REPORT ON

THE MARKET CONDUCT EXAMINATION

OF

The Beacon Mutual Insurance Company

State of Rhode Island
Department of Business Regulation
Insurance Division

April 20, 2007

Honorable A. Michael Marques
Director
State of Rhode Island Department of Business Regulation
233 Richmond Street, Suite 237
Providence, RI 02903

Dear Director:

In accordance with your instructions and pursuant to the statutes of the State of Rhode Island, a Market Conduct Examination ("Examination") was conducted of The Beacon Mutual Insurance Company ("Beacon") of Warwick, Rhode Island.

As permissible under Rhode Island General Law ("R.I.G.L.") § 27-13.1, the Department of Business Regulation ("DBR," "we," or "us") retained the services of Deloitte Financial Advisory Services LLP ("Deloitte FAS") to provide assistance in reviewing and analyzing information and other data relevant to this matter. The specific procedures performed by Deloitte FAS were established through discussions with DBR over the course of the Examination. The specific procedures were conducted by Deloitte FAS under the supervision and control of DBR.

R.I.G.L. § 27-13.1 provides authority for this Examination. The Examination was conducted in accordance with standards established by the National Association of Insurance Commissioners, as well as procedures developed by DBR's Insurance Division.

The primary purpose of the Examination was to evaluate Beacon's compliance with Rhode Island General Laws, Public Laws, and Insurance Regulations, and to determine whether Rhode Island employers and claimants were being treated equitably. The work performed during the Examination satisfied this purpose, and forms the basis for DBR's findings and recommendations presented in this report.

The attached report summarizes the scope of the Examination, the procedures performed, the findings, and recommendations. The report is comprised of six sections as outlined below:

- **Executive Summary** – A high-level overview of the Examination's scope, procedures and relevant findings;
- **Background, History, Culture and Corporate Structure** – The history of Beacon, the regulations it is subject to and the corporate structure and culture, including the evolution of the underwriting department and underwriting principles;
- **Financial Controls and Cash Disbursements** – The financial controls environment at Beacon including process flows and systems controls in its finance

department; also included in this section are findings related to cash disbursements, agent commissions, and conflicts of interest;

- **Premium Pricing** – Findings related to Beacon's premium pricing methodology including high-level policy pricing patterns, certain Beacon programs, out-of-state coverage and specific policy pricing queries and comparisons; and
- **Political Activities** – Findings related to Beacon's relationships with political consultants and other transactions that may have related to political issues.
- **Recommendations** – DBR recommendations for addressing some of the concerns outlined within the report.

STATE OF RHODE ISLAND

County of Providence

Sharon K. Gordon and Elizabeth Kelleher Dwyer, being duly sworn, state as follows:

We have authority to represent the Rhode Island Insurance Division in the examination of the Beacon Mutual Insurance Company;

A market conduct examination was made of the affairs of Beacon Mutual Insurance Company;

The following pages numbered five to three hundred twelve, consecutively, constitute the report thereon to the Director of the Department of Business Regulation for the State of Rhode Island;

I have reviewed the examination work papers and examination report, and the examination of Beacon Mutual Insurance Company was performed in a manner consistent with the standards and procedures required by the Rhode Island Insurance Division.

Sharon K. Gordon

Sharon K. Gordon CPA, CFE
Chief Insurance Examiner

Elizabeth Kelleher Dwyer

Elizabeth Kelleher Dwyer, Legal Counsel

Subscribed and sworn before me by Sharon K. Gordon and Elizabeth Kelleher Dwyer on this 20th day of April 2007.

[illegible]

Notary Public

My commission expires 10/21/10.

EXECUTIVE SUMMARY

Introduction

Most examinations performed by the Insurance Division of the Department of Business Regulation can be categorized as either "financial" or "market conduct" examinations. While financial examinations deal primarily with insurer solvency and compliance with state laws related to solvency, market conduct examinations deal primarily with treatment of policyholders and claimants and compliance with state laws related to insurer conduct.

As a result of concerns over pricing and discriminatory behavior at Beacon, DBR scheduled a targeted market conduct examination ("Examination") that began in September of 2005. During the Examination process, the report on whistleblower allegations issued by Beacon's outsourced internal auditors, Sansiveri, Kimball and McNamee LLP ("SKM") was made public. Due primarily to the serious allegations delineated in the SKM Report, as well as Beacon's failure to disclose such allegations to DBR staff, DBR decided that it was necessary to broaden our Examination and conduct a more extensive, forensic-type investigation utilizing the services of an expert consultant, Deloitte Financial Advisory Services LLP. This report sets forth the findings of our Examination.

Beacon serves a special purpose in the insurance market in Rhode Island, not only as the workers' compensation carrier of last resort but as the primary workers' compensation carrier in the state. Beacon has by far the greatest market share of any workers' compensation carrier in Rhode Island. It would therefore not be an overstatement to say that Beacon's market behavior has a significant impact on employers doing business in Rhode Island. In fact, as the market of last resort, Beacon's continued existence is vital to the economic well-being of the state of Rhode Island.

Our Examination disclosed a corporate culture at Beacon that developed over a number of years and culminated in weak management and controls; inappropriate producer, agency and vendor relationships; favoritism and bias in pricing; inappropriate and lavish spending as well as a disregard for the regulatory process and Beacon's corporate mission and purpose. Certain board members and other favored employers were granted significant and unsupported discounts, leading to lower-priced workers' compensation insurance compared to similarly situated insureds. Charitable contributions were made to institutions related to board members and senior management with little or no evidence supporting the efficacy of the contribution. Commissions were paid to select agents despite missing the required minimum performance thresholds in their contracts. Finally, management, favored agents, and select insureds enjoyed golf trips and other perks constituting unsuitable expenditures for a "non-profit independent public corporation" serving as the market of last resort to Rhode Island employers.

The breakdown in corporate governance and sound management at Beacon is of utmost concern to DBR. Beacon is a mutual insurance company "owned" by its policyholders and operated for the exclusive benefit of those policyholders. Beacon's management owes a duty and responsibility to *all* policyholders, not just a chosen few. Management is not free to utilize the assets of Beacon for any purpose beyond that enumerated in the company's enabling act. It is an egregious misuse of management prerogative to divert the assets of this insurer to certain favored insureds at the expense of all others. Corporations such as Beacon that are instilled with the public trust must be held to a higher standard. Strong corporate governance is essential to ensure the continued viability of any such entity. We can only speculate what might have happened had this behavior continued.

This Executive Summary and the accompanying report present our procedures and findings resulting from the Examination of The Beacon Mutual Insurance Company.

Summary of Procedures

During the course of the Examination, we performed detailed procedures in each of the following sections:

- Background, History, Culture and Corporate Structure,
- Financial Controls and Cash Disbursements,
- Premium Pricing and
- Political Activities.

The accompanying report details the procedures performed throughout the Examination in each corresponding section. Broadly, we:

- Read the Report of the Almond Ad Hoc Review Committee ("Almond Report") and SKM's investigation report into the original whistleblower allegations and both parties' supporting workpapers,
- Performed background research related to Rhode Island legislation, statutory filings, annual reports, and other sources,
- Conducted discussions and interviews with Beacon personnel,[1]
- Participated in discussions with Beacon's consultants and auditors,
- Performed data analyses utilizing Beacon's insurance and financial data as well as data obtained from third-party sources, and
- Obtained and forensically analyzed electronic mail ("Email") and other electronic files.

[1] During this Examination we reviewed Beacon's books and records and conducted discussions and interviews with Beacon employees. We did not interview third parties such as agents, vendors or insureds as part of this Examination. DBR, however, retains the right to perform such inquiries at DBR's discretion subsequent to the release of this report.

Summary of Findings

Background, History, Culture and Corporate Structure

The State Compensation Insurance Fund ("Fund"), a non-profit independent public corporation, was created on July 11, 1990 by the legislature with the enactment of R.I.G.L. §§ 27-7.2-1 *et seq*. The corporation was capitalized with a loan from the state of Rhode Island in the amount of $5,000,000. The creation of the Fund was one of a number of reforms enacted by the legislature in response to a "crisis" in the workers' compensation insurance market in Rhode Island characterized by increasing premiums and the departure of private carriers from the marketplace. In addition to creating the Fund, the legislature enacted several broad-based reforms impacting the workers' compensation system as a whole, including substantially amending certain statutes governing benefits paid to injured workers in addition to significant reforms to the Workers' Compensation Court.

The name of the Fund was changed to The Beacon Mutual Insurance Company in July 1992. Beacon is organized and operated as a domestic mutual insurance company for the purpose of insuring Rhode Island employers from liability for personal injuries for which their employees may have been entitled to benefits under provisions of Rhode Island Workers' Compensation, Federal Longshore and Harbor Workers, or Employers Liability laws. The current version of Beacon's enabling act[2] states its purpose as, "to ensure that all employers in the state of Rhode Island have the opportunity to obtain workers' compensation insurance at the lowest possible price. It is also the policy and purpose of this act to establish and maintain that [Beacon] shall be the workers' compensation insurance carrier of last resort" (2003 P.L. ch. 410 § 3). Beacon's obligation as the "carrier of last resort" or "residual market" insurer was added by the legislature effective May 18, 1992. Beacon did not issue its first policy, however, until August 1992.

Since inception, Beacon experienced rapid increases and decreases in growth. In the 1980s and early 1990s, many insurance carriers stopped writing workers' compensation in the state, contributing to a "crisis" in the industry. The substantial majority of employers were therefore forced to rely on Beacon's predecessor, a statutorily mandated pooling mechanism among voluntary workers' compensation carriers, to procure necessary workers' compensation coverage. As part of the legislative reform mentioned previously, beginning in May 1992, the "carrier of last resort" obligation was transferred from this "pool" of carriers to Beacon, causing Beacon's market share to grow rapidly.

As the workers' compensation market stabilized, Beacon lost market share to carriers reentering the state. To illustrate, in 1994, Beacon's market share was 90% but by 1997, it had dropped to 51.5%.[3] Beacon's enabling legislation states that "[t]he general assembly declares that a stable market for workers' compensation insurance for all employers seeking coverage is necessary to the economic welfare of Rhode Island, that a

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[2] In 2003 R.I.G.L. §§ 27-7.2-1 *et seq*. was moved to 2003 P.L. ch. 410 § 3. This move was expressly stated by the legislature.

[3] 1997 represented the year in which Beacon experienced its lowest market share since its creation to date.

stable and competitive insurance market will benefit all employers, all employees and their families…" 2003 P.L. ch. 410 (3)(f). Thus, the return of carriers into the marketplace and the decrease in Beacon's market share was the fulfillment of the legislative intent as stated in Beacon's enabling legislation. However, instead of welcoming the competition, Beacon management changed its marketing strategy to win back its former position. Beacon began focusing on its distribution channel of independent insurance agents, and offering deep discounts and programs that were counter to the filed and approved rates it was required to utilize.

Beacon focused on keeping its largest agents satisfied through pricing favors called "agent accommodations" and the intentional manipulation of contingent commission rules. Senior management also provided several of their largest agents with Beacon-sponsored gifts, travel and golf-related events.

Certain agents began to exert significant influence over day-to-day pricing decisions that should have been made using the prescribed underwriting principles per Beacon's filed and approved rates. Underwriters' decisions on pricing were overturned based on senior management's unsupported discretion following negotiations with agencies. These decisions, and other pricing decisions that deviated from the schedule rating and experience rating tools that Beacon was required to utilize, were referred to as Beacon's "Right Pricing" philosophy.

Beacon won back its market share by 2003, when it captured approximately 76% of all Rhode Island workers' compensation premium written, accounting for approximately 90% of all insured employers in Rhode Island. Beacon's market share increase was, at least in part, a result of pricing and business practices that constituted a number of statutory violations outlined throughout this report. In a memo dated April 13, 2006, that Joseph Solomon ("Solomon"), Beacon's former chief executive officer ("CEO"), addressed to the board of directors subsequent to the release of the Almond Report, he explained, "Beacon's growth, financial results and the stability we have brought to the Rhode Island workers' compensation market have been extraordinary. Unfortunately, it appears to have occurred at the detriment of equity, consistency and process."

In addition to premium pricing issues, the corporate structure and financial controls environment at Beacon allowed senior management to engage in an array of questionable and unchecked business practices. In addition to maintaining direct control over all departments at Beacon, Solomon also appeared to control many of the members of the board of directors.

We agree with the following statements in the Almond Report which indicated that:

- *"Beacon's system of internal controls and processes is not sufficient, nor adequately documented, to support many of the management decisions being made,"*
- *"There exists a strong culture of conformity at Beacon which may discourage any dissent or challenges to management decisions,"*

- *"Directors have not exercised strong control over Beacon and Board discussion appears to have been limited or dominated by certain individuals, particularly the former Chairman."*

Broad Statutory Violations

Based on the results of the Examination, DBR has concluded that Beacon has violated the following statutes with the listed practices and programs. See the "Statutory Violations" section of the report for more detailed information.

R.I.G.L. § 27-7.1-5.1(a) – Beacon and every other insurer writing in Rhode Island may only write insurance on forms and rates that have been approved by DBR. DBR approval is to assure that the statutes governing workers' compensation insurance have been followed and to assure that the rates charged are not excessive, inadequate or unfairly discriminatory. Beacon systematically violated this statute by charging employers rates that had not been approved by DBR. Beacon violated this statute by:

- Failing to adopt the National Council of Compensation Insurance's ("NCCI") advisory loss cost decreases approved by DBR in 2005 and 2006,
- Utilizing unapproved "Safety Groups,"
- Entering into multiple-year deals with select employers,
- Applying a loss rating approach called "Trend and Development" to select large policies,
- Utilizing incorrect experience modification factors,
- Misclassifying payroll exposure,
- Entering into unapproved special shared earning plans, and
- Failing to file net of commission pricing.

2003 P.L. ch. 410 § 3 – On at least two occasions, Beacon offered coverage through its out-of-state fronting arrangements to out-of-state payroll exposure for employers with no business connection to a Rhode Island employer.

R.I.G.L. § 27-7.1-4.1 – Unfair discrimination occurs when similarly situated employers receive different rates without justification of different risk, experience, or expenses. This Examination found that Beacon violated this statute in the rating of policies, including 13 accounts on Beacon's "VIP" list that received preferential treatment.

R.I.G.L. § 44-17-1 – We found numerous accounts with both Rhode Island and out-of-state policies that showed very large credits on the Rhode Island policies but no credits on the out-of-state policies. Interviews and documents indicated that the credits on the Rhode Island portion of these accounts were increased in order to offset the high out-of-state policy prices. These "high" out-of-state prices were a result of the fronting company, in accordance with statutory requirements, utilizing it's filed and approved rates in the other states. This practice not only violated the statutory requirement to utilize filed and approved rates in Rhode Island, but also reduced the premium tax payable to the State of Rhode Island. Insurers, including Beacon, pay 2% premium tax on gross premiums written in Rhode Island.

R.I.G.L. § 28-37-14 – This law requires the payment of an assessment to the Rhode Island Department of Labor and Training ("DLT") based on gross premiums. The practice of combining in-state and out-of-state policies for pricing purposes also reduced the amount of the assessment payable by Beacon under this statute and shifted the payment burden to other insurers in the state.

2003 P.L. ch. 410 § 11(d)(2) – Between September 26, 2001 and March 22, 2006, Beacon failed to notify DBR of "consent-to-rate" pricing. Over 2,800 policies were issued with consent-to-rate pricing between 2002 and 2005 without proper notification to DBR.

2003 P.L. ch. 410 § 6, § 10, and § 13 – The Examination found numerous expenditures authorized by Beacon senior management or the board of directors that DBR has concluded were not necessary or appropriate to administer Beacon's operations.

2003 P.L. ch. 410 § 16 – This section provides that Beacon's board of directors is responsible for establishing the schedule of commissions to be paid to Beacon's independent agents. In the "Agent Commissions" section of this report, we outlined a number of instances where Beacon senior management or underwriting personnel modified these schedules for certain agents in order to provide higher commission than Beacon was obligated to pay pursuant to its contracts. We also found that Beacon's board of directors was not provided sufficient information to determine the effect of the adjustments to the contingent commission formula. DBR concludes that these modifications represent violations of 2003 P.L. ch. 410 § 6, § 10 and § 13, since such payments were not necessary for the administration of Beacon and were violations of 2003 P.L. ch. 410 § 16 because the payments were made in addition to the "schedule of commissions" approved by the board.

R.I.G.L. § 27-54-1 – This law makes it illegal for anyone to provide false information to DBR knowingly, and with the intent to deceive, during an examination. We found one instance where Beacon underwriting management instructed underwriting personnel to create and backdate a document to be provided to DBR as part of the Examination**.**

Financial Controls and Cash Disbursements

During the course of the Examination, we identified certain financial control risks that may have allowed for abusive practices in terms of excessive spending on items that DBR has concluded were not necessary to Beacon's operations. Several risks we identified related to process controls based on discussion with and interviews of Beacon finance department personnel include:

- Each individual department is responsible for establishing its own controls, policies and procedures.
- The chief financial officer ("CFO") does not function as an executive-level officer. Instead, the title of CFO is a formality and a requirement for signing certain official Beacon documents.
- No one in the finance department is responsible for reviewing the reasonableness of expenses originating from other departments.
- Beacon does not have a formal vendor selection and approval process, and thus new vendors are not evaluated appropriately.
- Beacon does not have a formal procedure related to check signing authorization.
- Checks of $5,000 or less are automatically signed with printed signatures and are not subjected to independent verification of the reasonableness or appropriateness of the payment outside of the requesting department.
- Beacon's finance department did not verify approval for all payments that Solomon represented were approved by the board.

