with an estimated liability of $127 million to $160 million would be transferred to a private insurer at an estimated cost of $80 million. This is about 10% of currently active cases and they produce over 20% of the annual payout. […] Each agency's WC Claims appropriation is reduced by about 22% in FY 02 and by about 21% in FY 03. Statewide, these reductions are $13.5 million in both FY 02 and FY 03.[5]

Mr. Wambolt noted that the LPA was presented as significant reductions in the budget and that the $80 million cost of the premium was "off-budget." He spoke about the arrangement with Joe Prevuznak, who was managing the worker's compensation program at DAS. He also contacted OPM. Both DAS and OPM informed Mr. Wambolt that the LPA was for old, expensive cases. He repeatedly asked about whether there had been discussion about doing a settlement program in-house that might cost considerably less, but he got no response. Mr. Wambolt also claimed he got no response as to whether or not alternatives to the LPA had been considered.

Mr. Wambolt had extensive knowledge about another workers compensation program, the Second Injury Fund (SIF). He was aware that the SIF had settled cases worth $1.5 billion for $450 million, or 27 cents on the dollar. Joe Prevuznak, he knew, transferred to DAS from the SIF partly because of Mr. Prevuznak's successful record of settling cases "in-house".

Mr. Wambolt also engaged in conversation with a worker's compensation commissioner. From this interaction, Mr. Wambolt concluded that in general, a worker's compensation case worth one million dollars over the life of the claim would have a present value of around $250,000. After reviewing the math, it appeared to Mr. Wambolt that spending $80 million for

[5] *A Summary of Revenue Appropriations and Bonds Authorized by The General Assembly 2000 Session, Connecticut State Budget 1999-2001 Revisions*, Office of Fiscal Analysis.

cases worth $127 million would translate to a 60% rate of settlement,[6] which he thought presented a terrible deal for the state. He questioned DAS about the possibility of settling the cases "in-house" and suggested allocating to DAS $20 million for a smaller-scale LPA or "in-house" program to test its success before committing to a larger and more costly LPA. Mr. Wambolt surmised from DAS's responses that the decision to go forward with the LPA had already been made.

In analyzing the LPA, Mr. Wambolt examined monthly DAS and TPA reports. He performed his investigation by questioning the agencies and bringing forth his concerns. Mr. Wambolt prepared a White Paper. Mr. Wambolt found the information he was given on the LPA deal to contain generalities and "ranges" of numbers, and this made it difficult to pinpoint the exact figures for his analysis. The state's consultant on the deal, MRM, estimated at one point that the total liability ranged from $127 - $160 million, but Mr. Wambolt was unsuccessful when he requested more specific figures. Taking the lower figure in the range, Mr. Wambolt observed that paying $80 million on $127 million for 20 plus years of liability was not a good deal for the state. Alternatively, if the liability approached $200 million, as later projected by MRM, the state also got a bad deal because under the contract with ACE, the liability reverts back to the state after $150 million. Mr. Wambolt also expressed frustration at the ever-changing number of claims that would be sold off as part of this $80 million deal. He noticed that the mix of cases kept changing, but the numbers in projected savings stayed the same.

Mr. Wambolt thought that the director of workers' compensation at DAS, Joe Prevuznak, also would have preferred to do the settlements in-house. First, Mr. Prevuznak had a record of successfully settling many cases for the SIF. Second, Mr. Prevuznak had been successful at settling workers' compensation claims after his transfer to DAS. Mr. Wambolt thought Mr.

[6] $80/$127 = 62%.

Prevuznak was being a "good soldier" and that he had no choice but to follow the decision from top levels to outsource. Unfortunately, Mr. Prevuznak passed away unexpectedly before our office was able to interview him for this report.