During our procedures related to the accounts payable disbursements data, we identified a number of potential risks related to Beacon's information systems, particularly those related to the processing of accounts payable disbursements and maintenance of Beacon's vendor master file including:

- The majority of personnel in the finance department have access to the vendor master file, including the ability to add, change or delete vendor information without approval or oversight.
- The vendor master file has not been subjected to regular maintenance and purging. The data within this file contains records with missing data, duplicate information and outdated and dormant accounts.

- An employee can generate and send out valid checks without a record of the payments being recorded in Beacon's books and records.

During the Examination, a total of 390 accounts payable disbursements were selected in order to identify potentially improper payments. We categorized and summarized our significant findings in the following sections. It is DBR's opinion that the following disbursements, in addition to several other disbursements in the "Financial Controls and Cash Disbursements" section, were not "necessary, appropriate, and convenient to administer" Beacon's operations, and therefore in violation of 2003 P.L. ch. 410 § 6, § 10 and § 13.

Golf Payments

We found that Beacon spent over $1.1 million on golf-related events, attire, and travel over the three-year period 2003 through 2005. These expenditures benefited Solomon and David Clark ("Clark"), Beacon's former vice president of underwriting, as well as several contract agents of Beacon. The $1.1 million included:

- Over $540,000 paid to a golf club in Massachusetts for a corporate membership where Beacon senior management entertained select agents and other guests. This amount included several events where Beacon covered the cost of certain agencies' functions where Beacon's sponsorship was kept private and the benefit to Beacon was unclear.
- Over $340,000 paid to a country club in Rhode Island including $203,000 which was paid to the pro shop for merchandise.
- Approximately $110,000 incurred by Beacon related to golf trips taken by Beacon senior management and selected agents to Scotland, Florida, California, North Carolina and Wisconsin. The Scotland trip alone accounted for approximately $34,000 of the total costs.
- At least $20,000 was paid to support the PGA career of an agent's son.

Charitable Contributions

Beacon paid $1.1 million to various charitable organizations over the three years 2003 through 2005. We found two instances where payments were made to organizations related to Solomon and Sheldon Sollosy ("Sollosy"), the former chairman of the Beacon board of directors, including:

- A $25,000 payment Solomon approved to a hospital in December 2005 that was not approved by the board of directors in accordance with Beacon's corporate giving policy.[4] Solomon was the corporate chairman for the charity event and his wife was on the board of trustees of the recipient organization. This insured's policy contained a multiple-year deal, understated payroll and an incorrect, lower experience modification factor. The pricing was heavily weighted in favor of the insured and over the course of the policy, losses exceeded premiums by approximately $10 million. See Allegation 5 in the "Original Whistleblower Allegations" section of the report for more detail.

- Beacon's board authorized a $100,000 donation over a five-year period to a local library. Sollosy was a "Trustee Emeritus" of this organization. It is unclear what benefit, if any, this donation had to Beacon or its policyholders and it appeared that the only connection to Beacon was Sollosy's relationship.

Beacon Senior Management Additional Benefits

In addition to management's compensation packages, which the Almond Report found "excessive," members of senior management received other benefits including:

- Solomon was provided a leased corporate car as part of his employment contract. Beacon payments for a Lexus and Volvo over the three-year period 2003 through 2005 totaled approximately $50,000. Solomon also authorized Beacon to buy a Lexus vehicle that was previously leased for him, and then to immediately sell the vehicle to a Beacon vice president. Beacon sold the Lexus to the vice president for $11,363 less than it cost Beacon. The difference in price was not included as income on the vice president's tax forms.
- Solomon paid for club memberships, in addition to the corporate country club membership, on behalf of several members of senior management. We found approximately $41,000 in payments related to these memberships.

Contingent Commissions

The Almond Report indicated that Solomon and Clark made certain adjustments to the annual contingent commissions calculations in order to pay commissions to large agents that did not earn them. We did not find any information that contradicted the Almond Report's findings in this area. Based on documentation we read related to contingent commissions, we found that the board of directors was not provided sufficient information to quantify the financial impact of these adjustments to Beacon. The Almond Report concluded that Beacon paid approximately $2.5 million in unearned commissions to agents that it was not contractually obligated to pay. During the course of our Examination, interviews and documents confirmed that Solomon and Clark made

[4] According to Beacon's Corporate Giving policy dated June 2005, contributions in excess of $10,000 to one entity in one calendar year require the approval of the board of directors.

inconsistent adjustments to the contingent commissions schedules for the benefit of a select group of contract agents.

Between the years 1999 through 2002, a select few agents were paid a total of $2 million in unearned commissions that were based on loss ratios that did not meet the 65% or better loss ratio per Beacon's contingent commission guidelines.

It is important to note that many of the agencies that did not qualify under the Beacon guidelines for contingent commissions are the same agencies that represent clients that received discriminatory credits on their Beacon policies, usually resulting in a higher than acceptable loss ratio.

Other Expenses

We found other payments for which the business purpose of Beacon was not apparent including:

- Beacon paid approximately $340,000 to an insured for use of a luxury box at Gillette Stadium in Foxborough, Massachusetts for football games and other events. The CFO of this insured was also a member of Beacon's board of directors and the chairman of Beacon's audit committee during the period that Beacon made some of these payments. Of the $340,000 paid by Beacon to the insured, $255,000 was paid for a luxury box, $71,000 was for additional football tickets, and $13,700 was paid for concerts and other tickets. Documents suggested that tickets were distributed to members of senior management, certain Beacon board members, certain agents of Beacon, and selected insureds. See Allegation 4 in the "Original Whistleblower Allegations" section of the report for more detail.
- Beacon had an unwritten policy of paying for the spouses of executives to accompany them on out-of-town business meetings. The Examination showed that both Solomon and the CFO took advantage of this policy.

Premium Pricing

Original Whistleblower Allegations

We compared the findings of the Almond Report with respect to the six policies mentioned in the original whistleblower allegations to our findings and nothing came to our attention that contradicted the Almond Report's findings. During the course of the Examination, some additional information pertaining to these accounts came to our attention, which we report in the "Original Whistleblower Allegations" section. The most significant of our findings related to a hospital in Massachusetts that was an affiliate of a hospital organization.

Beacon continued to insure this hospital for one year after it disaffiliated from the hospital organization despite the fact that it was a Massachusetts-based hospital with no corporate affiliation to a Rhode Island employer. Through interviews, we found that Beacon management knew this, but still offered the coverage because they "liked their premium." At the time, the premium of $2.1 million was Beacon's second largest account yet it was unprofitable to Beacon and its mutual policyholders. See Allegation 5 in the "Original Whistleblower Allegations" section of the report for more detail.

Two of the policies mentioned in the original whistleblower allegations were affiliated with members of Beacon's board of directors. In order to sit on the Beacon board of directors, a director must be a Beacon insured, with the exception of the Director of DLT and Beacon's CEO. We reviewed policies written by Beacon for companies either owned by or affiliated with members of Beacon's board of directors. We found instances where the policies were not properly underwritten, and where there was outside influence in the underwriting of the policy. In the cases reviewed and discussed below, the incorrect underwriting was always of benefit to the company owned by or affiliated with the board member.

Allegation 1 – Sollosy was the former owner of this insured. According to documents obtained during our Examination, Sollosy submitted only summary information to Beacon instead of detailed payroll information by individual employee. Claims filed on the policy did not match the job descriptions on the policy, which indicated that payroll was not classified correctly. As a result of these misclassifications, the account was unprofitable to Beacon. Senior management, despite having knowledge of the limitations imposed, did not make an effort to correct the problem.

Allegation 4 – The CFO of this insured was on the Beacon board of directors until his resignation in 2006. Our Examination showed that Beacon premium audit personnel reported payroll misclassifications on numerous occasions. Further documentation indicated that Solomon had knowledge of and approved the payroll misclassifications. If Beacon had priced the policy with the appropriate payroll classifications, the premiums for this insured might have been $431,000 higher over the nine-year period 1998 through 2006.

While the Examination did not find that board members other than Sollosy improperly influenced the pricing of their companies' policies, it is clear that Beacon senior management extended significant discounts because of their board affiliation.[5] As members of the board of directors, with certain fiduciary duties to Beacon policyholders, it is reasonable to expect board members to review the pricing of their own accounts and challenge Beacon's pricing practices when they result in inadequate premium. The

[5] In addition to these two insureds mentioned in the original allegations where Beacon board members were executives of the insureds, the Examination found that another insured owned by a Beacon board member received preferential pricing. Other companies with non-ownership affiliation to board members were also given preferential pricing.

failure to do so with respect to the above policies, and any other policy related to a board member's interest, represents a failure of corporate governance.

CompAlliance Program Credits

CompAlliance is a managed care and employee wellness program for insureds started by Beacon in partnership with Blue Cross and Blue Shield of Rhode Island. According to the filed and approved program, insureds can earn up to a 10% credit on premium depending on their level of health care coverage. The approved filing allows Beacon to grant credit based on the employers' level of health care coverage. We found that Beacon generally did not perform due diligence to determine the level of qualified coverage, if any, before issuing these discounts. Our data showed that, from the inception of the program, Beacon granted over $53 million in discounts related to the program.

Safety Groups

Approximately 17% of Beacon policies were part of a safety group in 2005. The rating plans offered for all of the 12 safety groups were not properly filed with DBR and therefore constituted a statutory violation as reported above. In addition, based on queries we performed on Beacon's insurance data:

- At least four safety groups were provided three-year deals guaranteeing stable pricing at some point over the history of the group,
- Six of the 12 safety groups had cumulative loss ratios through 2005 above the Beacon target loss ratio of 65%,[6]
- The safety groups with the three highest cumulative loss ratios were also those that received the highest discounts,
- Agents from Beacon's largest agencies acted as consultants to the following safety groups:
    - Manufacturers Comp Group of Rhode Island,
    - Care Provider Network,
    - Rhode Island Marine Trade Association,
    - Rhode Island Health Care Association and
    - Rhode Island Builders Association.
- We found some instances where specific insureds in a safety group received benefits greater than the maximum allowed according to the safety group agreement due to human error or pricing accommodations made by Beacon and

[6] See the "Overall Pricing Patterns – Loss Ratio" section for an explanation of the target loss ratio for in-state and out-of-state policies.

- Beacon developed three shared earnings plans specifically for certain safety groups, but did not file these plans with DBR.

Out-of-State Coverage

We found that Beacon did not have clear policies and procedures related to its coverage of:

- In-state payroll exposure related to out-of-state employers or
- Out-of-state payroll exposure related to Rhode Island employers.

As explained in the Massachusetts hospital example above in the "Original Whistleblower Allegations" section, we also found two instances where Beacon knowingly provided out-of-state coverage to companies with no corporate affiliation to Rhode Island employers.

Overall Pricing Patterns

We performed queries on Beacon's insurance data pertaining to Beacon's policies from 2003 through 2005 in order to identify patterns and trends of Beacon's pricing and noted the following:

- Approximately 15,700 Rhode Island policies were issued annually from 2003 through 2005, and the average policy issued over this three-year period had $9,740 of premium.
- Approximately 82% of all policies issued had less than $10,000 of premium but these only contributed approximately 19% of Beacon's total written premium.
- Approximately 29% of insureds received schedule or consent-to-rate credits totaling approximately $116,800,000 in discounts during this period. Of the 29% of insureds that received a schedule or consent-to-rate credit, the average discount was approximately 28%, and the average premium was $21,529.
- Less than 0.5% of all Beacon insureds were debited during the period, totaling approximately $1,500,000 of surcharges.
- Larger insureds were provided with more schedule and consent-to-rate credits despite having less favorable loss experience.
- Agents that produced the most business with Beacon procured more discounts for their accounts than agents with smaller books of business.
- Loss ratios for the books of business of Beacon's largest agents were higher compared to smaller agents.

- The 50 largest agents, approximately 8% of all Beacon agents, produced approximately 75% of total premium.

<u>Individual Policies</u>

During the course of the Examination we performed procedures on a number of different insureds. Based on the results of these procedures, we requested and read documentation supporting the premium pricing for 58 policies that violated one of the statutes listed above or showed significant agent influence. We categorized these findings into several "buckets" by issue. Many of the policies we looked at had more than one issue, and for the purpose of presentation have been counted more than once. The table below shows the results based on 20 categories of issues we identified throughout this Examination:

Category Description	Number of Policies
Inadequate Pricing	25
Agent Influence or Accommodations	21
Multiple-Year Deals	20
VIP Accounts - Preferential Pricing	13
Inappropriate Experience Modification Factor Utilized	11
Misclassification of Payroll	9
Combining Policies (In-state and Out-of-State)	8
Retroactive Adjustments to Credits/Shared Earnings	7
Out-of-State (Disproportionate Out-of-State Policy Size)	4
Special Shared Earnings	3
Tiered-Pricing Plans	3
Composite Rate	2
Improper Classification Code Rate Utilized	2
Net of Commission Pricing	2
Non-Collection of Prior Balances	2
Out-of-State (Non-RI Employer)	2
Political Motivation	2
Possible *Quid Pro Quo* Arrangements	2
Consent-to-Rate (other than non-notification)	1
Special Standard Commissions Paid	1
TOTAL	**140**

We did not read supporting documentation for every policy written by Beacon. The results above are based on the procedures we performed during the Examination. If we had performed additional procedures, we may have found other instances within these categories or additional categories altogether. Detailed findings for each of these insureds are presented throughout this report. We have summarized several of the most relevant findings below:

- Beacon underwriters have the ability to manually adjust several rates that should be automatically entered, including the base commission rate paid to agents and the approved classification code rates for payroll. We found that Beacon used incorrect classification code rates on several policies. We also found one instance where Clark authorized an adjustment to the base commission for an agent.

- We found that there was widespread knowledge among the underwriting department personnel of a "VIP List" maintained by Clark. We located several versions of this listing throughout the course of the Examination. Insureds on the listing included board members' companies, companies with relationships to Beacon senior management and companies attributed to certain Rhode Island politicians. We found that several of these companies received preferential treatment that often translated into pricing that was not commensurate with the loss experience. One company, owned by a Beacon board member, was provided favorable pricing by Beacon that included a multiple-year deal. The account also received significant discounts from the inception of the policy despite periods of substantial losses.
  - The Almond Report indicated that Solomon denied knowledge of the existence of the VIP listing, but we found Emails that showed Solomon suggested additions to the list as late as July 2005.
  - The Almond Report also said that Clark claimed that Solomon instructed him to delete the VIP list. We found an Email where Clark explained this instruction.
- We found seven instances where Beacon retroactively adjusted the credit structure of a policy following the policy expiration date. NCCI's Basic Manual does not allow for retroactive adjustments to credits nor does Beacon have an approved filing that would allow this.
- We found two instances that appeared to show a *quid pro quo* arrangement that resulted in preferential pricing for insureds. The first involved a contractor that performed work on a vice president's home and was subsequently provided a 20% discount for three years on his workers' compensation policy. The second involved another contractor on the VIP list who appeared to receive a discount as consideration for the fact that, as a non-union contractor, they were precluded from working on the construction of Beacon's facility.

Political Activities

The Examination revealed several transactions and relationships that appeared to be politically motivated. This activity increased during the period of time that Beacon-supported legislation was being considered by the Rhode Island General Assembly. Several of our findings have been summarized below. See the "Political Activities" section of the report for more detailed information.

Cornerstone Communications Group and Checkmate Consulting Group LLC

Beacon's former marketing and political consulting vendor, Cornerstone Communications Group ("Cornerstone"), was owned by a well-known lobbyist and political figure in Rhode Island. As part of Cornerstone's contract, Beacon provided office space and services for no charge between April 1, 2002 and March 15, 2006. Although we did not have access to the books and records of Cornerstone or its successor company to determine whether or not the income was reported as taxable by the payee, we found that Beacon did not include this benefit on Form 1099's for tax purposes.

Over the four-year period 2002 through 2005, Beacon paid Cornerstone approximately $720,000. We performed additional procedures on several selected payments and found approximately $93,000 of charges that were not adequately supported, or the benefit to Beacon was not clear. Among these charges we noted that:

- Beacon paid $21,000 purportedly for costs related to a public information campaign with DLT and the Independent Insurance Agents of Rhode Island ("IIARI"). No one we spoke to at Beacon could recall a campaign taking place and representatives from DLT told us no campaign took place.
- Cornerstone charged Beacon $34,000 reportedly for agent "focus groups" that it ran. No one we spoke to at Beacon could recall these focus groups taking place. Documents suggested that these costs were related to a marketing campaign called "Trusted Choice" that IIARI hired Cornerstone to coordinate. Beacon provided us with materials on this campaign.[7] The campaign was clearly designed for independent agents and was not specific to Beacon or workers' compensation insurance. In fact, none of the Trusted Choice documents we read mentioned Beacon or its financial support for the program.
- Beacon paid Cornerstone $27,875 for "safety videos." No one we spoke to at Beacon could recall Beacon commissioning Cornerstone to produce these videos and no one in the loss prevention department had any knowledge of the production. In the opinion of the loss prevention manager, the videotape that was provided in support of the charges was, put together "rather quickly" and of "poor quality." Members of Beacon's management team characterized these charges as "extremely disturbing" and said that they "smelled funny."

After Beacon publicly announced its disaffiliation from Cornerstone in November 2005 following comments that the lobbyist made about the Governor of the State of Rhode Island, several Cornerstone employees started a new company, which was operated by the lobbyist's son. Beacon paid this new company, Checkmate Consulting Group LLC, approximately $11,000 and provided them with office accommodations at no charge before severing the relationship in April 2006.

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[7] "Trusted Choice" was a "branding" campaign adopted by the Independent Insurance Agents & Brokers of America in 2002 to promote the use of independent agents.

Politically-Motivated Write-Offs

We found two accounts that had been cancelled for nonpayment where Beacon ceased its collection efforts and wrote the remaining receivable balances off to bad debt for politically-motivated reasons. Both of these accounts were connected to representatives of the Rhode Island General Assembly, and the transactions occurred while Beacon was attempting to ensure the passing of legislative changes to its enabling act.

- Beacon wrote off approximately $289,000 of receivables for companies related to the same owner and then reinstated the workers' compensation coverage without attempting to collect past due balances. The attorney for this insured was the brother of a state representative.
- Beacon wrote off an additional $229,000 of receivables for another company related to the attorney above and called off collections efforts.
- Beacon personnel we spoke with indicated that both of these transactions were politically motivated and were agreed to in order to "buy votes."
- Solomon authorized a payment of $25,000 to another state representative purportedly hired to assist in the collections efforts for the two companies mentioned above. No one we spoke to could recall any services performed by this person. Current Beacon management requested information from this representative and he responded that he has no documentation to support the work performed on this "fixed fee" arrangement.

Beacon Mutual Political Action Committee

Beacon established the Beacon Mutual Political Action Committee ("PAC") reportedly to reduce the amount of personal requests that Beacon senior management was getting for political donations. It is our understanding that not-for-profit entities such as Beacon are banned from making direct political contributions. All PAC contributions were made by Beacon management and their families and the owner of Cornerstone individually, and Beacon funds were not used. However, some members of senior management indicated that their PAC contributions would be reimbursed by Beacon through bonuses.

Contributions to a Politician

Between May 27, 2005 and June 30, 2005, we found that 14 Beacon employees, board members and related consultants contributed $15,600 to the political campaign of a Rhode Island candidate. Several of these "personal" political contributions of Beacon employees were made at the request of Solomon in a coordinated effort. Based on discussions with several of the donors, Solomon offered to personally reimburse them for their donations, and two employees told us that they accepted his offer and were reimbursed. We also found several Emails during this period between the candidate and

Beacon senior management that discussed the pending legislation; however, we did not find any evidence that the candidate took any action to support the legislation.

This is the conclusion of the Executive Summary of the Examination report. The following detailed report is integral to the Examination and must be read in order for the reader to gain a complete understanding of the scope, procedures and findings relating to this Examination.

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EXAMINATION PROCEDURES

Overview and Purpose

We developed procedures to accomplish the following:

- Understand Beacon's background, history, culture and corporate structure and how these factors have affected business operations, specifically related to premium pricing and agent relationships,
- Obtain an understanding of the financial controls environment,
- Gain an understanding of the cash disbursement process and identify potential improper payments made by Beacon,
- Compare Beacon's premium pricing philosophy and practices to the statutory guidelines under which it is regulated,
- Identify instances where Beacon or its executives made business decisions or used Beacon funds for personal financial gain or related to political matters, particularly in relation to the pending Beacon legislation,
- Identify potential areas for process and controls improvement, including, but not limited to, the areas of finance, underwriting and corporate governance.

Procedures

Broadly, we performed the general procedures listed below for each of the corresponding sections of the report that follow.

- **Background, History, Culture and Corporate Structure**
  - Held informal discussions and formal interviews with selected Beacon underwriting, premium audit, finance, human resources, information systems and senior management personnel
  - Read background information, including annual reports, Beacon's website and other news sources
  - Met with SKM, Beacon's outsourced internal auditors and KPMG LLP ("KPMG"), Beacon's independent auditors
  - Participated in discussions with representatives from NCCI
- **Financial Controls and Cash Disbursements**
  - Discussed the controls environment and obtained an understanding of the cash disbursement cycles at Beacon
  - Obtained detailed general ledger and insurance financial data, and reconciled this data to Beacon's audited financial statements

- Isolated the cash disbursement data from both the detailed general ledger and insurance financial data
- Performed queries on the cash disbursement data to profile the data, to look for potential controls issues and to identify anomalies
- Made judgmental selections of specific vendors and disbursements based on the results of the queries performed on the cash disbursement data
- Discussed the business purpose for certain vendor relationships and requested and read supporting documentation for selected payments, including, but not limited to, cancelled checks, invoices, check requests, purchase orders, contracts, agreements, memorandums and other correspondence, including Email
- Performed a search of publicly available records related to certain selected Beacon employees, executives, board of directors members, insureds and vendors including the following:
    - Online and manual public records, including, but not limited to, online searches covering litigation, bankruptcies, business affiliations, judgments, federal and state tax liens, UCCs, assets, regulatory filings and news media and trade sources, as well as manual civil and criminal litigation searches that were conducted on-site in relevant jurisdictions
    - Our searches primarily focused on records positively identifiable with the subjects via known social security numbers, addresses, dates of birth or other identifying information. The level of research for each subject varied on a judgmental basis.
    - We compared the results of the public records search to Beacon's vendor and cash disbursements data to find potential corporate affiliations and undisclosed relationships.
- Requested and read selected agent contracts related to commissions and obtained an understanding of the processes and personnel involved in the commissions calculation through discussions and interviews
- Read the Almond Report dated April 10, 2006 and workpapers related to work performed on contingent commissions
    - The Almond Report and workpapers were prepared by Giuliani Security & Safety LLC ("GSS") and the law firm of Bracewell & Giuliani LLP.
- Scanned payroll data including dates of services, names of employees, and salary information
- Searched Email and other electronic documents

- **Premium Pricing**
  - Read correspondence between Beacon and DBR including rate and program filings
  - Requested and read certain hardcopy documentation including policy files, Beacon account summaries, and policy declarations
  - Requested and were granted read-only access to Beacon's document imaging system and insurance software system and performed searches for policy information
  - Ran queries on Beacon's insurance software and premium audit software to show financial performance, loss experience and policy notes entered by underwriting, premium audit and finance for selected policies
  - Identified policy pricing trends, anomalies, and notes as a result of the queries performed on the insurance and premium audit data, selecting specific insureds for more detailed procedures
  - Interviewed Beacon personnel related to findings and made additional policy selections based on the results of our interviews
  - Read the Almond Report, SKM's report and related workpapers that pertained to the original whistleblower allegations
  - Compared the Almond Report findings to information obtained during the Examination and noted any supplementary or contradictory information gathered from our procedures for the policies mentioned in the whistleblower allegations
  - Obtained an understanding of Beacon's CompAlliance, Loss Free, Safety Group programs as well as its out-of-state coverage, and performed queries around Beacon's application of the guidelines of each of these related to premium pricing
  - Queried Beacon's insurance data to show the financial performance and Beacon pricing practices of policies based on a number of factors, including policy size, agent size and credit structure
  - Requested and obtained from NCCI electronic data containing Beacon's 1998 workers' compensation classification code rates as well as NCCI's experience modification factors ("EMods") for Beacon policies with rating effective dates between January 1, 1995 and September 19, 2006[8]
  - Compared the financial performance of insureds from selected industry classifications to identify pricing that appeared to be out-of-line compared to their peer groups

[8] This data included information as of April 20, 2006.

- Searched Email and other electronic documents for versions of the "VIP Listing" referenced in the Almond Report and performed additional procedures on selected accounts from this listing
- Searched Email and other electronic documents to identify additional policies and to supplement the results of our queries

- **Political Activities**
  - Obtained an understanding of Beacon's relationships with lobbyists and political consulting firms and judgmentally selected related disbursements for additional procedures
  - Searched Emails and other electronic documents to identify potentially improper politically- related payments and relationships

EXAMINATION PROTOCOL AND ELECTRONIC DISCOVERY

Data and Document Requests

Solomon requested that we follow certain protocols during the Examination with respect to requests for documents and data and interview scheduling. Solomon asked us to process all requests through an attorney from Beacon's counsel and a finance department employee. The attorney insisted that a representative from counsel be present for all substantive discussions that we scheduled with Beacon personnel.

Initially, all documents we requested, regardless of the source, were sent from Beacon employees to counsel and the finance employee before being provided to us. In some cases, documents remained in their possession for several days before eventual delivery to us.

On April 18, 2006, A. Michael Marques ("Marques"), DBR Director, addressed a letter to the members of Beacon's board of directors explaining the "problems this Department [DBR] is encountering in completing its market conduct and forensic examination." Marques explained that "This conduct [Beacon's counsel's scheduling and attendance of interviews and 'legal review' of requested documents] has severely delayed and interfered with the flow of information." The letter requested the board of directors to direct management to "confirm that information will be given to the examiners directly from Beacon employees, without review by counsel, and that no attorney representing Beacon, or any other person from Beacon management, will attend future interviews with Beacon employees."

Within a week of the aforementioned letter, Clifford Parent ("Parent"), the former acting CEO of Beacon following the termination of Solomon, mandated compliance with Marques' requests and all of the protocols were eliminated with one exception. Parent requested that we continue to copy the finance employee, but not counsel, on all document requests so that Beacon could retain a log of all documents provided to us by Beacon during the Examination in case they were asked to produce certain documents at a later date. Following the implementation of these changes, the efficiency of data requests and level of cooperation with Beacon personnel improved.

Electronic Discovery

Electronic Data Requests and Court Proceedings

On March 3, 2006, during our initial discussions with Beacon information systems personnel, we learned that Beacon had implemented a backup facility for its Lotus Notes Email system in November 2004 ("Journal Tape"). This Journal Tape was designed to retain a copy of all Emails sent from or received by Beacon Email addresses. Shortly after this initial meeting, but before the protocol had been discussed with Beacon's counsel and disseminated to the Examination team, we requested the Journal Tape from information systems personnel at Beacon. A Beacon information systems employee provided the Journal Tape to us on the afternoon of March 3, 2006.

Also on March 3, 2006, we requested the hard drives of 22 Beacon employees for imaging by the Analytic and Forensic Technology Practice ("AFT") of Deloitte FAS. Solomon, at the direction of counsel, rejected this request. Pursuant to R.I.G.L. § 27-13.1, Sharon Gordon, DBR Chief Insurance Examiner, delivered a *subpoena duces tecum* for the computers late in the afternoon reiterating the request.

Beacon's counsel formally objected to the subpoena via a letter dated March 3, 2006, which alleged, among other things, that:

- "…the demand is oppressive, overly broad and unduly burdensome, and seeks confidential information, notably, attorney-client privileged information and protected health care information, to which the Department is not lawfully entitled."
- "…the Subpoena flouts every standard of reasonableness afforded by modern jurisprudence and is an illegal and abusive exercise of the Department's powers."
- "Both federal and state law prohibit such information [confidential health care information] to be disclosed to third parties without strict adherence to the applicable statutes."

On the evening of March 3, 2006, after we learned about Beacon's objections to the above-mentioned subpoena, we notified Solomon and Beacon's counsel that the Beacon information systems department had provided us with the Journal Tape earlier in the day. Neither Solomon nor counsel objected to our possession of the tape at the time and the AFT professionals left the premises to return to Deloitte FAS' computer forensic laboratory in Boston, Massachusetts. We made a replica of the Journal Tape and placed both the original and copy in an evidence storage vault within the computer forensic laboratory.

Beacon's counsel drafted another letter, also dated March 3, 2006, which alleged, among other things, that the Journal Tape was "mistakenly turned over to the Department" by an employee, who failed to "consult with Beacon's management or counsel prior to releasing the tape, and released the tape contrary to a written protocol that Beacon had recently established to respond to the Department's requests for information." Counsel requested that "the Department refrain from reviewing any of the contents of that tape and return the tape (and any copies made of it) to Beacon immediately."

Beacon's counsel filed a Temporary Restraining Order ("TRO") with the Kent County Superior Court ("Court") on March 7, 2006. On March 9, 2006, the Court issued a temporary order granting Beacon's motion to quash the March 3, 2006 subpoena and ordering the return of the original Journal Tape to Beacon and the copy of the Journal Tape to be held in the Court's evidentiary vault. We returned the original Journal Tape to Beacon and the copy of the Journal Tape to the Court on March 10, 2006. We did not read any Emails from the Journal Tape or its copy before returning them to Beacon and the Court, respectively.

On March 17, 2006, DBR filed a “Memorandum in Support of Motion for Interim Preservation and Motion for Reconsideration” to the Court. This motion requested that the Court order Beacon to immediately copy and seal the 22 hard drives requested in the March 3, 2006 subpoena.

On March 28, 2006, both DBR and Beacon agreed to a Consent Order that empowered Beacon to retain the services of a third-party consultant, to “create two mirror image copies” of the 22 hard drives outlined in the March 3, 2006 subpoena. We observed, but did not participate, in the imaging process. Based on our observations, Beacon’s third-party vendor attempted to make a bitstream image (also known as a forensic bit-stream drive copy) of each hard drive onto other “wiped,” or forensically sterile, hard disks using an ImageMasster Solo II Forensic disk-duplicating device. We observed that Beacon’s third-party vendor did not perform an EnCase[9] forensic software preview of the image copies while onsite at Beacon.

On April 28, 2006, the Court entered a second Consent Order which released 19 of the 22 hard drives initially requested. The hard drives for three of the 22 employees originally requested were not provided to us over concerns of attorney-client privilege as well as privacy concerns. In addition, an information systems employee provided us with a listing of all Beacon-owned technology assets. Although Beacon provided only one computer per employee to the third-party consultant, this technology asset listing indicated that several of the employees had more than one computer which had not been previously copied. Furthermore, we learned that the common business practice at Beacon was to leave all Email on the network servers rather than extracting the Email to hard drives. We were also told that Sollosy also had a Beacon Email account.

When we received the copies of the 19 drives from the Court, we documented that many of the copies were flawed, despite the printed report of the ImageMasster device stating that the drives were copied successfully. After documenting the flawed copies, we obtained permission from Beacon to perform our own EnCase forensic images of certain hard drives listed below. We completed these forensic images successfully. They were validated and successfully previewed before leaving the Beacon site.

We performed the following procedures between May 2, 2006 and May 9, 2006:

- Imaged 13 hard drives for five employees (including two former employees, Solomon and Clark, who were terminated by the board of directors on April 20, 2006) and Sollosy,

[9] An EnCase forensic image is a proprietary bit-stream copy of a hard drive's data that is embedded with self-authentication checkpoints throughout the file and is read in “read-only” mode by the EnCase forensic software.

- Requested and obtained the Lotus Notes Email files as of May 2006 and network folders stored on Beacon's network servers for each of the 19 employees and Sollosy,
- Requested and obtained a backup containing the Lotus Notes Email files and network folders for each of the 19 employees and Sollosy.[10]

On May 31, 2006, the Court entered two additional orders releasing the copies of the hard drives pertaining to the remaining three of the 22 employees[11] and the Journal Tape from the Court's evidentiary vault. The hard drive images were made by Beacon's third-party vendor on April 7, 2006, at the same time as the failed images above. Supplemental consent orders entered by the Court on June 15, 2006 and July 10, 2006 approved the release of the home computers of the three employees initially withheld for privilege and privacy concerns, plus one additional underwriting employee. We imaged five additional computers representing the work and home computers of three employees on June 13, 2006 and June 22, 2006.

Summary of Email and Other Electronic Data Sources

During the course of this Examination, we imaged 17 hard drives pertaining to eight different current and former employees and one hard drive pertaining to the former chairman. We also obtained archived and current server Email and network folders for 23 different current and former employees and the former chairman.

Confidentiality Agreement

On April 28, 2006, Deloitte FAS, DBR, Beacon and The Law Offices of Michael D. Lynch executed a Confidentiality Agreement to "preserve the attorney-client privilege and confidentiality with respect to the law firm's direct (non-Beacon) clients, and to prevent any claim of waiver of such privilege and confidentiality being made by any other person or party as a result of the release of the Email tape and hard drive to the Department and Deloitte FAS for the limited purposes identified in this agreement."

The terms of the Confidentiality Agreement were limited to data obtained from "the Lotus Notes Email tape and the…hard drive [of] Michael D. Lynch" ("Lynch"), Beacon's vice president of legal services. This agreement was subsequently amended by two

[10] We requested backup files for Beacon's Email server and network folders as of the date closest to the implementation of the Journal Tape. According to an information systems employee, the dates of the backup files closest to the November 2004 Journal Tape implementation Email and network folders were April 3, 2005 and March, 31, 2005, respectively.

[11] The data obtained from computers of human resources department personnel was subject to additional confidentiality provisions protecting "confidential health information" as well as other confidential human resources-related information separate from the Confidentiality Agreement related to attorney-client privileged information discussed further in this section.

supplemental orders approved by the Court on June 15, 2006 to include data retrieved from the home and office computers, Email files and network folders for four employees.

At the direction of Elizabeth Kelleher Dwyer, Deputy Chief of Legal Services DBR, we performed supplemental procedures on Emails not covered by the Confidentiality Agreement, as amended. We isolated Emails for the 19 employees, former employees and the former chairmain of the board that included any of the Beacon attorneys' Email addresses in the To, From, CC or BCC fields and subjected these Emails to the terms of the Confidentiality Agreement as well.