The Usual Method Of Legislative Approval Was Not Followed

Mr. Wambolt questioned why bond money was used to fund the LPA when surplus funds could have been allocated to a smaller LPA or used for "in-house" stipulated settlements to test the program before incurring additional costs through bonding. These questions caused Mr. Wambolt to notice and consider the unusual method by which the LPA was brought before the Legislature. The LPA was brought under the Bond Act. The language authorizing the LPA was under Sections 11 to 13 of PA 01-7, JSS, "ACC Increasing Certain Bond Authorizations for Capital Improvements and Concerning Certain Unexpended Bond Proceeds," and therefore did not go before the Appropriations Committee. Mr. Wambolt noted that it was highly unusual to bring a substantial policy proposal in a bond act. Former Commissioner Waters agreed that this means of coming before the Legislature was quite uncommon. The bond act simply creates a menu of possible projects authorized by the bond commission. A proposal authorized under a bond act allows OPM to directly allocate funds to the agencies. On the other hand, a proposal authorized under a budget permits the Appropriations Committee to decide whether or not to authorize OPM to allocate the funds among the agencies. The Appropriations Committee examined the budget, not the bond act, and saw savings of $13.5 million for the FY 02 and FY 03 budgets. The committee did not review the full proposal. As a result, the LPA, presented to the Appropriations Committee as savings, was approved. The Bill did not go to any committee for consideration, although there had been a hearing that dealt with high workers compensation

costs. In fact, only three analysts from OFA examined the appropriations. Not until after the contract was signed did the Labor and Public Employees Committee hold a hearing, on January 22, 2002. At this hearing, the Attorney General provided testimony in written form (as described above) including his concerns about the claims selected and process of implementation, and Mr. Wambolt testified about his concerns.

Projected Savings not Realized

According to Mr. Michael Wambolt, one of the reasons why the legislature approved the LPA was the apparent deficiency in the DAS's budget that gave the impression that DAS was facing a budget crisis. Mr. Wambolt pointed to the documents showing the original appropriations for Workers' Compensation to each state agency, the deficiencies, adjustments, and expenditures. The totals for all agencies in each fiscal year are summarized in the chart below:

	FY 00	FY 01	FY 02	FY 03
Claimed Savings			13,530,800	13,530,800
Carry Forward from Previous Year		3,614,405		
Original Appropriations	46,349,565	46,723,782	47,984,423	50,952,127
Adjustments Deficiency	10,700,000	11,100,000 3,917,000	14,914,000	6,552,410 16,950,000
Revised Appropriations	57,049,565	65,355,187	62,898,423	74,454,537
Expenditure	53,367,738	62,453,194	59,978,838	75,244,639

Mr. Wambolt also pointed to stipulations, and the total amount of stipulations and percentage of the cost of stipulations with respect to total claims expenditure is summarized in the following chart:

	FY 99	FY 00	FY 01	FY 02	FY 03	FY 04	FY 05
Stipulated Settlements	6,575,681	3,091,836	5,378,946	339,508	630,000	160,500	1,138,948
Percentage of Claims Expenditure	13%	6%	8%	1%	0.83%	0.21%	1.43%

From the numbers presented in the charts above, Mr. Wambolt put forth two observations. First, the deficiencies in the budget deemed a crisis was actually the result of the higher rate of stipulated settlements from FY 99-01. This led Mr. Wambolt to conclude that DAS was doing a good job at settling the cases (despite periods of freezing settlements) and speculate whether they would be even more effective if some of the money going to the LPA was to be appropriated to DAS. Mr. Wambolt also pointed out that after the LPA went into effect in FY 01, the DAS rate for stipulated settlements decreased to as little as 0.21%. Second, even after the LPA went into effect and there was a claimed savings of $13.5 for FY 02 and 03, there was no decrease in expenditures. In fact, expenditures rose sharply in FY 03. He questioned whether the state could do the settlements more cheaply "in-house." He suggested the state could spend $10 million over 2 years or $15 million over 3 years to see how many cases they could settle.

The fact is that expenditures have not decreased since the sale of the 660 cases to ACE. It is difficult to see whether the $13.5 million per year in savings ever materialized. In FY 02 there was a $14.9 million deficiency. Almost $60 million was spent even though DAS reports

show there is no new significant increase in new claims. In FY 03, about $23 million in deficiency adjustments were added. Current data shows that claims have not risen significantly and therefore, cannot be the reason that the projected savings were not realized. Former Commissioner Waters testified that the lack of savings was a result of increased medical costs in the program's remaining cases, but we are unable at this time to either prove or disprove the accuracy of that contention.