The Confidentiality Agreement outlined procedures for AFT to perform to protect the privileges claimed. These procedures required AFT to:

- Physically separate the raw data from the "forensic investigators and auditors conducting the forensic audit of Beacon's business records,"
- Conduct keyword searches to identify documents that are "potentially relevant to the examination and forensic audit,"
    - While conducting these searches, AFT personnel were not authorized to "access or otherwise examine the material or documents identified by such searches."
- Conduct a second word search on the "potentially relevant" data population to identify documents associated with The Law Offices of Michael D. Lynch or any one of five named attorneys ("Lynch Firm Lawyers"),
- Provide to Lynch a privilege log of documents identified as associated with the Lynch Firm Lawyers for Lynch to read and assert attorney-client privilege or confidentiality concerns and
- Make available to "other Deloitte FAS or Department personnel" any "potentially relevant" documents that were not associated with the Lynch Firm Lawyers, or which were associated with the Lynch Firm Lawyers to which Lynch had not asserted attorney-client privilege or confidentiality concerns.

Collectively, the resulting documents that followed the completion of the procedures specified above were subjected to the procedures listed below.

Email Procedures – Not Sourced From Journal Tape

We loaded all Emails that met the following criteria onto a secure database, accessed via a web-based litigation management application called Concordance:

- Emails that were gathered from the computers we imaged as well as network Email for 24 Beacon-related personnel consisting of employees, former employees and the former chairman of the board ("Custodians") and

- Emails that were subjected to the procedures required by the Confidentiality Agreement.

The population of Email files listed above dated as far back as 1998. We judgmentally selected the period January 1, 2003 forward for the purposes of the Examination.[12] We developed a forensic keyword listing and applied these keywords against the Email data set. We also performed supplemental searches on the pre-January 1, 2003 population.[13] After eliminating duplicates, we read 49,865 Emails that met all of the aforementioned criteria.

The following table summarizes the Beacon Email files we obtained from all sources other than the Journal Tape:

	Number of Email Files
All Email files obtained from imaged computers and network Email for 24 Custodians:	742,682
Less: Email files which did not contain at least one keyword and/or duplicate Email files:	(684,513)
Unique Email files which contained at least one keyword:	58,169
Less: Email files read by Lynch and asserted as privileged or confidential in accordance with the Confidentiality Agreement:	(247)
Subtotal	57,922
Less: Email from Subtotal dated before 1/1/2003:	(8,200)
Plus: Selected Email files from Pre-1/1/2003:	143
Emails read other than from Journal Tape:	49,865

Email Procedures – Sourced From Journal Tape

In addition to Emails gathered from computers, we imaged network Email for the Custodians and we judgmentally selected seven Custodians from the Journal Tape population including five members of senior management, one board member and an underwriting employee. The purpose of reading Emails from the Journal Tape population was to identify potentially relevant Emails that may have been deleted.

We reduced the number of keywords included in the non-Journal Tape population by eliminating disbursement-specific terms, focusing on policy pricing issues for the Journal Tape population. We performed a modified keyword search on the Journal Tape population of documents for the seven Custodians and extracted all Emails associated

[12] We limited this date range to Emails from January 1, 2003 forward in order to coincide with the timeframe of many of our data queries in the "Financial Controls and Cash Disbursements" and "Premium Pricing" sections.

[13] These supplemental searches were performed on the post-keyword set of data which was already subjected to the requirements of the Confidentiality Agreement.

with any of the Lynch Firm Lawyers. These Emails were sent to Lynch for his assessment in accordance with the Confidentiality Agreement. We read all Emails in the resulting population in addition to the Emails that Lynch did not assert privilege or confidentiality concerns.

The following table summarizes the Beacon Email files we obtained from the Journal Tape:[14]

	Number of Email Files
All Email files included on the Journal Tape:	1,681,122
Less: Email files which did not contain at least one keyword, duplicate Email files, and Email files not related to one of the seven selected Custodians:	(1,661,660)
Subtotal	19,462
Less: Email files read by Lynch and asserted as privileged or confidential in accordance with the Confidentiality Agreement:	(145)
Emails read from Journal Tape:	19,317

Email Procedures – Summary

In total, we read 69,182 Emails sourced from imaged computers, network Email and the Journal Tape, as summarized below:

	Number of Email Files
Emails read (other than from Journal Tape):	49,865
Emails read from Journal Tape:	19,317
Total Emails read:	69,182

After we read the 69,182 Emails, we judgmentally identified 1,058 as relevant to the Examination. These Emails were categorized and printed.

Procedures – Other Electronic Documents

We performed procedures on electronic documents other than Email that were captured from Custodians' hard drives and network home directory folders. We applied a modified keyword search on the text and title of the following electronic document types:

[14] The Journal Tape provided to us for this Examination contained Email data through 2/4/2006. According to an information systems employee, this backup was performed as part of Beacon's "standard operating procedure." Beacon continued to utilize the Journal Tape backup facility. However, we did not request subsequent versions of the backup tapes.

Type of Document	Document Suffix
Microsoft Word Document	*.doc
Microsoft Excel Workbook	*.xls
Microsoft PowerPoint Presentation	*.ppt
Text File	*.txt

These keywords were applied against all non-Email electronic documents of the type described above for all 24 Custodians. Keyword-responsive documents from the computers and network home directories of Lynch were sent to him for his evaluation of privileged and confidential information.

We created a spreadsheet that included the name of the keyword-responsive, non-privileged documents and the keyword(s) for which the document was flagged. We also included a preview field which not only identified the keyword, but also included 60 characters in the string of letters or numbers before and after each keyword. We read all of the records in this preview field and flagged certain documents for further procedures. Documents that were flagged were located, printed and included for consideration with respect to our findings detailed in sections below.

The table below illustrates the population of non-Email electronic documents that we read during the course of this Examination:

	Number of Electronic Documents
All electronic documents (xls, doc, txt, ppt) retrieved from hard drives and home directories for 24 Custodians	70,913
Less: electronic documents not responsive to keywords	(49,895)
Keyword-responsive electronic documents	21,018
Less: Keyword-responsive electronic documents read by Lynch and asserted as privileged or confidential in accordance with the Confidentiality Agreement:	(17)
Total electronic documents read by Deloitte FAS in Preview style	21,001
Less: electronic documents not flagged for further procedures	(20,974)
Total electronic documents printed and read	27

Electronic Documents Redacted by Lynch

Based on the procedures above, Lynch redacted 247 Emails from the non-Journal Tape population, 145 Emails from the Journal Tape population and 17 non-Email electronic documents recovered from his computers and network folders. Based on the Confidentiality Agreement, as of the date of this report, we have not challenged the privilege and confidentiality assertions of any of these 409 documents as allowed by the Confidentiality Agreement.[15]

[15] According to the Confidentiality Agreement, "If the [DBR] and attorney Lynch are unable to resolve any questions of privilege or confidentiality that attorney Lynch may raise, the [DBR] and Lynch shall expeditiously and jointly seek *in camera* review of any disputed documents by a justice of the superior court sitting on the business calendar in Providence County Superior Court."

BACKGROUND, HISTORY, CULTURE AND CORPORATE STRUCTURE

Corporate Status

Beacon, a non-profit independent public corporation, was founded on July 11, 1990, as The State Compensation Insurance Fund, formed pursuant to R.I.G.L. §§ 27-7.2-1 *et seq*. The name of the fund was changed to The Beacon Mutual Insurance Company in July 1992. Beacon is organized and operated as a domestic mutual insurance company for the sole purpose of insuring Rhode Island employers[16] against liability for personal injuries for which their employees may have been entitled to benefits under provisions of Rhode Island Workers' Compensation, Federal Longshore and Harbor Workers or Employers' Liability laws.

Rhode Island Workers' Compensation Crisis

Beacon reported in its 2003 Annual Report entitled, *What a Difference a Decade Makes,* that the Rhode Island workers' compensation industry experienced a crisis in the late 1980s and early 1990s. Peter Burton, director of NCCI at the time, called the state's program "probably the most out-of-balance system in the United States." Prior to July 11, 1990, the Rhode Island workers' compensation market was served by private competitive insurance carriers. These carriers would rate based upon filings approved by DBR, either on behalf of an approved advisory organization or for the individual insurers. The "residual market," which is composed of employers who cannot obtain insurance from a competitive carrier, was served by a "residual market pool." Each insurer writing in Rhode Island was required to accept the same percentage of residual market losses and premium as that insurer's percentage participation in the voluntary market.

In the late 1980s, losses were increasing in the Rhode Island workers' compensation market. NCCI, as the approved advisory organization, made a series of filings increasing rates. Despite the filings, competitive insurers perceived that the rate increases were not keeping up with increasing workers' compensation costs resulting in large losses for the insurers.[17] This resulted in insurers withdrawing from the market. By 1990, virtually no voluntary competitive market existed in Rhode Island and the workers' compensation market in Rhode Island was in crisis.

In response to this crisis, the legislature made significant changes to the workers' compensation system. First, it created Beacon to serve as the residual market carrier, or the carrier of last resort. Beacon was not, however, limited to writing residual market risks, but was also allowed to compete with other carriers for voluntary market risks. During this same period, the legislature also enacted a series of provisions known as the

[16] In 2004, the law changed to read "Rhode Island employers and employees injured in Rhode Island." See the "Premium Pricing – Out-of-State" section for a discussion of the issues with Beacon and out-of-state coverage.

[17] Development of losses for these years has shown that the competitive insurers' perception was correct. In the late 1980s, the loss ratios of insurers writing in the market commonly exceeded 100%.

"Fresh Start" provisions designed to encourage carriers back into the Rhode Island market. Under the Fresh Start provisions, if competitive carriers wrote in the market and suffered losses, they would be partially compensated for those losses. Finally, the legislature enacted a series of measures to change the workers' compensation benefit structure as well as the procedures of the Workers' Compensation Court. These reforms resulted in a significant decrease in the losses in the Rhode Island workers' compensation market. The reduction of losses had the beneficial effect of bringing voluntary carriers back into the market and reducing premiums paid by employers.

Creation, Purpose and Administration of Beacon

As stated previously, Beacon was formed, legislatively, as a response to the workers' compensation crisis in Rhode Island. Beacon's rating is governed both by R.I.G.L. §§ 27-7.1-1 *et seq*., which applies to all carriers writing workers' compensation insurance in Rhode Island, and 2003 P.L. ch. 410 (formerly R.I.G.L. §§ 27-7.2-1 *et seq*.), commonly referred to as Beacon's enabling act. The only portions of R.I.G.L. §§ 27-7.1-1 *et seq*. that do not apply to Beacon are those that are in direct contradiction to 2003 P.L. ch. 410.

The enabling act states that the purpose of Beacon:

> *"…is to ensure that all employers in the state of Rhode Island have the opportunity to obtain workers' compensation insurance at the lowest possible price. It is also the policy and purpose of this act to establish and maintain that [Beacon] shall be the workers' compensation insurance carrier of last resort"* (2003 P.L. ch. 410 § 3*).*

This act provides that:

- "…the management and control of [Beacon] is vested solely in the board" (2003 P.L. ch. 410 § 5).
- After the expiration of the terms of the initial board of directors, the law required that the governor appoint four directors. Three additional directors (which must be Beacon policyholders) are elected by Beacon's mutual policyholders. The CEO of Beacon and the Director of the State of Rhode Island DLT are also ex-officio directors. Other than the Director of the DLT, no other government representatives may be directors and none of the board members, except for the CEO, "may represent or be an employee of an insurance company" (2003 P.L. ch. 410 § 4).
- The CEO, appointed by the board and subject to the board's authority, is responsible for administering Beacon (2003 P.L. ch. 410 § 7).

Section 10 of the enabling act affords Beacon powers similar to other domestic mutual insurance companies but bans Beacon from becoming a member of NCCI:

> *[Beacon may] perform all other functions and exercise all other powers of a domestic mutual insurance company that are necessary, appropriate or convenient to administer [Beacon] and to its members; provided, that [Beacon] shall not be a member of the National Council on Compensation Insurance (NCCI)* (2003 P.L. ch. 410 § 10).

Section 11 of the enabling act requires Beacon to provide coverage to "any employer that tenders the necessary premium," subject to certain limitations, including:

- The employer must fill out an application in good faith either directly or through an insurance agent licensed by the state to procure workers' compensation insurance (2003 P.L. ch. 410 § 11(b)(1)).
- Coverage may be denied, cancelled or non-renewed for:
    - "Non-payment of premium for current or prior policies issued by [Beacon] to the applicant, or to another entity for which [Beacon] deems the applicant to be a successor in interest."
    - "The failure or refusal by an applicant or insured to fully and accurately disclose [to Beacon] the information concerning the applicant's or insured's ownership, change in ownership, operations, or payroll, including allocation of payroll among state and federal compensation programs, classification of payroll, and other information determined by [Beacon] to be important in determining proper rates."
    - "The failure or refusal by any insured or applicant to comply with [Beacon's] safety requirements or to permit premises inspections to the sole satisfaction of [Beacon]" (2003 P.L. ch. 410 § 11(b)(2)).
- Any determination made by Beacon for the purposes of denial, cancellation or non-renewal, except for cancellation for nonpayment of premium, may be appealed to the Director of DBR in writing within 30 days of notice (2003 P.L. ch. 410 § 11(b)(3)).

Beacon is not considered a state agency for any purpose (2003 P.L. ch. 410 § 15). All property, including premiums paid to Beacon and Beacon investments, are solely for the use of Beacon and are not state property. The employees of Beacon are not state employees (2003 P.L. ch. 410 § 14).

Private independent insurance agents licensed to sell workers' compensation insurance in Rhode Island are allowed to sell Beacon coverage according to the rules adopted by the board of directors. The board "shall by rule also establish a schedule of commissions for voluntary risk and residual risk coverage that [Beacon] will pay for the services of an insurance producer" (2003 P.L. ch. 410 § 16).

The State of Rhode Island provided initial funding of $5,000,000 to capitalize Beacon, which Beacon repaid in full in June 1996. Since June 1996, there has been no state funding of Beacon.

During the transition period following the creation of Beacon, a 3% capital assessment was levied on all insurance carriers that wrote workers' compensation and employer's liability insurance in the state of Rhode Island. This capital assessment was paid to Beacon "to ensure the solvency of [Beacon] and [Beacon's] ability to establish a surplus reasonably adequate to complete the assumption of the residual risk market in furtherance of the public purposes stated in this act" (2003 P.L. ch. 410 § 19(b)). This capital assessment was subject to the Director's approval in terms of amounts and continuance and was suspended by the Director effective as of January 1, 1995. Beacon received $20,758,685 in capital assessments from inception through December 31, 2004, according to its 2004 audited financial statements.

Beacon is also obligated to remit to the DLT an annual fee equal to 0.2% of its earned premiums "in recognition of the continuing obligations of the [DLT]…" (2003 P.L. ch. 410 § 19(e)).

Beacon, however, was exempted from paying taxes pursuant to R.I.G.L. §§ 44-17-1 *et seq*. (Taxation of Insurance Companies) 2003 P.L. ch. 410 § 21(b) from 1996[18] until the exemption was repealed effective July 1, 2005.

Statutes Affecting Premium Pricing

2003 P.L. ch. 410 § 11(c)(1) states that Beacon is subject to workers' compensation rate regulations in R.I.G.L. §§ 27-7.1-1 *et seq*. Rates utilized by Beacon are subject to approval by the Director. The Director shall consider certain standards when approving rates, the first being that "Rates shall not be excessive, inadequate, or unfairly discriminatory" R.I.G.L. § 27-7.1-4.1(1). Furthermore, the enabling act states that "if…the director finds that a rate or filing of [Beacon] is unjust, unreasonable, inadequate, excessive or unfairly discriminatory, he or she may, after a hearing…issue an order…stating when within a reasonable period after [the order] the rate shall no longer be used…" (2003 P.L. ch. 410 § 11(c)(2)).

R.I.G.L. § 27-7.1-5.1 requires that Beacon must file:

> *…every manual, minimum premium, class rate, rating schedule, or rating plan and every other rating rule, and every modification of any of the foregoing which it proposes to use. An insurer may file its rates either by filing its final rates or by filing a multiplier to be applied to prospective loss costs that have been filed by an advisory organization on behalf of an insurer as permitted by § 27-9-8.1.*

[18] When the Rhode Island workers' compensation markets were split between residual and voluntary risks, Beacon paid premium taxes on its voluntary business. When this bifurcation of the market was eliminated in 1996, Beacon became exempt from this premium tax provision until July 1, 2005.

> *Every filing shall state the proposed effective date of the filing* (R.I.G.L. § 27-7.1-5.1).

See the "History of Beacon's Filings" section for more information on Beacon's filed and approved programs.

Beacon, and every insurer issuing workers' compensation in Rhode Island, shall not "make or issue a contract or policy except in accordance with the filings which have been approved and are in effect for that insurer as provided in this chapter or in accordance with subsection (c) of this section" R.I.G.L. § 27-7.1-5.1(d). The exception noted in subsection (c) refers to the following clause:

> *§ 27-7.1-6.2 Consent to rate. – Notwithstanding any other provision of this chapter, upon the written consent of the insured, filed with the director, a rate in excess of the rate determined in accordance with the other provisions of this chapter may be used on any specific risk.*

This clause is echoed in the enabling act, which states:

> *[Beacon] and any workers' compensation insurance policyholder may mutually consent to modify the rates for that policyholder's workers' compensation insurance policy, provided [Beacon] files notice of the modification with the [Director]*(2003 P.L. ch. 410 § 11(d)(2)).