Mr. Wambolt concluded that in reality, the state incurred expenses totaling more than $95 million to sell off only 660 cases that may be worth considerably less than $127 million. The purpose of this deal was purported to provide savings of $27 million to the State over two years. However, the bottom line is that expenditures have in fact increased.

9. At The Time The LPA Was Agreed To The State Had Little Or No Reliable Data On Whether It Would Benefit From The Transaction

The State ultimately entered into an agreement with ACE Financial Solutions to transfer 660 worker's compensation cases for an $80 million premium based on the figures provided by MRM. One problem with MRM's analysis is that the bundle of cases that MRM examined is not the same bundle of cases ACE received in the final LPA. MRM selected 726 cases, but from the time MRM submitted its report to the actual LPA, hundreds of the cases it chose were closed, the exact number of which, remarkably, could never be ascertained with certainty because MRM provided conflicting data. On the eve of the transfer, Joe Prevuznak, head of DAS's worker's compensation unit, added about 212 new cases to the portfolio to bring the total to 662. The 212 new cases belong to a class called temporary totals, a class that had not been previously examined by MRM.

MRM's Original Estimates Category	(Dec. 19, 2000) No. of Claims	Estimated Liability
Widow	44	$29.0 million
Retirees	385	$40.3
Permanent Totals	85	$76.0
Separated	212	$7.0
Total	726	$152.3

MRM's Adjustments Category	(October 10, 2001) No. of Claims	Estimated Liability
Widow	44	$29.0 million
Retirees	210	$40.3
Permanent Totals	76	$76.0
Separated	113	$6.0
TTD	212	$40.0
Total	655[7]	$191.3

At the inception of the LPA, 160 out of the 660 cases actually received in the transfer were already considered by Berkley to be closed.

Aside from the fact that many of the cases in the LPA were not those selected by MRM, many other problems existed in MRM's methodology. MRM reviewed a selection of cases, starting with cases that were five years or older and then expanding to include cases between three and five years old. MRM classified the cases into four categories, with a formula for liability for each type of claim, and then applied a percentage of additional liability to each category to arrive at a total of $126 million in future liabilities. Then, a blanket 20% risk adjustment was applied to that total to arrive at $156 million maximum potential future liability. As a result, risk percentages were applied twice. MRM asserted that these percentages were "industry-accepted" and did not provide additional justification. MRM did not review each individual case, and for certain cases, it simply added a blanket percentage risk to arrive at its recommendation. MRM also did not state the values in net present value. Most importantly, MRM did not take into consideration the possibility of settlement, an element essential to the

[7] [[7 Cases unaccounted for]]

attractiveness of assuming an LPA. See Appendix 1. An assessment of the probability of settlement for each claim is crucial to pricing an LPA because it determines the profitability of assuming liability for the purchaser. By ignoring this essential factor, MRM's projections appear to be considerably over inflated as borne out by the fact that, although MRM predicted a trail out of many decades for the cases, Berkley reported that as of June 30, 2002, 43.4% of the LPA cases had closed.

MRM classified the cases in four different categories and applied a general method of estimation to the cases in each category. The categories were widows, retirees, permanently injured employees (hereafter "permanents") and separated employees (hereafter "separateds".) Widows were defined as surviving dependents of a former State employee whose death was attributable to a work-related injury. Retirees were defined as former State employees who either had an active claim resulting from an injury during employment or were receiving a disability retirement as a result of a work-related injury. Permanents were defined as permanently disabled state employees who suffered a serious job-related injury, which resulted in an inability to continue to perform their previous duties with the state. Last, separateds were former state employees who had one or more accepted claims as a result of a work-related injury. The separated claimants have left the State's employment to seek other employment within their post-injury capabilities.

The method of estimation for each category by MRM was as follows:

The estimated liability for widows was calculated using the claimant's life expectancy and yearly indemnity benefits. Estimated liability for permanents was calculated using a function that takes into account the average total medical indemnity over three years, the claimant's life expectancy, the yearly indemnity benefits, and a percentage risk of death.