We discuss consent-to-rate policies in more detail in the "Statutory Violations" section.

The enabling act also permits Beacon to assess a premium surcharge of up to three times the applicable premium on certain insureds "who present higher than normal risks within a class" subject to an appeal to the Director (2003 P.L. ch. 410 § 11(d)(3)).

For the purpose of determining whether Beacon's filings have met the legal requirements, the Director "may employ staff personnel and outside consultants including, but not limited to, those authorized under § 27-9-52. The reasonable costs related to the review of workers' compensation rate filings, including the conduct of the hearing, shall be borne by the rating organizations or insurers making the filing" (R.I.G.L. § 27-7.1-13).

DBR Oversight

Beacon is subject to the provisions of R.I.G.L. §§ 27-13.1-1 *et seq*., which provide that DBR may examine the affairs of licensed insurers at any time. This statute is based on a National Association of Insurance Commissioners' Model Act.

DBR's retention of Deloitte FAS for the purpose of assisting in this Market Conduct Examination fell under R.I.G.L §§ 27-13.1-1 *et seq*.

History of Beacon

The first employee of Beacon was Donald Vass ("Vass"), who was appointed president of Beacon upon inception of operations. Shortly thereafter, in January 1992, a second employee was hired to oversee the underwriting, premium audit and loss prevention departments.

Beacon wrote its first workers' compensation policy in August 1992 and quickly grew into the largest provider of workers' compensation coverage in Rhode Island. A member of senior management informed us that Beacon's initial expectation was that it would write approximately $15 million of insurance premiums in the first year, but due to a number of factors including major competitors leaving the state, Beacon very quickly rose to 90% of all premiums. Beacon was not adequately staffed to handle the influx of business immediately after writing its first policies in August 1992, but was required to accept the business as the "insurance carrier of last resort."

As a result of the legislative reforms discussed previously, the average cost of workers' compensation insurance decreased from 3.93% of employer payroll in 1993 to 1.63% in 2000 (a 59% decrease in eight years).

A contributing factor to the decrease in insurance rates was the influx in competition following the stabilization of the workers' compensation market. According to a member of senior management, Beacon helped stabilize the market in ways such as enforcement of compliance with premium audits and implementation of aggressive loss control programs. A senior management representative said that this stabilization helped Beacon fulfill one of its public purposes of promoting healthy competition in the workers' compensation insurance market as other carriers began to reconsider Rhode Island as a viable business opportunity. In fact, DBR was not required to implement any of the Fresh Start provisions because even with decreases in premium, the market did not continue to suffer the losses seen in the late 1980s.

During this period of decreases in the cost of workers' compensation insurance, Beacon's market share also decreased. According to DBR's records, Beacon's market share (as a percentage of total workers' compensation premiums) from inception through 2005 was:

Year	Percentage Market Share
1992	0.4%
1993	67.6%
1994	90.0%
1995	78.7%
1996	61.8%
1997	51.5%
1998	55.4%
1999	58.6%
2000	64.5%
2001	66.1%
2002	73.8%
2003	76.0%
2004	73.3%
2005	74.8%

Beginning in 1996, the underwriting department at Beacon implemented a number of new pricing methodologies and practices in an effort to compete with the carriers entering or reentering the market. Beacon began offering deeper discounts (utilizing schedule rating and consent-to-rate credits), multiple-year deals and certain out-of-state coverage to its insureds and agents. Other carriers were able to bundle their workers' compensation policies with other property/casualty and liability lines of business, but since Beacon was a mono-line carrier, it had to compete on price and service in workers' compensation only. Details of the premium pricing methodologies employed by Beacon during this period are provided in the "Underwriting at Beacon" and "Premium Pricing" sections that follow.

The pricing methodology changes that Beacon implemented in 1996 and 1997 met management's expectations, and Beacon's market share as a percentage of total written premium increased 47.6% in the six years 1997 through 2003. By 2003, Beacon wrote approximately 76% of the total written premium for workers' compensation insurance in Rhode Island, and Beacon claimed to issue 90% of the total workers' compensation policies.[19]

[19] "Market Share" is determined by DBR based on premium volume data extracted from the National Association of Insurance Commissioners' database, not the number of policies. Therefore, the 90% figure claimed by Beacon based on the number of policies cannot be verified by DBR records.

Beacon's Corporate Structure and Environment

CEO Transition

Vass was the President and CEO of Beacon from inception until 2002. Senior management described Beacon during this period as having a "state-run" feel that members of the senior management team resented.

Solomon was hired by Vass on December 13, 1993 as Senior Vice President and Chief Operating Officer ("COO"). Subjects interviewed provided varying accounts of the relationship between these two. An underwriting employee recalled that Solomon gradually accumulated power over time and that Vass' health began to deteriorate. A member of senior management claimed that Solomon became more aggressive and explained that Vass was "in [Solomon's] way."

Solomon assumed the position of CEO on February 18, 2002, but did not name a successor COO, maintaining responsibility for both executive roles. Shortly after his promotion, an underwriting employee explained that Solomon determined "who was going to be on [Solomon's] team." Some of those employees that Solomon determined were not on his "team" were transitioned out of their roles. See the "Underwriting at Beacon" section for more information on management of this department.

Organizational Structure

Under Solomon's leadership, Beacon was organized into seven departments, each with a vice president at the head with the exception of the human resources department, whose leader was a director. Although the vice president of finance's title was changed to include CFO in 2003, none of the job responsibilities changed and the only reason for the change was to satisfy certain contractual and regulatory requirements that insisted on a CFO signature.

Each member of the seven-person senior management team reported directly to Solomon. During interviews, members of senior management referred to the corporate structure as "silos," describing the limited visibility and lack of connectedness across the operations of each group. Each department was responsible for developing its own policies, procedures and controls. Other than Solomon and select internal audits performed by SKM, there was limited corporate oversight of the organization.

Solomon was the only officer at the executive level. No other member of senior management effectively filled the role of CFO or COO or held a position of authority that allowed for checks and balances against his control. If any member of senior management rose in opposition to a directive from Solomon, one senior management employee explained, "[they] would pay the price." Other employees described discussions with Solomon as "one-way dialogues" and they explained that employees tried to get on Solomon's good side, but felt that they were afraid of him and never wanted to cross him.

Senior management was aware that the reporting and operating structure was not collaborative. One individual explained that the senior management group contracted with a consultant from a college in Massachusetts to learn how to transition from a "group to a team," but admitted that nothing seemed to change.

The Board of Directors

Beacon's enabling act states that "the management and control of [Beacon] is vested solely in the board." In many ways, however, Solomon controlled the board of directors. This control was evidenced in an Email that Clark sent to Solomon following a board meeting in April 2004. The night before the Email was sent the newest member of the board apparently asked Solomon several difficult questions. Solomon emailed the senior management team seeking "honest and critical feedback on what I could have done differently regarding the confrontation." Clark responded by Email and wrote:

> *I can remember my first board meeting. I did not sleep the night before. I studied all my numbers. I knew a lot about the larger accounts. I knew about my organization. Then came the meeting. I was sweating bullets! When it was over - I was shocked.* ***No questions, no challenges, nothing that put me on my heals [sic]. It was a piece of cake****. Possibly my expectations were all wrong. Maybe [my prior employer's] micro management style fostered my fears/concerns. But now, after 2'ish years of attending board meetings,* ***still no tough questions or challenges. Not to anyone. Never a tough question/discussion over PowerComp. Never a tough dialogue****, until last night! Don't get me wrong, I am not complaining. Maybe I don't understand what a board is supposed to do, but I have always felt that they would challenge us on issues, not to be bastards, but to be assured that we understood what we were doing, and that we are doing things the way they want. Our board does not do this.* ***Heck, the Chairman, if he stays awake, keeps his cell phone on and actually answers it when it rings. That's almost embarrassing. You have a great relationship with all board members… You control them. Now enter [a new board member at the time]. I think you struggle with him because you have not developed control of him****. He is not afraid to ask those tough questions. None of the other board members do that…****When you think of our board, do they really know what each department does? I do not think so.*** *Maybe we need to do our new employee orientation talks for the board. This might sound dumb, but maybe we need to force feed this on them? Maybe we need to get them to know the company better - from the inside. We have nothing to hide…Regarding what you could have done/said differently last night - I have nothing to offer? You were caught off guard.* ***Never has anyone challenged [you] before. Never has anyone pushed back on [one of your]…statement[s]. You have always been in control…*** (Emphasis added).

Working Environment

Although Solomon did not share power with senior management, at the employee level, he appeared to be a popular CEO and employees appeared to be generally satisfied with their jobs. Under his direction as COO and later CEO, Beacon regained its position as the dominant writer of workers' compensation insurance. Beacon also built its own facility in Warwick, Rhode Island, moving in on September 27, 2000.

Beacon also paid its employees well, especially at the senior management level. While compensation was not a focus of the Examination, the Almond Report addressed these benefits and found:

- "All Beacon executives (with the exception of the VP of Finance and Director of Human Resources) were being paid more than the median of the [executive compensation study performed by a consulting company on similar companies and industries]."
- "The majority of [executives were] being paid more than 30% more than the peer group [of the lower quartile of the study]."
- Senior management's split-dollar life insurance policies, long-term disability supplement, deferred compensation plans and severance agreements were not considered in the consulting company's study, but represent a substantial benefit to these employees.[20]

Beacon's culture appeared not to endorse corrective action for poor performance. As evidenced by the workload inequity and slow operations of the underwriting department, Beacon appeared to allow poor performers to enjoy the status quo (see the "Underwriting at Beacon" section). An underwriting employee recalled complaining repeatedly to human resources about Clark's practices in underwriting, but that the response was "[Clark is] still your vice president."

Based on Emails read during the Examination, Solomon and other members of senior management appeared to distribute positive news to employees and appeared to quickly counter negative press with Beacon's position.

An underwriting employee admitted that the underwriting department was not properly following filed programs and explained that, in retrospect, he should have seen all of the problems over the years, but that he might have been "blind" because subconsciously he was happy with his job, compensation and short commute.

When we asked employees about the Almond Report, some indicated that they were not surprised about the premium pricing issues raised, but others expressed disappointment about Solomon's and Clark's abuse of expenditures. One underwriter expressed "shock"

[20] We also noted that Beacon provided senior management with country club memberships, personal financial consultants, and other benefits. See the "Financial Controls and Cash Disbursements" section for more information.

by the level of compensation for senior management. This reaction appeared to indicate a general lack of transparency in the business practices at Beacon.

History of Beacon's Rate Filings

We previously noted that Beacon is obligated to file its rates and programs with DBR and that those rates and programs are subject to approval by the Director. The Director considers whether the filed rates and programs are "excessive, inadequate or unfairly discriminatory" (R.I.G.L. § 27-7.1-4.1(1)).

We requested and obtained correspondence between Beacon and DBR relating to rate and program filings. We read the documents and developed the timeline of filings below. Based on our reading of these documents, we extracted the filings and correspondence most relevant to Beacon's policy pricing. We also included other important dates. Any deviation from filed rates and programs is a statutory violation.

Date	Description
July 11, 1990	Beacon was formed pursuant to R.I.G.L. §§ 27-7.2-1 *et seq*..
August 13, 1992	Beacon wrote its first workers' compensation policy.
June 8, 1994	Letter from Beacon's counsel to DBR that included two programs to be filed. First, Beacon filed a "Loss-Free Credit Program providing premium credit for voluntary and residual program insureds with two or more years of loss-free experience" and a "Residual Market Deductible Reimbursement Program providing a premium credit for residual market insureds with loss ratios below thirty percent in amounts corresponding to the insured's mandatory deductible payments for the prior policy year." This program was approved by DBR in July 1994.
October 20, 1994	Letter from Beacon's counsel to DBR that included a "Group Rating Plan" for the Rhode Island Builders' Association Workers' Compensation Safety Group. This filing explained the safety group's policy, which included a retrospective premium. While this filing provided the specifics of the measurement dates and retrospective premium factors, it did not specify the premium credits offered to the group. This program was approved by DBR in December 1994.
December 5, 1995	First letter from Beacon to DBR that listed consent-to-rate modifications to the filed NCCI rating plan.
February 15, 1996	Letter from Beacon's counsel to DBR that revised the Schedule Rating Plan to allow an increase in the maximum schedule credit from 25% to 35% depending on the insured's participation "in the CompAlliance managed care and employee wellness offered with Blue Cross & Blue Shield of Rhode Island." This program was approved by DBR in February 1996.
May 29, 1996	The bifurcation of the Rhode Island insurance market between Residual and Voluntary risk pools was eliminated by law with the passing of 96-H 8332A. This action also eliminated the premium tax on Beacon.

Date	Description
October 4, 1996	Letter from Beacon's counsel to DBR that announced Beacon's adoption of the "NCCI Loss Costs Filing and Multiplier." Beacon also proposed to adopt "revised Experience Rating Plan Values, Retrospective Rating Plan Values and Miscellaneous Values included within such NCCI filing, as approved by the Department." This program was approved by DBR in November 1996. With this approval, Beacon's Loss Cost Multiplier was established at 1.577. See the "Underwriting at Beacon" section for more information on this factor.
June 3, 1997	Letter from Beacon's counsel to DBR that proposed a credit of 1% to 4% to "health care insureds whose caregiver employees successfully complete either of two training options offered to help such employees deal with acts of aggression by patients." This program was approved by DBR in June 1997. This program was modified via letter dated April 23, 1998, below.
June 20, 1997	Letter from Beacon's counsel to DBR that proposed three Shared Earnings Dividend Plans. Two of the plans were "sliding scale" plans and the third was a "level" dividend of 10%. The dividends were subject to the discretion of the board of directors. This program was approved by DBR in July 1997.
April 23, 1998	Letter from Beacon's counsel to DBR that proposed a 1% return of premium or premium credit to healthcare insureds "whose caregiver employees successfully complete refresher training in connection with the Caregiver Self-Protection Program." This program was approved by DBR in May 1998.
May 8, 1998	Letter from Beacon's counsel to DBR that proposed an additional sliding scale Shared Earnings Dividend Plan. This program was approved by DBR in May 1998.
October 15, 1998	Letter from Beacon's counsel to DBR that announced Beacon's adoption of the "NCCI Loss Costs Filing and Multiplier," which increased Beacon's Loss Cost Multiplier to 1.605. Beacon also adopted "the revised Premium Discount Program (Type A discounts), Experience Rating Plan Values and Retrospective Rating Plan Values." This program was approved by DBR in March 1999, subsequent to the confirmation letter sent by Beacon's counsel to DBR on February 22, 1999, below.
December 17, 1998	Letter from Beacon's counsel to DBR that included a "Group Filing Plan by which the Chambers Safety Group and the Beacon have consensually agreed to establish the premium for the group." The attachment to the letter indicated that Beacon provided an "up-front premium credit" of up to 15% and participation in the "Level 10" shared earnings dividend program for an additional return of premium of up to 10%. To become a "qualified member" of the program, an insured needed to be a member of one of the Chambers of Commerce of the State of Rhode Island and attend two safety training classes during the policy year. This program was approved by DBR in December 1998.

Date	Description
February 22, 1999	Letter from Beacon's counsel to DBR confirming Beacon's adoption of the November 1, 1998 loss cost filing by NCCI as announced in the October 15, 1998 letter above. This program was approved by DBR in March 1999.
September 6, 2000	Letter from Solomon to DBR that stated the position that Beacon was not required to submit notification via letter to DBR when they used a lower consent-to-rate.
September 15, 2000	Response from DBR to Solomon, which stated that DBR's position was that while consent letters from the employers were not required for lower rates, "under all circumstances, Beacon is required to file the required notice with this Department of any modification."
September 26, 2001	Last letter from Beacon to DBR that listed consent-to-rate modifications to the filed NCCI rating plan.
July 1, 2005	Beacon's premium tax exemption was repealed.

Underwriting At Beacon

History of the Underwriting Department

Beacon's rapid initial expansion required personnel in every department. The newly hired vice president in charge of the underwriting department had no prior experience in workers' compensation insurance. The underwriting department was also originally tasked with the responsibilities of overseeing the premium audit and loss prevention departments. During these early years, the underwriting department applied the NCCI-filed rate structure with little variation. Negotiations with agents and insureds over pricing rarely occurred, and the underwriting department was charged with entering payroll figures into formulas to determine the appropriate premium.

Marketing Shift in Underwriting

In September 1996, Beacon hired an underwriting employee who had previously been employed by one of Beacon's contract agencies. Beacon had been losing significant market share to carriers reentering the market after the stabilization. This underwriting employee recalled that Solomon told him "to find a way to help Beacon compete." Beacon's plans to regain market share were to establish relationships with Beacon's three largest independent insurance agents, or the "Big Three." This represented a change in the way Beacon did business, and managing the agent distribution process became the focus of the underwriting department. Several people in the department stated that the *agents*, and not the insureds, became Beacon's primary customers.

An underwriting employee said that Beacon could compete through pricing. The employee described the workers' compensation market in 1996 as "soft," and once Beacon established that they would be receptive to schedule and consent-to-rate credits, the agents started to become "insistent" on pricing concessions. Underwriting personnel stated that Beacon "gave in [to the requests] when it wanted to give in."