Estimated liability for retirees was calculated using a function that takes into account the average total medical indemnity over three years, the claimant's life expectancy, the yearly indemnity benefits, a cost of living adjustment, and a fifty percent disability adjustment. Estimated liability for Separateds was calculated using a function that takes into account the average total medical indemnity over three years, the claimant's life expectancy, the yearly indemnity benefits, a cost of living adjustment, a fifty percent disability adjustment, a thirty-five percent adjustment factor, and a twenty percent at-risk adjustment.

Although it appears at first glance that MRM analyzed the cases to some degree of specificity, they applied a blanket percentage of liability to most cases twice with little justification, and they did not take into account the probability of settlement for individual cases, leaving out information crucial to the pricing of the LPA. MRM also did not analyze each case individually, leaving many claims grouped together for calculation purposes. Further, MRM's exact methods cannot be determined by the Draft Report dated December 19, 2000, and Adrien Theriault's testimony only added confusion to the matter. Mr. Theriault, as president of MRM, was largely unable to clarify the gaps and inconsistencies in their methodology. He did not know how some of the figures in his report were obtained. Clearly, MRM applied broad and arbitrary percentages to individual and aggregate totals and failed to discount to present value, all of which had a significant impact on the pricing of the LPA. The generality with which MRM proceeded is evident in the large range for estimated liability it provided, which was anywhere from $126.6 million to $151.9 million. The following tables from MRM's Draft Report dated December 19, 2000 illustrates MRM's estimation:

Categories	Berkeley's Reserves	MRM's Projections
Widows	$18,029,031	$28,935,399
Retirees	$24,589,898	$31,960,094
Permanent Totals	$30,773,232	$60,293,617
Separated	$4,115,605	$5,465,794
Total	**$74,507,766**	**$126,654,904**

When MRM applied the 20 percent adjustment to reflect an "at risk" element, the liability levels increase for each group except the widows as follows:

Category	MRM's Adjusted Liability With "At Risk" Factor
Widows	$28,935,399
Retirees	$40,244,932
Permanent Totals	$75,923,009
Separated	$6,882,644
Total	**$151,985,885**

Once MRM realized that Joe Prevuznak added 200 plus cases to the portfolio, MRM increased their projections by another $40-$60 million, bringing the total liability to $175 million to $195 million. Again, there was no consideration given to discounting the estimates to net present value.

MRM and ACE applied different methods to estimate future liability and ultimately to price the LPA. MRM employed a more simplistic, generalized method and failed to discount to net present value while ACE performed a more detailed and sophisticated analysis on each individual case, taking into account the likelihood that many of the cases would settle and the ultimate profitability, or return on equity. A thorough and effective analysis of an LPA should examine what the LPA would be worth to the entity assuming the risk in addition to the projected liability of the entity transferring the risk. The state lacked crucial information on the pricing of the loss portfolio arrangement because MRM did not assess the value of the LPA to ACE. To the transferor, the pricing of an LPA is partially determined by how much liability the entity can unload by expending a fixed amount of money. Ideally, the transferring entity would like to unload as much liability as it can, paying as little money as possible. Therefore, it is extremely important for the risk-transferor to accurately project what the LPA would be worth to the entity assuming the risk. Profit is the single most important element that attracts an insurer to assume the risk of an LPA. Essential to applying the premium in a way that maximizes profit is the ability to settle most of the claims, thereby freeing as much capital as possible for investment in other projects.

MRM did not analyze each case individually even though it was given full access to all the claims. MRM made sweeping generalizations and applied arbitrary and random risk percentages. In short, MRM's methodology appears to have substantially over-inflated future liability and failed to capture the worth of the LPA to ACE by ignoring the probability of settlement. In fact, MRM provided only two considerations as factors that determine the value of the LPA to the party assuming the risk. MRM pointed to the financial advantage that the loss portfolio insurer would be able to take the entire liability as a charge against earnings in the year

they take over the liability and that many insurers are able to leverage the opportunity to write other business as a result of the surplus created by the transaction.