Underwriting personnel explained that Solomon continued to come up with different methodologies, ideas and approaches to premium pricing, and that it was the underwriting department's responsibility to take Solomon's direction and "make it palatable" for Beacon. At Solomon's direction, Beacon began to develop programs and offer special deals to insureds. Because of Beacon's focus on the agent network, these programs, deals and ultimately credits were more often provided to the top-producing agents, including the "Big Three" and several other major agencies.

An underwriting employee recalled that the marketing initiative was successful in fulfilling Solomon's purpose of allowing Beacon to compete. The employee said that Beacon tracked its success ratios during this period and claimed that Beacon won 90% of all proposals that it bid on and that its retention rate on renewal business was in the mid-90^{th} percentile range. Beacon was successful in winning back and increasing its market share despite being the carrier of last resort and a mono-line carrier unable to bundle its product with other insurance lines.

Two of Beacon's key target customers during this campaign were self-insured companies and trade organizations. Some of the deepest discounts and most aggressive commitments were provided to these accounts. Self-insured trade organizations were recruited to Beacon as "safety groups" that offered steep credits, tailored safety programs and dividend plans for tens or hundreds of different insureds (see the "Premium Pricing – Safety Groups" section for more information). Additionally, Beacon began to offer multiple-year deals to attract previously self-insured businesses that wanted to know the cost of insurance for more than one policy year before coming to Beacon (see "Statutory Violations" section for more information on multiple-year deals). A member of senior management said that before Beacon offered these programs, there were approximately 140 self-insureds in the state of Rhode Island, a number that was reduced to approximately 20 following Beacon's marketing campaign.

One underwriter claimed that he "never priced an account where I didn't think we'd make a profit," but explained that the "profit" might not have been in the initial policy period. He said that Beacon's loss prevention and claims control services would make the policy profitable to Beacon over time. The insureds could cancel their policies with Beacon at any time, however, so the prospect of turning these project accounts around was risky.

The vice president of the underwriting department during the reclamation of Beacon's market share through aggressive pricing practices said that he raised concerns about Beacon's pricing practices to Solomon before his promotion to CEO. In the spring of 2000, while Solomon's influence continued to increase, this employee was moved out of underwriting and into an unrelated position with no oversight of the underwriting department.

Underwriting Management Changes

To replace the vice president of the underwriting department, Beacon went outside the company. Clark was referred to Beacon by the wife of one of Beacon's largest (and most influential) agents. Clark was hired by Beacon in March 2000 as the new vice president of the underwriting department. One member of senior management recalled that senior management expected Clark to help Beacon reduce the credits that it was giving away. While some aggressive practices such as multiple-year agreements were phased down by Clark, business at Beacon continued to be focused on satisfying its major agents and pricing below the competition.

Environment of the Underwriting Department

Much in the way that senior management described their conversations with Solomon as one-way dialogues, some of the senior underwriters interviewed indicated that Clark's (and other superiors') suggestions were non-negotiable "orders." Some said that they would argue with Clark, and sometimes he would listen, but rarely would he change his opinion. One employee described this relationship as "the classic case of the workflow moving in the wrong direction – top down."

Management of the agent relationships and select insureds were the underwriting department's top priorities. Underwriters, some who spent significant time reviewing the experiences of various insureds and developing their professional pricing opinions, were constantly being overruled by underwriting management. Sometimes underwriters were told that the decisions were made by Solomon, and in some situations, he contacted the underwriters directly to make changes. Others indicated that it was not uncommon for an agent to "go over their head" straight to an underwriting manager or executive if the agent felt that the underwriter was not cooperating. According to underwriting personnel, some underwriters became frustrated with the constant overrides and "played the game" by pricing accounts not based on their professional judgment, but at a lower price that would limit or eliminate the pushback from management and the agent.

Organization of the Underwriting Department

According to the senior underwriters and managers interviewed, the level of agent involvement in premium pricing, which was one of the primary factors in Beacon's diversion from approved rates and programs, depended on the agency. The underwriting department was segregated by "territories" based on premium size and agency. Therefore, the same underwriter dealt with the same agent over the years. If an insured switched agencies, Beacon assigned it a new underwriter. Interviews with Beacon employees revealed that certain agencies:

- Applied more pressure on underwriting,
- Were afforded more accommodations and pricing concessions,

- Were paid contingent commissions that were not earned and
- Participated more often in Beacon "sponsored" activities.

Underwriting personnel explained that the most influential agents were some of the highest volume agents. Underwriters that were not responsible for handling these agencies and other major agencies explained that they rarely had issues with management overrides.

Agents gradually became more involved in the pricing decisions. Underwriting personnel described Beacon's philosophy of "holding the line" with respect to renewal pricing for large accounts. They indicated that Solomon never wanted to lose a renewal because of price. Therefore, once an agent pressured the underwriting department to increase the credits on one of its accounts in one year, it was often treated as an annuity. Underwriters avoided taking away credits in subsequent years, even if it was warranted, because of the risk of damaging the agent relationship. When the decision was made to take credits away from a poor performing insured, Beacon preferred the "stair-step" approach of gradually rescinding the amount of credits over time, rather than re-pricing the account on renewal.

Underwriters indicated that some agents would state the price that they could sell or renew the business, and one employee explained, "nine times out of ten," management would concede the pricing.

In addition to providing its agents with favorable pricing, which allowed the agents to keep their book of business and their commission income steady, Solomon's and Clark's preferred agents began receiving gifts, complimentary travel and golf outings and unearned commissions. See the "Financial Controls and Cash Disbursements" section for more information.

<u>Underwriting Resources</u>

Our interviews revealed that the workload in the underwriting department was not evenly distributed. At the time of our interviews, there were at least two senior underwriters with no agencies and at least one senior underwriter with one agency while other underwriters claimed to be overwhelmed. Also at this time, Beacon had just placed an advertisement for another senior underwriter, but still had not reallocated the workload. An underwriting employee explained that one of the reasons why Beacon placed the advertisement was to recruit someone who was not "Beacon-ized."

For example, underwriters indicated that one particular insured was too big for one underwriter to handle. The underwriter handling this account repeatedly asked to be removed from the account. He recalled one instance where he sent an Email asking to be removed and Clark confronted him and said, "…don't ever put anything like that in writing." Underwriting personnel supported these comments and one underwriter explained, "we really can't be an insurance company to [this insured]. This account drove [underwriting] crazy…it was a full-time job." Despite the complaints, this account was never reassigned to another underwriter and continued to be renewed. See Relevant Finding 9 in the "Selected Individual Insureds" section for more information on this insured.

We were told by a number of people that the underwriting department was in the middle of restructuring and realignment that had dragged on for approximately three years. Underwriting management claimed that many of the process improvements that were needed to fix the underwriting department were developed as part of the restructuring, but senior management never gave the approval to implement them. One member of senior management compared the restructuring of the department to "a hamster in a wheel" because underwriting management continually delayed changes over worries of disrupted service.

One employee described the underwriting department as "paper pushers" and said that as the company grew and matured, the underwriters were not provided the training opportunities to learn commensurate with Beacon's growth. Few of the underwriters or underwriting managers have their Chartered Property Casualty Underwriter certification. Following the shift in Beacon's business practice, the underwriters who were simply processing paperwork before now had the responsibility of managing the agent relationships and negotiating pricing on top of their other duties.

Premium Audit Department

Premium audit personnel informed us that the primary responsibilities of their department were to make sure that insureds were properly classified according to their relative risk, and that payroll was properly stated. They added that premium audits were performed by one of the 11 in-house field or telephone auditors, or by third-party premium audit vendors called "fee auditors."

Beacon's auditing software, AuditLynx, scheduled and assigned all premium audits. Audits were generally performed annually, after the conclusion of each policy year.[21] In addition to "final" audits, audits of new business were generally performed within three months of signing a new account and interim audits were required for some higher-risk insureds such as construction and temporary employment agencies. Beacon also performed cancellation audits after the termination of a policy.

Premium audits were conducted onsite or over the phone, depending on the complexity of the insured and the level of risk. The auditors described the nature of insureds' business operations and ownership structure including number of employees, locations and business processes. Auditors compared the payroll records of the insureds against tax forms or DLT notices. If deemed necessary, auditors requested cash disbursement data,

[21] According to premium audit personnel, annual audits were waived for small policies whose premium was less than $3,000 and that met certain other criteria, including previous audits where the estimated payroll had minor or no variances from audited payroll.

independent contractor and temporary employment agency invoices, or any other information they believed to be necessary to verify payroll and classification.

Since the implementation of the PowerComp system in October 2003, premium auditors were not automatically provided with pricing factors for the insureds that they were auditing. For example, premium auditors that received their assignment from AuditLynx were not provided with the credit structure or EMod figures despite the fact that EMods are important factors for premium audits as higher EMods can be an indication of misclassification issues. Auditors could query the PowerComp system for more information on their insureds in order to view these factors, but this was not a required procedure.

All premium audits were announced[22] and scheduled ahead of time, which allowed the insured to pull together the necessary information ahead of the audit. The advance notice, however, might have allowed insureds to improve working conditions, clean and tidy up premises, coordinate audit responses and avoid the appearance of temporary or undocumented workers at the locations visited.

Audit Adjustments

Premium audits involved comparisons of the estimated payroll by classification to the actual payroll. If the difference in payroll for any classification was greater than 20%, the underwriter was expected to access and read the audit report. If the variances were all under 20%, the audit adjustments were automatically posted and premium adjusted accordingly.

We discussed these audit adjustments with premium audit personnel who explained that after an underwriter accessed and read the audit reports for variances over 20%, the underwriter had the option of endorsing or not endorsing the proposed changes. If the changes were endorsed, they were posted to the policy in PowerComp and premium was adjusted. If the underwriter did not endorse the adjustments, the changes were not posted to the policy. The vice president of underwriting received a spreadsheet entitled the “Not Endorsed” report that contained a listing of “not endorsed” audits. It is our understanding, however, that this report did not provide information such as the nature of the proposed adjustment or the effect on premium. Underwriters were not required to discuss “not endorsed” audits with the auditors, and there was no policy in place requiring auditors to follow up on significant adjustments. A premium audit employee explained that once an audit was released, premium audit generally did not follow up on its results until the following year’s renewal. The Almond Report noted, however, that Premium Audit recently implemented the use of a report that allows underwriting and premium audit to track the premium and payroll adjustments within a 60-day window.

[22] Beacon did conduct a surprise audit of an insured in July 2006. This insured had been hiding payroll in the past. See the “Political Activities” section for more information.

Moratorium on Premium Audit Adjustments

Information systems personnel explained for a period of two years following the implementation of the PowerComp system, Clark mandated a moratorium on premium audit adjustments. They explained that the main reason for this change was that Beacon experienced a number of billing errors following the conversion that were exacerbated by numerous audit adjustments. One member of senior management believed that the moratorium was Clark's "knee-jerk" reaction to PowerComp's failures.

Relationship with the Underwriting Department

Several of the underwriters interviewed had a negative opinion of the premium audit department. One underwriter explained that there were "two competing cultures" between the underwriting and premium audit departments and described the group as "disenfranchised police." Another underwriter explained that he felt that the premium audit function tried to fulfill the underwriting department's responsibilities and said that audit had a "we're going to find something [wrong]" attitude and a "gotcha!" mentality that he felt was inappropriate.

One underwriting department employee explained that the premium audit department was just a "spoke" in the underwriting wheel. In other words, they felt that underwriting was responsible for collecting information from a number of varying sources, only one of which was the audit department. According to this employee, auditors who voiced frustrations over decisions made by underwriting were not privy to the same sources of information that underwriting considered.

The CFO was also in charge of oversight of the premium audit department. Despite this responsibility, Beacon employees indicated that the CFO had "no real level of involvement" in the department and that they "[did] not know premium audit." A Beacon employee indicated that they could "count on one hand" the number of times the CFO acted as a messenger between the premium audit department and underwriting or senior management. The minimal vice presidential oversight of and involvement with the premium audit department created an absence of a formal vehicle for auditor follow-up on adjustments. While underwriting could refer problems directly to Clark, premium audit did not have a similar figure for reference. It also appeared that underwriting decisions, at times, were made without the consideration of or contradictory to premium audit findings. See the "Premium Pricing" section for specific examples.

Underwriting Guidelines and Regulatory Compliance

In addition to an uneven workload, inadequate management and poor communication with premium audit, the underwriting department had few definitive underwriting policies and little formal training in appropriate underwriting procedures. According to the last version of audited financial statements issued as of the date of this report, Beacon wrote approximately $148 million of workers' compensation insurance and handled approximately 90% of the policies in the state of Rhode Island, but Beacon never had a formalized manual outlining the controls and procedures for the underwriting department. When we requested these documents, we were provided with a document entitled "Underwriting Manual" dated August 2005. This document was a collection of Emails and meeting notes that addressed various selected underwriting subjects. This "manual" did not provide clear or complete guidelines for the underwriters, especially as it related to appropriately pricing Beacon's policies under the filed rates and programs approved by DBR.

One underwriter explained that by having no standards or rules, Clark and other underwriting supervisors could manage the business "intuitively." Since there were no written guidelines that explained how to appropriately price an account, underwriters could not point to a violation of company policy when they argued with management.

As an example, the "manual" provided the following guidance for schedule rating, one of the foundations of premium pricing for Beacon:

> ***Schedule Rating – Responsibility for Completing –*** *It is the responsibility of the Underwriter to fully complete schedule rating forms. This responsibility may not be delegated to the Underwriting Assistants.*

The manual did not instruct the underwriters how to appropriately apply the schedule rating methodology or provide guidance in terms of schedule credits or debits (see "Schedule Rating" section that follows). The manual also did not include descriptions of all of Beacon's filed programs or copies of the actual filings that the underwriters could utilize for reference. An underwriting manager stated that it should have been the underwriting department's responsibility to ensure that the programs and rates they offered were compliant with previously filed rates, but claimed that access to Beacon's filings was limited. Beacon's counsel maintained all copies of Beacon's filings and correspondence with DBR. These filings were the basis on which the underwriting department was obligated to write workers' compensation insurance, but it did not appear that the underwriters had free access to these documents.

The underwriting department includes several employees in charge of "regulatory relations." Based on our discussion with regulatory relations personnel, the primary responsibilities of this department were handling complaints received from DBR, compliance with the reporting requirements of the DLT, monitoring changes in the industry from NCCI or insurance bulletins, and calculation of contingent commissions for agents. The regulatory relations department was not responsible for monitoring the activities of the underwriting department. In January 2003, Beacon recruited the former Associate Director and Superintendent of Insurance at DBR. Despite his governmental background, this person was not assigned to this monitoring role.

In their interviews, underwriting managers admitted that their department was oblivious to the regulations. They complained that there was "no formal vehicle" in place to address these issues. Several underwriters and underwriting managers told us that they "assumed" that Beacon was following its filed rates simply because no one ever told them otherwise.

Beacon's corporate counsel, while responsible for filing the programs, did not appear to be involved in the day-to-day operations of the underwriting department and was not responsible for approving pricing, special deals or letter agreements with agents and insureds.

Based on our discussions with KPMG and SKM, Beacon's external and internal auditors, respectively, they did not focus their engagements on Beacon's compliance with filed rates.

We are not aware of one person, group of persons, department or consultant that regularly monitored the pricing practices of Beacon's underwriting department. One underwriter joked: there were three ways to write workers' compensation insurance, "the right way, the wrong way, and the Beacon Way." Based on the results of our procedures detailed below, the "Beacon Way" was often at odds with the approved rate filings.

Beacon's Premium Pricing – Experience Rating and Schedule Rating

Beacon was statutorily obligated to follow the approved NCCI rating plan filing from inception until 1996 when it adopted the NCCI Advisory Loss Costs effective November 8, 1996 and subsequently, the NCCI Advisory Loss Costs effective as of November 1, 1998. The NCCI rating plan is a combination of schedule rating and experience rating methodologies promulgated by NCCI. Collectively, this is referred to as the "Book Method."

The following is a high-level illustration of the major premium elements involved in the Rhode Island Workers' Compensation Premium Algorithm:

	Premium Element	Subtotal Description
	(Payroll [By Classification] / 100) * Classfication Code Rate	MANUAL PREMIUM
X	EMod	MODIFIED PREMIUM
X	Schedule Rating factor (1 - scheduled credit % or 1 + scheduled debit %)	STANDARD PREMIUM
_	Premium Discount	ESTIMATED ANNUAL PREMIUM

Beacon's enabling legislation, 2003 P.L. ch. 410 § 11(d)(2), allowed Beacon and its insured employers to mutually consent to modify filed premium rates. Beacon interpreted this "consent-to-rate" statute not only as allowing it to surcharge insureds above and beyond the maximum 25% schedule debit, but also to supplement schedule credits with consent-to-rate discounts. See the "Statutory Violations" section below for more information on consent-to-rate. According to the premium pricing algorithm utilized by Beacon's insurance software, PowerComp, the consent-to-rate factor was included along with the schedule rating factor (as well as other Beacon-specific credits such as Loss Free and CompAlliance) before the derivation of "standard premium." Accordingly, Beacon's high-level Book Method premium algorithm was:

	Premium Element	Subtotal Description
	(Payroll [By Classification] / 100) * Classfication Code Rate	MANUAL PREMIUM
X	EMod	MODIFIED PREMIUM
	Schedule Rating Percent (Credit) / Debit	
+	Consent-To-Rate Percent (Credit) / Debit	
+	CompAlliance Percent (Credit)	
+	Loss-Free Percent (Credit)	
=	Total (Credits) / Debits Percentage	
X	Credit Factor (1.00 - Sum of Total (Credits) / Debits Percentage)	STANDARD PREMIUM
_	Premium Discount	ESTIMATED ANNUAL PREMIUM

To illustrate the effect of the premium elements above, assume the following facts about an example policy for Company A:

- Annual payroll of $10,000,000 equally split between the following two NCCI classification codes and their respective rates:
  - *8810 Clerical Office Employees NOC*, with a class code rate of $0.50
  - *5222 Concrete Construction in Connection With Bridges or Culverts*, with a class code rate of $35.00.
- The EMod promulgated by NCCI for this policy period was 1.20.
- Underwriting determined that Company A qualified for a 20% schedule credit.
- Underwriting determined that Company A qualified for an additional 15% consent-to-rate credit.
- Company A was not qualified for Loss Free or CompAlliance credits.