The table below shows that MRM predicted it would take ACE over 35 years to close 726 cases and $126 million of liability using the $80 million premium:

Payout of Current Liability	Current Liability Paid	Number of Claimants Closed	Number of Claimants Open	Cumulative Liability Paid	Remaining Liability to be Paid
Next 10 years	$48,742,666	22	726	$48,742,666	$77,912,238
Next 5 years	$22,492,644	42	704	$71,235,311	$55,419,593
Next 5 years	$19,794,122	87	622	$91,029,433	$35,625,471
Next 5 years	$16,348,920	135	575	$107,378,353	$19,276,551
Next 5 years	$11,071,270	181	440	$118,449,622	$8,205,282
Next 5 years	$4,962,441	106	259	$123,412,063	$3,242,841
Remaining Years	$3,242,841	153	0	$126,654,904	0
Total	$126,654,904	726			

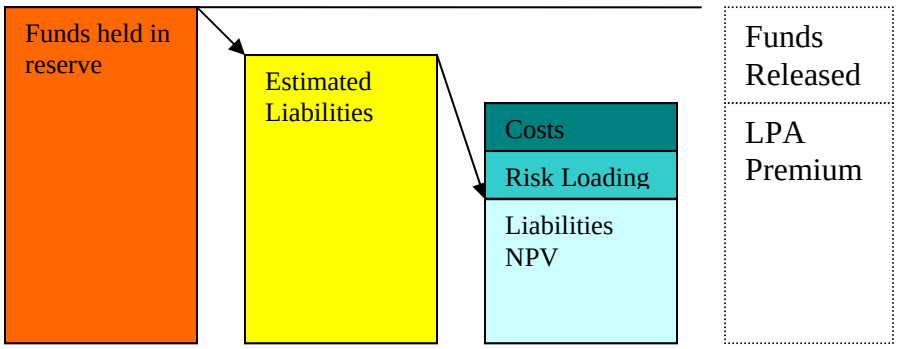
Because MRM did not consider the likelihood that many of the cases would settle, MRM's predictions were completely inconsistent with the actual results. Contrary to MRM's prediction that it would take ACE over 35 years to close about 600 cases, in three years, according to Mr. Drake, Berkley was able to close 545 cases out of the 660 cases that it assumed.

Final Considerations

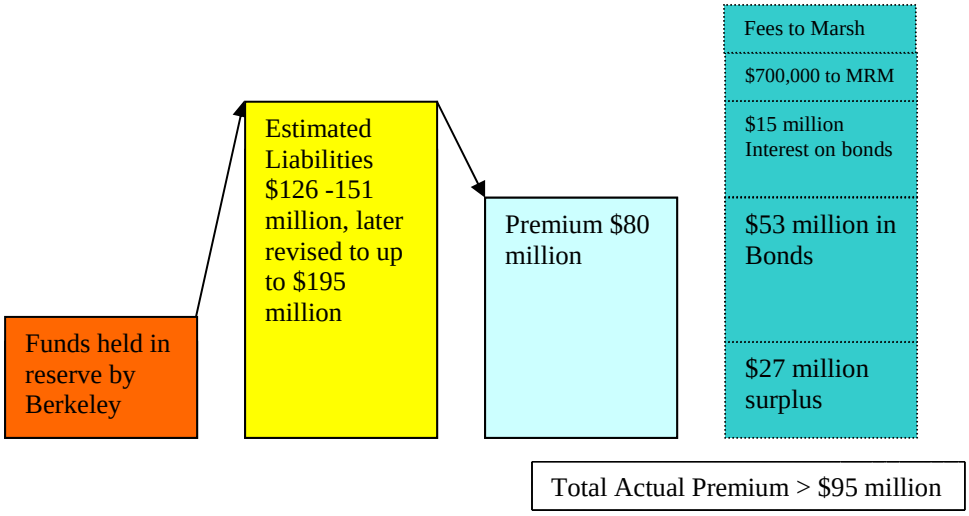
Consider the theoretical model for an LPA as described in Appendix I.[8] When an entity engages in a loss portfolio transfer, it is freeing the reserved funds for use in other investment projects. It follows from that logic that an LPA only makes sense if the entity can pay a

[8] A loss portfolio arrangement is an agreement in which the current accounting practices allow the ceding company to recognize current gains as a result of making a payment to the assuming company which is less than the loss reserves that are transferred. This is the American Institute of Certified Public Accountant's definition and also the New York Insurance Department definition for Rule 103. An additional definition for New York Rule 108 is that the consideration paid by the ceding company be based upon present value discounting concepts. JERRY MISZNER, 1985 CASUALTY LOSS RESERVE SEMINAR 547, http://www.casact.org/pubs/CLRSTrans/1985/542.pdf

premium that is less than its estimated liabilities and less than the amount of funds held in reserve.



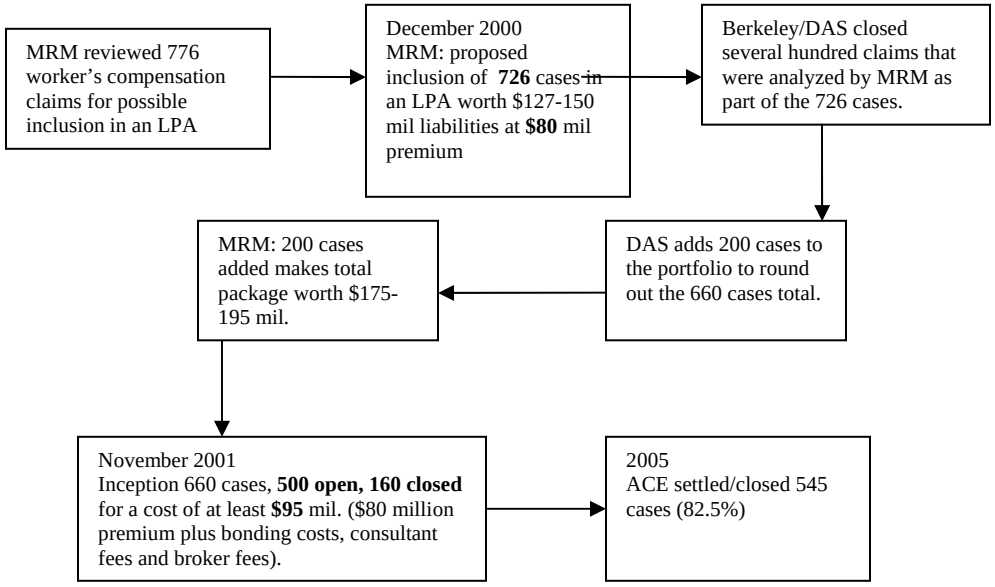
In the case of the worker's compensation LPA, the State of Connecticut did not have sufficient funds in reserve. Moreover, the estimated future liabilities were over inflated due to MRM's methodologies. The model for the state is as follows:



By entering into a loss portfolio arrangement, the state did not release any funds; in fact, it had to finance the premium through bonding. As a result, what the state really paid on the premium is

much higher than $80 million dollars. Taking into account the amount in interest the state is still paying on the bonds and the transaction costs associated with the services provided by MRM and Marsh, the total cost incurred is greater than $95 million. Because the liabilities were over inflated, the premium paid by the state could have been more than the actual liability for the cases transferred.

DAS spent almost $100 million to sell off 660 claims, 160 of which were considered closed at the inception. Even if MRM's estimates were true, that the liability for 726 cases ranged from $127 million to $150 million, the LPA was still a questionable deal for DAS because DAS spent almost $100 million for perhaps $127 million worth of liabilities without even considering the financial implications of the possibility of settling the claims.



Conclusion

We do not know what the remaining one hundred cases will cost over the life of the deal so cannot say with absolute certainty that it was a bad deal. However, if ACE did in three years what MRM believed would take over thirty-five years, with all the other shortcomings in the MRM methodology, it appears the State was badly served by entering into the LPA.

Recommendations

1. The State should study and consider establishing a possible separate "settlement fund" and develop an organized and systematic program to settle Workers' Compensation cases "in-house." The evaluation should focus on whether a properly managed settlement program could save the State significant amounts of money in administering its Workers Compensation system without using financing vehicles like LPAs.