Company A's premium would be calculated (using Beacon's high-level book method premium algorithm[23]) as:

[23] According to Beacon's premium algorithm, the "Total Credits" subsection was inclusive of Loss Free and CompAlliance credits.

	Premium Element					
	Classification (A)	**Payroll (B)**	**(B) / 100 = (C)**	**Rate (D)**	**(C) * (D)**	
	8810	$ 5,000,000	$ 50,000	$ 0.50	$ 25,000	
	5222	$ 5,000,000	$ 50,000	$ 35.00	$ 1,750,000	
	MANUAL PREMIUM					$ 1,775,000
X	EMod					1.20
	MODIFIED PREMIUM					$ 2,130,000
	Scheduled Credits				20%	
	Consent To Rate Credits				15%	
	Total Credits				35%	
X	Credit Factor (1.00 - Total Credits)					0.65
	STANDARD PREMIUM					$ 1,384,500
	Premium Discount Percentage		**Tier**	**Discount %**	**Discount ($)**	
	First $10,000		$ 10,000	0.0%	$ -	
	Next $190,000		$ 190,000	-9%	$ (17,290)	
	Next $1,550,000		$ 1,184,500	-11%	$ (133,849)	
	Premium Discount		$ 1,384,500			$ (151,139)
	ESTIMATED ANNUAL PREMIUM (WRITTEN PREMIUM)					$ 1,233,361

<u>NCCI Classification System</u>

Manual premium, the first subtotal in the premium algorithm, is calculated based on the amount of payroll in each job classification. Rule 1-A-1 of NCCI's 2001 Basic Manual explains that "The purpose of the classification system is to group employers with similar operations into classifications so that the assigned classification reflects the exposures common to those employers and the rate charged reflects the exposure to loss common to those employers." Classification codes ("Class Code(s)") rates are also referred to as "loss costs."

Class Codes are a combination of four digits with detailed descriptions of job responsibilities for each code. Each Class Code is assigned to a dollar value factor. According to Beacon's 1998 *Rate Comparison By Class Guide*, the dollar values attributed to Class Codes in Rhode Island ranged[24] from a low of $0.28 for *8803 Auditors, Accountant or Factory Cost or Office Systemizer – Traveling* to a high of $83.65 for *5059 Iron or Steel: Erection-Frame Structures Not Over Two Stories in Height*. These factors are stated as "Per $100 of Payroll." For example, the manual premium cost of workers' compensation insurance for employees classified in the 8803 Class Code is 0.28% of payroll.

Underwriters must apply judgment in the selection of payroll classification and assign the classification that most accurately describes the job responsibilities of the employees being considered.

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[24] This range includes only the four-digit class codes and is not inclusive of Federal classes or special rate multipliers.

Classification Codes are not employer-specific, and are based on the risks of the entire class of employees.

NCCI's Basic Manual and Scopes Manual, which provide guidance in terms of classification decisions, also provide a number of different exceptions and rules. One of the exceptions relevant to this report is the United States Longshore & Harbor Workers' Compensation Act ("USL&H"), which provides for additional benefits for marine-related[25] risks. Additional compensation benefits are built into USL&H rates based on a factor of 83% (the base class code rate is multiplied by 1.83).

The classification codes utilized by Beacon are also inclusive of a Loss Cost Multiplier ("LCM") specific to Beacon. The loss cost values are calculated to cover the cost of claims only. Beacon's LCM is multiplied by the base NCCI classification rates in order to gross up for certain costs and profit for Beacon including:

- Production Expense,
- General Expense,
- Taxes, Licenses and Fees,
- Underwriting Profit and Contingencies,
- Expense Gradation,
- Provision for Bad Debt and
- Merit Rating Plan Discount.

Effective as of November 1, 1998, Beacon's filed and approved LCM was 1.605 based on DBR's approval of Beacon's filing dated March 4, 1999.

<u>Experience Modification Factor ("EMod")</u>

According to NCCI's publication entitled the *ABC's of Experience Rating*, experience rating "is a method for tailoring the cost of insurance to the characteristics of an employer. It gives the employer the opportunity to manage its own costs through measurable and meaningful cost-savings programs." Experience rating "predicts whether a qualifying employer is likely to develop loss experience that is better or worse than that of the average risk in a particular classification. It modifies manual premium by a factor that is designed to more accurately price qualified employers…[using] the employer's past experience to project future losses."

A neutral EMod factor of 1.00 indicates that the insured is expected to develop loss experience equal to the average risk in its classification. If the employer has shown the

[25] According to the U.S. Department of Labor, this act provides for compensation and medical care to employees disabled from injuries that occur on the navigable waters of the United States, or in adjoining areas used in loading, unloading, repairing, or building a vessel. The Act also offers benefits to dependents if the injury causes the employee's death. The term "injury" includes occupational disease arising out of employment.

ability to manage its losses lower than its peers, the EMod would drop below 1.00, and vice versa.

An employer qualifies for experience rating if their workers' compensation "subject premium" (a subtotal not shown in the high-level algorithms above, before modified premium) meets or exceeds the premium eligibility point as defined in the NCCI Experience Rating Plan Manual. As of the date of this report, the premium eligibility point for Rhode Island was governed by the 2003 Experience Rating Plan Manual, which requires either (a) a subject premium of at least $10,000 within the most recent 24 months of its experience or (b) if it has more than 24 months experience, its average annual subject premium must be at least $5,000. This $10,000/$5,000 threshold was established by NCCI's Filing Memorandum Item 01-RI-00, which implemented a three-year transition to the current premium eligibility point. According to this document, the Rhode Island minimum requirement was historically below the New England states' average before the increase. This Filing Memorandum increased the limits according to the following schedule:

Effective Date	Premium Eligibility Point
September 1, 2000	$6,500 / $3,250
September 1, 2001	$7,500 / $3,750
September 1, 2002	$10,000 / $5,000

Schedule Rating

Schedule rating allowed Beacon underwriters to further modify premium pricing "to reflect such characteristics of the risk that are not reflected in its experience" (2001 NCCI Basic Manual, Appendix D, Rule 3). Seven qualitative factors should be considered for credits (discounts) or debits (surcharges) to be applied to the policy if the insured is judged to be significantly better or worse than its class, respectively. The 2001 NCCI Basic Manual listed the seven qualitative characteristics for consideration and the range in credits and debits for each category in the State of Rhode Island:

Characteristic	Range of Discount/ Surcharge
Premises	-10% to +10%
Classification Peculiarities	-10% to +10%
Medical Facilities	- 5% to + 5%
Safety Devices	- 5% to + 5%
Employees – Selection, Training, Supervision	-10% to +10%
Management – Cooperation with Insurance Carrier	- 5% to + 5%
Management – Safety Organization	- 5% to + 5%

Application of the schedule rating was subject to the following rules (2001 NCCI Basic Manual, Appendix D, Rule 2(a-f)):

a. The amount of the schedule rating factor is subject to a maximum of that listed in the Schedule Rating Table [25% maximum for Rhode Island].

b. The amount of the schedule rating factor is applied in a multiplicative manner after the application of the experience rating modification (if an experience rated risk) and before the application of premium discount and expense constant.

c. The credit or debit must be within the range for a specific risk characteristic as provided in this Plan.

d. At the time that the schedule rating factor is applied, the carrier must have documentation on file detailing the basis for the credit or debit. This documentation must be provided to the insured on request.

e. The effective date of the schedule rating factor must be on or after the date of the carrier's receipt of the documentation supporting the basis for the schedule rating factor.[26]

f. If the insured can correct the reason for any schedule debit to the satisfaction of the carrier, the debit may be removed effective on the date that documentation for the correction is received in the carrier's office.

The prior NCCI Basic Manual released in 1996 did not include a section for Schedule Rating, but Rule VI(G) Premium Modifications – Experience Rating Plan referred the reader to the Experience Rating Plan Manual. As of 1996, the most current Experience Rating Plan Manual appeared to be the 1984 version. The appendices to Part Four of the 1984 Experience Rating Plan Manual contained the schedule rating table. This section provided rules similar to Rule 2(a-f) above with several exceptions:

- There shall be an annual report to the National Council on Compensation Insurance illustrating the total dollar amount of schedule debits and the total dollar amount of schedule credits.
- Standard earned premium figures reported to the National Council on the aggregate calls for experience (e.g., policy year, calendar year, etc.) must exclude (i.e., be prior to) the effects of schedule rating premium adjustments. Net earned premium reported on these calls must include (i.e., be after) the effects of schedule rating premium adjustments. Schedule rating premium adjustments must be reported under unique statistical codes on unit statistical reports submitted to the National Council.
- The Schedule Rating Program can be used only on risks that are rated in compliance with the National Council on Compensation Insurance's filed and approved rates without deviation.

[26] See the "Premium Pricing" section for examples we found of Beacon retroactively applying credits to policies that had already been priced and whose effective dates of coverage had already passed.

The 1984 Experience Rating Plan Manual also limited the maximum schedule rating modification to 25%.

According to the 2001 NCCI Basic Manual, the eligibility for schedule rating was a manual premium of $5,000 and was no longer linked directly to experience rating eligibility.

During his interview, an underwriting manager explained that Beacon should have been able to train the underwriting department better in terms of the appropriate application of schedule rating. This manager understood that the underwriting department at Beacon was not appropriately rating insureds based on NCCI guidance.

Premium Discount

One of the last major elements of Beacon's premium pricing algorithm is the Premium Discount. This factor is separate from credits and is purely mathematical. It is a tiered discount percentage approved by NCCI that is applied to the standard premium subtotal to reduce written premium based on the size of the policy. The table below lists the percentage discounts for each tier of premium:

Tier	Premium Discount
First $10,000	0.0%
Next $190,000	9.1%
Next $1,550,000	11.3%
Over $1,750,000	12.3%

Beacon's Use of 1998 Loss Costs and LCM

Until October 1, 2006, Beacon had not adopted a loss cost filing since November 1, 1998. During this time, DBR approved two NCCI advisory loss cost modifications effective January 1, 2005 and January 1, 2006. Both of these modifications resulted in overall decreases of advisory loss costs.

In 1998, the legislature amended R.I.G.L. §§ 27-7.1-1 *et seq*. and required the filing of Advisory Loss Costs by NCCI for all insurers participating in the workers' compensation market in Rhode Island. R.I.G.L. § 27-7.1-24 provided a transition period of three years during which "any member or subscriber of an advisory organization was authorized to continue to use all rates and deviations filed or approved for its use until the insurer makes its own filing to change its rates, either by making an independent filing or adopting an advisory organization's approved prospective loss costs, or modifications of those loss costs."

In 2001, NCCI made a filing and requested a decrease in advisory loss costs. While this filing was pending, the legislature extended the transition period to five years and added, "No advisory organization shall file, and the department of business regulation shall not accept a filing by an advisory organization, as to proposed changes in rates previously approved unless the filing shall include relevant data through July 7, 2003." By extending this period the legislature did not allow DBR to take action to reduce advisory loss costs during 2001.

Based on this legislation, workers' compensation rates in Rhode Island were essentially frozen from 1998 through the middle of 2004 (when data through July 7, 2003 was available). NCCI filed updated loss costs for Rhode Island in the middle of 2004. Beacon contacted DBR at the time of the filing to express the opinion that the statute prevented DBR from considering the filing. DBR disagreed with that assessment and scheduled a hearing on the NCCI filing. Beacon had an attorney present at the initial pre-hearing and the Hearing Officer specifically "invited" Beacon to intervene in the proceeding to provide DBR with any criticism of the filing. Beacon declined to intervene but sent an attorney to each day of the hearing. DBR analyzed the filing, modified the request and approved advisory loss costs effective as of January 1, 2005.

The advisory loss costs approved and effective January 1, 2005 represented an average loss cost reduction of 20.2%. Beacon wrote approximately 90% of the workers' compensation policies in the state and the data emanating from those polices was used by NCCI in their calculation of the loss costs. Therefore, in correspondence to Beacon dated January 18, 2005, Marques hypothesized that Beacon would adopt the plan, or file a similar rate reduction.

In January 2005, Beacon informed DBR that it would not be adopting the advisory loss costs approved for NCCI effective January 1, 2005. According to Solomon's January 28, 2005 letter to DBR, "Beacon disagreed with NCCI's [sic] presenting a loss costs case in the fall of 2004 because we believed that legislative history would not permit such a filing, as well as our concern over the lack of current data in the case." Beacon's position was that they were not required to adopt the loss cost filings, but the letter did not specify the basis for this position. Beacon stated that it did not challenge or intervene in the loss cost filing process in order to avoid "related attorney, actuary and administrative costs."

On September 9, 2005, NCCI filed a request to further reduce loss costs effective January 1, 2006. DBR ordered Beacon to participate in the hearing to provide any criticism of the NCCI filing. Beacon filed legal challenges to DBR's authority to make this order. Because the appeal of this order to the Rhode Island Supreme Court could delay the proceedings thereby delaying the decrease in loss costs for Rhode Island employers, DBR decided to withdraw the order and proceed forward on the NCCI advisory loss cost filing without Beacon. DBR issued a decision effective January 1, 2006 further reducing advisory loss cost in Rhode Island by 4.2%.

By not adopting the NCCI advisory loss cost filings in 2005 and 2006 (or writing on an approved alternative rate plan) and continuing to apply the 1998 NCCI loss cost and LCM filings related to the pricing of policies effective January 1, 2005, forward, Beacon has violated R.I.G.L. § 27-7.1-5.1(a). See the "Statutory Violations" section for a more detailed discussion on this violation.

Beacon's Premium Pricing – Practice

Beacon did not utilize the filed and approved Book Method to develop its pricing for many of its accounts. Instead, underwriting management and senior management pushed a "right pricing" philosophy.

Solomon described this philosophy in a letter to DBR dated February 28, 2005:

> *Our "right pricing philosophy" incorporates substantial flexibility, which allows us to remain to be a competitive state fund and also to be the insurer of "the market of last resort."*
>
> *"Right Pricing" is a philosophy employed by The Beacon to charge an appropriate premium to a policyholder based on the policyholder's individual loss experience, and knowledge of any other factors that may impact the [sic] for a loss.*
>
> *Using this Right Pricing philosophy, a policyholder can partner with The Beacon and help control the premium by participating in safety programs and other loss prevention initiatives recommended by us…*
>
> *"Right Pricing" attempts to modify the [NCCI rating plan prescribed] rate charged to policyholders by making appropriate adjustments, whenever needed, to premiums based on the policyholder's individual loss experience, and changes to factors which may impact the potential for a loss…*
>
> *[Right Pricing] allows The Beacon to more appropriately rate each individual policyholder, which ensures that policyholders are receiving the lowest possible price.*

In the same letter, Solomon complained that "the currently filed NCCI plan is very structured and does not allow for any flexibility in rewarding better than average risks." Solomon also said that "Our belief is that the NCCI rating plan is discriminatory against good risks in that they [good risks] are held accountable to absorb cost in terms of higher premiums as a result of poor performers within the same class." Solomon, in a letter dated May 26, 2005, called the NCCI plans "one dimensional in that [they] include only past loss experience and do not take into account other relevant employer information and rating factors."

Beacon's "right pricing" methodology was inconsistent with the Book Method. As we report in the "Premium Pricing" section below, pricing for certain favored accounts and agents was predetermined with the absence of a proper schedule and experience rating analysis. We understand, from interviews of underwriting personnel, that Beacon's pricing methodology for these accounts was often based on negotiation and "agent accommodations" rather than underwriting principles. Common practices and terminology used by the underwriting department such as entering into multiple-year deals guaranteeing a "stable pricing approach," "stair-stepping," "composite rating," "holding the line" and "agent accommodations" were directly in contrast to the Book

Method. We discuss this terminology further in the "Premium Pricing" section of this report.

The 2001 NCCI Basic Manual, Appendix D, Rule 3 indicated that schedule rating should be used to modify premium pricing "to reflect such characteristics of the risk that *are not reflected in its experience*" (emphasis added), but we have found numerous instances where Beacon has raised credits to "offset" an increasing EMod, thereby nullifying the intentions of two major components of the Book Method, which are supposed to be mutually exclusive.

Beacon often set up meetings to discuss pricing on upcoming renewals well in advance of the renewal period with some of its major agents. Some underwriting personnel felt that these meetings were "too far in advance" in order to adequately consider the current policy period performance before deciding on the following year's price.