2. The provisions of Public Act No. 07-01 Sept. Spec. Sess. which we advocated and the Legislature passed, needs to be carefully monitored to ensure that its terms are complied with and to see whether further legislation is necessary. It can help assure appropriate limits to the use of "privatization" through the §16 cost benefit analysis.

3. The State should consider whether and how MRM can be held accountable for its highly troubling performance. By following their faulty reserve numbers and premium pricing, the State proceeded with a project of highly suspect and challengeable value and appears to have overpaid for the LPA, although the ultimate outcome cannot be known with certainty.

Appendix I

The Dynamics Of An LPA

A loss portfolio arrangement (LPA) is a buyout of retained liabilities.[9] An LPA is a risk management option for insurers who have assumed a large amount of risk over a long time, have large loss reserves or risks that are subject to great volatility.[10] A state overseeing a large workers' compensation plan is one example. For the insurer, an LPA could reduce the risk that losses may ultimately settle out for more or less than the amount expected, convert a variable cost into a fixed cost, and remove long-term liability.[11] An LPA also allows the organization to focus on new activities and release funds set aside as reserves to optimize the use of capital.[12] For the party assuming the risk, the main attractiveness of an LPA is the promise of immediate cash and future profits. The party assuming the risk is then responsible for settling outstanding claims, on the expectation that the premium it received plus investment income will be sufficient to cover any expenses it incurred to close or settle the cases.[13]

Generally, a loss portfolio arrangement is an insurance technique employed by insurers to strengthen an insurer's balance sheet, enhancing its bottom line.[14] Insurers benefit from loss portfolio transfers in the following ways. Large liabilities, in the form of loss reserves, are eliminated from the balance sheets.[15] Further, if the premium paid out is less than the reserves,

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[9] LAURA SULLIVAN, CONSIDERING LOSS PORTFOLIO TRANSFERS (2004), http://www.mib.com/kd/html/Risk_Manager-m2.html (Nov. 2, 2005). *See generally* RONALD E. FERGUSON, DURATION, http://www.casact.org/pubs/proceed/proceed83/83265.pdf.
[10] *Id.*
[11] *Id.*
[12] AON RISK CONSULTING, LOSS PORTFOLIO TRANSFERS, www.aon.com/uk/en/risk_management/risk_consulting/actuarial/loss_portfolio_transfer.jsp (Nov. 2, 2005).
[13] Robert Darby, *Evaluating Loss Portfolio Transfers*, CAPTIVE INS. CO. REPORT (Feb. 1998).
[14] RICHARD A. CROOKER & BARRETT T. BROWN, THOUGHTS ON INSURANCE APPROACHES TO TRANSACTIONS, 652 PLI/LIT 159, at 165 (Apr. 23, 2001).
[15] *Id.*

the result is an immediate increase in the ceding entity's net worth.[16] Eliminating the payment of large liabilities in the future gives the ceding entity a less volatile balance sheet, which provides more predictability and precision for future budgeting.[17] In addition, a tax reduction can be realized for the full amount of the premium up front, instead of over a long period of time as the liabilities are paid.[18] Last, there is reduction in administrative costs.[19] For state and municipal insurers, the benefit of an LPA to a state or municipality is chiefly the reduction in administrative and support costs. The state or municipality does not enjoy the full range of benefits that private insurers get from engaging in loss portfolio transfers. Because the liability reverts back to the state or municipality should the assuming insurer become insolvent, any loss portfolio arrangement entered into by the state or municipality is not a true transfer of risk.

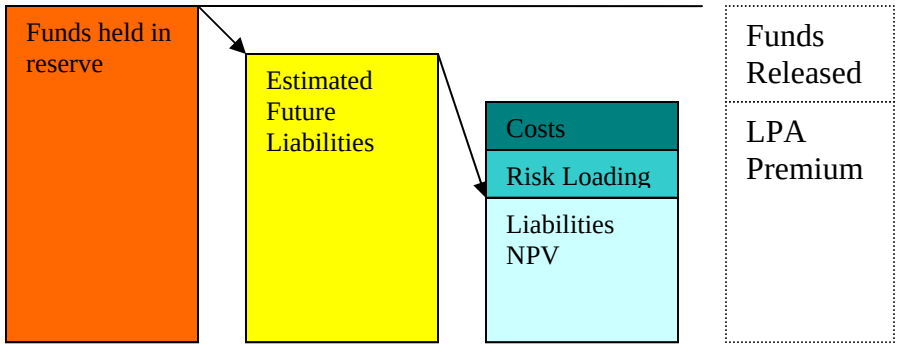
Pricing an LPA

The pricing of an LPA is an evaluation of the risk of future liability. When an entity transfers its liability for a premium, the entity wants to at least reduce liabilities by as much as the amount it paid.[20] A thorough evaluation should include projected losses for the liabilities to be transferred, current market appetite for LPA's, solvency of the insurer, and most importantly, the expected settlement patterns for the liabilities.[21] In projecting total liabilities to be transferred, it is important that the entities state the amounts in present value, or discounted basis.[22] Net present value is the sum of a stream of future cash flows discounted to its present

[16] *Id*.
[17] *Id*.
[18] *Id*.
[19] *Id*.
[20] Robert Darby, *Evaluating Loss Portfolio Transfers*, CAPTIVE INS. CO. REPORT (Feb. 1998).
[21] AON RISK CONSULTING, LOSS PORTFOLIO TRANSFERS, www.aon.com/uk/en/risk_management/risk_consulting/actuarial/loss_portfolio_transfer.jsp (Nov. 2, 2005).
[22] Robert Darby, *Evaluating Loss Portfolio Transfers*, CAPTIVE INS. CO. REPORT (Feb. 1998). *See also* New York Regulation 108, 11 N.Y. A.D.C. 112.3(a)(2) (2005) (defining a loss portfolio transfer as an agreement where the consideration paid by the transferor is derived from present value or discounting concepts based on anticipated investment income).

value.[23] Simply put, net present value is the net result of a multiyear investment expressed in today's dollars.[24] For the ceding party, the estimated liabilities must be appropriately discounted to net present value to accurately reflect the present worth of the future stream of liabilities as compared to the cost of the premium. In the case of a loss portfolio arrangement, estimations of premium and total liability would be inaccurate if the entity does not apply a discount method, that is, if it does not take into account the time value of money and the interest rates on potential investments.[25]

A model of an LPA analysis by Aon Risk Consulting shows that the premium for an LPA is the liabilities of the ceding party discounted to net present value plus the cost of risk loading[26] and other transactional costs.[27]



In theory the risk-transferring entity should have on reserve an amount greater than its estimated future liabilities. In evaluating an LPA, outstanding liabilities are usually discounted to net present value because when the liabilities are transferred, cash is reduced by the premium paid,

[23] Net Present Value, http://en.wikipedia.org/wiki/Net_present_value (Dec. 1, 2005).
[24] *Id*. *Also see* Net Present Value, http://www.macroanalytics.com/html/net_present_value.html (Dec. 1, 2005).
[25] *Id*.
[26] Risk loading is the cost of capital for covering unexpected losses. MICHEL M. DACOROGNA, INSURANCE FINANCE CONVERGENCE AND DIVERGENCE, http://www.mfn.unipmn.it/~colloqui/dacorogna.ppt#19 (Nov. 15, 2005).
[27] AON RISK CONSULTING, LOSS PORTFOLIO TRANSFERS, www.aon.com/uk/en/risk_management/risk_consulting/actuarial/loss_portfolio_transfer.jsp (Nov. 2, 2005).

and the assuming entity will earn an investment income on the premium.[28] An LPA is beneficial to the risk transferor only when the premium it pays is less than the estimated ultimate payout on the claims transferred discounted to present value.[29] It is also crucial in pricing an LPA that the risk transferor contracts with a solvent insurer since the liability can revert back to that entity if the assuming party becomes insolvent.[30]

[28] Robert Darby, *Evaluating Loss Portfolio Transfers*, CAPTIVE INS. CO. REPORT (Feb. 1998).
[29] *Id*.
[30] *Id*.