Trend and Development Pricing

Beacon also utilized an actuarial premium pricing model called "Trend and Development Pricing" on some of its largest accounts. This model, also referred to as a loss rating approach, was used on some, but not all, accounts over $100,000 in written premium. This model was also used in the pricing of safety groups. This rating approach was neither filed nor approved by DBR, and was not consistent with the approved Book Method.

An underwriting manager confirmed that Beacon began using this rating methodology "formally" since April 2002 following an audit by General Re Corporation ("GenRe"), Beacon's reinsurance provider. GenRe provided Beacon with the original worksheets used in the Trend and Development method. The original worksheets were amended in 2003 based on input from Beacon's actuaries.

One employee said that Beacon applied a "quasi loss rating" approach using the Trend and Development method. Underwriting used the loss rating data as a pricing point, but modified the actual pricing based on the same subjective factors, such as schedule rating applied on non-loss rating accounts. The Almond Report indicated that Beacon was not consistently applying the Trend and Development method to all qualifying accounts.

Underwriting Documentation

The underwriting department was limited in options when it came to documenting the pricing it provided to insureds. Underwriters need to fill out a schedule rating plan form for every risk subject to schedule rating. As mentioned above, the schedule rating plan forms were limited to the evaluation of the seven characteristics only, mutually exclusive to experience and other factors, such as loss ratio, consent-to-rate credits, loss history, payment history or any other factors that might influence pricing. In many of the examples provided in the "Premium Pricing" section below, the credit structure, if not premium, were determined before the underwriter began the Book Method documentation. Therefore, the documentation of the ultimate premium pricing was an exercise in backfilling.

Additionally, underwriters that spent significant time analyzing and pricing accounts ahead of renewals told us that they found it very frustrating when management overrode their decisions arbitrarily based on a discussion they might have had with an agent or Solomon.

We asked some underwriters a theoretical question during their interviews, "if you believed that a 20% schedule credit is the right price, but were directed by management to provide a credit of 40%, how did you document and support the higher credit?" Underwriters explained that they were not allowed to indicate that the credits were based on direction from management. They could not use phrases such as "at the direction of…" or "according to…" in the schedule rating plans, so they were forced to support the higher credit with other language, even if it was inappropriate.

One underwriter explained that when they were asked to document pricing that they felt was inadequate, they wanted to hand the documentation to their superiors and tell them, "You write it!" Some underwriters indicated that there might have been career implications to this insubordination, though, so they continued to document as requested. In response to this question, one underwriting manager commented, "how do you document the undocumentable?"

Similarly, if a price for an account was derived using the Trend and Development method or another unapproved approach, the underwriter had to document it as if the pricing was independently determined using the Book Method. The actual reasoning for high consent-to-rate credits, stable pricing agreements, combined multiple-state policies and composite-rated policies could not be appropriately documented using the Book Method approach, but management did not provide options or guidance for documentation, so the underwriters complied.

Underwriters did have certain tools available for documentation of the orders that they were given. The most commonly used method was the "Notepad." The Notepad is an electronic diary that is kept for each insured within the PowerComp system. Notepad entries that we read often included terminology that linked the underwriting decision to the source, such as "per," "according to," and similar phrases. Email correspondence and referral forms also provided us with the reasoning for underwriting decisions.

Interview Excerpts

The following selected excerpts from interviews with underwriting personnel illustrate the environment and business practices of the underwriting department:

Premium Pricing

- When asked why Solomon would have been involved in premium pricing decisions, one underwriter said, "this is Rhode Island. Golf, country clubs, charity balls…[he] was very good at keeping track and made sure changes were made on Monday [after being asked for favors]."
- An underwriter explained that agents are "very involved" in premium pricing decisions and said, "if [an agent] needs something, they'll probably get it."
- An underwriter said that "it was not in Beacon's culture to debit" insureds because they had plenty of flexibility as they were operating at "$160 million in premium and a 30% loss ratio."
- Some indicated that "ego" had a lot to do with Beacon's approach, and underwriting personnel told us that the motto of the business at the time was that Beacon was "in it to win it."
- Senior management's direction to underwriting was to maintain a "balanced book of business" at a loss ratio of approximately 65%. Underwriters acknowledged that for every favor or concession that led to an inadequate premium, another account was going to get "screwed" to maintain the overall loss ratio.
- An underwriter explained that Beacon was very "liberal" with its major agents and that the agents took advantage of this relationship by being very aggressive. This translated to the agents having a heavy influence over pricing decisions and many agent accommodations. They described pricing negotiations as if they "had this bank of tokens [credits]" and needed to be liberal with them in order to maintain the agent relationship and avoid Clark's involvement.
- An underwriting manager explained that one job responsibility was "to make management's requests legal," that is, to make sure that promises and deals cut by Solomon and Clark were documented properly. Because many of the deals could not be documented properly, this manager believed that there were deals that senior management did not consult with underwriting on because senior management knew they would object.

Management Style

- Several underwriters explained that if they argued the merits of their supervisor's order, the reasons were "business decisions" as opposed to "underwriting decisions."
- In some cases, senior management entered into special deals, such as multiple-year agreements, without notifying the underwriter on the account. Upon renewal,

when the underwriter proposed a change in the credit structure, the agent or insured notified them of a preexisting arrangement.

- A member of senior management hypothesized that since Clark came from a branch office of another insurance company, he might have been unfamiliar with the filing requirements and regulatory oversight that his former employer's headquarters operations handled.
- Several underwriters named one of Beacon's largest agents as particularly demanding. They pointed to the fact that this agent's wife apparently introduced Clark to Solomon and that Clark and the agent had a very friendly relationship. One employee stated that some underwriters were "scared" of this agent because if they did not cooperate with him, Clark would "put the fear of God" in them.

Statutory Violations

Based on the result of this Examination, DBR has concluded that certain Beacon business practices are in violation of Rhode Island statutes. Detailed examples of these practices are presented in the sections to follow. This section delineates DBR's position with respect to broad statutory violations committed by Beacon.[27]

Non-Adoption of January 1, 2005 and January 1, 2006 NCCI Advisory Loss Costs

R.I.G.L. § 27-7.1-5.1(a) provides:

> *Every insurer shall file with the director every manual, minimum premium, class rate, rating schedule, or rating plan and every other rating rule, and every modification of any of the foregoing which it proposes to use. An insurer may file its rates either by filing its final rates or by filing a multiplier to be applied to prospective loss costs that have been filed by an advisory organization on behalf of an insurer as permitted by § 27-9-8.1. Every filing shall state the proposed effective date of the filing.*

As detailed above, effective January 1, 2005, the DBR approved advisory loss costs for NCCI, which provided an overall decrease of 20.2% from the advisory loss costs approved in 1998. The following year, NCCI made a filing to further reduce advisory loss costs. Effective January 1, 2006, advisory loss costs were decreased by an additional 4.2% (4.4% for "F" classifications).

[27] The underwriting violations reported below are limited to policies written by Beacon. Out-of-state policies written through fronting arrangements are subject to the governing statutes of the state of coverage, which is outside of the scope of this Examination.

Pursuant to R.I.G.L. § 27-7.1-5.1(a), as of January 1, 2005, Beacon's only options were to adopt the NCCI advisory loss costs or to file its own rates.[28] However, in January 2005 Beacon advised that it would not adopt NCCI advisory loss costs and indicated that at some time in the future it would make its own rate filing. Beacon thereafter continued to rate on the inflated advisory loss costs approved in 1998.

Safety Groups

R.I.G.L. § 27-7.1-2 provides:

> *(a) Every insurance company issuing workers' compensation insurance policies covering the payment of compensation and benefits provided for in this chapter shall file with the director:*
>
> > *(1) A copy of the form of the policies. A policy may not be issued until the director has approved the form; and*
> >
> > *(2) Its classification of risks and their premium rates and any subsequent proposed classifications and premium rates, which may not take effect until the expiration of sixty (60) days from the date the director has approved them.*
>
> *(b) Premium rates less than those approved may be used and filed with the director. If the director has reason to believe that the filing produces rates that are inadequate or unfairly discriminatory, the director may disapprove them.*
>
> *(c) Any policy forms, subject to this chapter and filed by an insurer or rating organization on behalf of its members or subscribers with the director, shall be deemed public information at the time of the filing; and the director shall furnish the policy forms and all pertinent information as to the policy forms, upon written request, to any insured, to any authorized representative of an insured, to any insurance company trade association, or to any trade association of insurance producers.*

On October 20, 1994, Beacon filed a group rating plan for the Rhode Island Builders' Association ("RIBA"). DBR approved this plan effective December 7, 1994. On December 17, 1998, Beacon filed another group rating plan for the Rhode Island Chambers of Commerce ("RICC"). The DBR approved this plan effective as of the date of the filing. The Examination found, however, that Beacon was rating 10 additional "safety groups" even though no plan had been filed for these groups. With regard to the two filed plans (RIBA and RICC), Beacon internally modified the plans such that the details of the programs as of 2006 are substantially different from the programs on file

[28] Insurers are given a reasonable period of time to implement newly approved advisory loss costs. In this case, however, Beacon made a written declaration that it was not adopting the advisory loss costs. Since it did not have approved rates on file, with this declaration Beacon was out of compliance with R.I.G.L § 27-7.1-5.1(a)

with the DBR. Modifications to the RIBA and RICC filings were never filed and approved and, therefore, rating based on these programs is also in violation of R.I.G.L. §§ 27-7.1-2 *et seq.* and 27-7.1-5.1(a).

The queries performed on Beacon's insurance data during the Examination indicated that, as of 2005, over 17% (2,742) of all Beacon insureds participated in one of Beacon's safety groups.[29] These groups afford their members the ability to receive reductions in premium through credits and participation in shared earnings programs that they might not have been eligible for on a standalone basis. See the "Safety Groups" section for a more detailed analysis of these programs.

Every policy issued by Beacon for which the pricing was determined through an unapproved safety group pricing mechanism constitutes a statutory violation under R.I.G.L. § 27-7.1-5.1(a).

Consent-to-Rate Credits – Failure to Notify

2003 P.L. ch. 410 § 11(d)(2) states:

> *Notwithstanding any law to the contrary, the fund and any workers' compensation insurance policyholder may mutually consent to modify the rates for that policyholder's workers' compensation insurance policy, provided the fund files notice of the modification with the director of the department of business regulation.*

Many states have similar statutory provisions; however, the modifications are limited to increases in premium.[30] Beacon has, however, interpreted this section as permission to discretionarily modify filed rates downward without regard for all other rating standards set forth in statute. Although the language varies somewhat from that contained in R.I.G.L § 27-7.1-6.2, the language in the Beacon statute does not indicate a clear legislative intent to allow Beacon to consent-to-rate to a rate lower than its filed programs. The reason that consent-to-rate is traditionally permitted only for rates in excess of filed rates is for those unusual circumstances where the insured presents such a unique risk that the insurer could not provide the insurance at the filed rate. Consent-to-rate does not, however, excuse the insurer from the statutory mandate that insurance rates not be "excessive, inadequate or unfairly discriminatory" per R.I.G.L. § 27-7.1-4.1(1). The risk of unfair discrimination is enhanced when individual insureds can consent-to-rate to lower rates while similarly situated insureds with homogeneous risk pay higher filed rates. If an insurer feels that rates are overstated for a class of insured, its obligation is to file actuarially justified programs for all similarly situated insureds under R.I.G.L. § 27-7.1-2(b). There is no option to consent to a lower rate with a few select insureds. In fact, the language "mutually consent" infers some level of unwillingness on the insured's

[29] These queries included Rhode Island policies only.

[30] We discussed this matter directly with several state regulators and found no examples of lower rates resulting from a consent-to-rate provision.

part to agree to the modified rate, which would only happen in a premium increase situation.

As mentioned previously, Beacon considered this provision to allow them to "consent" to a lower premium than would be allowed under the filings made with DBR. This conclusion was apparently reached internally, with no formal confirmation from DBR that this was an appropriate analysis of the statute. Prior to 2001, however, DBR did accept consent-to-rate credits without challenge.

On September 6, 2000, Solomon wrote a letter to the DBR, in which he stated, "It is my understanding that The Beacon Mutual is not required to submit notification via consent-to-rate letter, when using a rate which is lower than that already filed and approved by the Insurance Division." DBR replied to Solomon in a letter dated September 15, 2000 and stated, "It is the Department's position that if the rate is written in excess of the rate filed, the insurer is required to obtain the written consent of insured. In situations where the rate is lower than that filed, consent-to-rate letters are not required. However, under all circumstances, Beacon is required to file the required notice with this Department of any modification as referenced above." At no time did DBR allow Beacon to "consent-to-rate" without the statutory notification to DBR, whether the rates were higher or lower than filed rates, nor did DBR relieve Beacon of its statutory obligation under R.I.G.L. § 27-7.1-4.1

Between September 26, 2001 and March 22, 2006, Beacon failed to notify the DBR of consent-to-rate pricing. According to the Almond Report, this practice was terminated due to lack of oversight following an employee's death. The Almond Report explained, "It appears to us that the procedure was mistakenly forgotten." The Examination established that the underwriter involved in this process passed away while still employed at Beacon on February 2, 2002, over four months after the last consent-to-rate notification was sent.

A memo from Beacon's counsel to Clark, dated May 17, 2005, was disclosed during the Examination, which stated:

> *On May 12, 2005, in a meeting with members of the Rhode Island Division of Insurance ("Division"), I took the position that no consent to rate modification notifications were required from Beacon due to [DBR's] letter of September 15, 2000. There was no push back from the Division in response to my position. I indicated that Beacon had the materials and that they would be available if the Department wanted them at any time.*

This memo appeared to indicate that Beacon or Beacon's counsel took the September 15, 2000 letter to mean that consent-to-rate notifications were no longer required, and that the underwriter's passing was not the only reason that Beacon stopped filing consent-to-rate letters.

DBR strongly disagrees with Beacon's counsel's characterization of the May 12, 2005 meeting. At that meeting, Beacon's counsel indicated that Beacon was acting upon the written direction of DBR in discontinuing the filings. Beacon was unable to produce any such correspondence, and a search of DBR's records revealed no such correspondence. Once again, the sole document related to this issue (the September 15, 2000 DBR response) clearly states that consent-to-rate filings are required under all circumstances. In any event, it is clearly unreasonable to conclude that an official DBR position related to statutorily required filings could be inferred from a regulated entity's "perception" of DBR's reaction to a statement made in a meeting that occurred nearly five years subsequent to Beacon taking such position. DBR's position in the written communication of September 15, 2000 continued to be in effect throughout much of the period covered by this Examination. At no time was Beacon excused from the statutory requirement that all consent-to-rate filings be properly made with DBR.

The following table illustrates Beacon's representation[31] of the effect of consent-to-rate. Between 2002 and 2005, Beacon reported that it used consent-to-rate on 2,834 policies without reporting them to the DBR that resulted in discounts of $101,539,431 over the period.[32]

Policy Year	Premium Prior to Consent to Rate Adjustment	Consent to Rate Adjustment	Premium After Consent to Rate Adjustment	Total Claims Paid	Total Claims Incurred	Policy Count
2002	$ 63,183,851	$ 29,210,342	$ 33,973,509	$ 21,448,266	$ 24,623,354	718
2003	$ 56,623,485	$ 25,332,320	$ 31,291,165	$ 16,657,876	$ 21,473,285	637
2004	$ 54,585,132	$ 23,491,719	$ 31,093,413	$ 10,508,267	$ 15,907,852	661
2005	$ 59,232,710	$ 23,505,050	$ 35,727,660	$ 3,938,914	$ 9,795,125	818
Totals	**$ 233,625,178**	**$ 101,539,431**	**$ 132,085,747**	**$ 52,553,323**	**$ 71,799,616**	**2,834**

Issuance of each of these policies without proper notification to DBR constituted a violation of 2003 P.L. ch. 410 § 11(d)(2).

Unfair Discrimination

R.I.G.L. § 27-7.1-4.1(1) provides that, "Rates shall not be excessive, inadequate, or unfairly discriminatory."

Beacon's enabling act contains two provisions, applicable only to Beacon, which show a legislative intent that Beacon's rates not be unfairly discriminatory. 2003 P.L. ch.410 § 11(c)(2) provides:

[31] The data contained in this table was extracted from Beacon's response to certain data requests posed by the Rhode Island Attorney General in the DBR proceedings entitled "The Beacon Mutual Insurance Company Loss Cost Rate Filing" DBR No. 06-I-0034 filed January 17, 2006 and dismissed May 17, 2006.

[32] Consent-to-rate adjustments were apparently quite significant during this period since base rates in use by Beacon were artificially high. This is the period that rates were "frozen" by the General Assembly due to extensions in the transition law as well as voluntary writers' inability to lower rates absent a filing from NCCI.

> *Notwithstanding the provisions of this section, if, at any time, the director finds that a rate or filing of the fund is unjust, unreasonable, inadequate, excessive, or unfairly discriminatory, he or she shall, after a hearing held upon not less than ten (10) days written notice, specifying the matters to be considered at that hearing, issue an order specifying in what respects he or she finds that the rate or filing is unjust, unreasonable, inadequate, excessive, or unfairly discriminatory and stating when within a reasonable period after this the rate shall no longer be used or the filing shall be deemed no longer effective. That order shall not affect any contract or policy made or issued prior to the expiration of the period set forth in the order. If the director finds that an unfair discrimination exists in the application of a rate or filing to an individual applicant or insured, the director may, after a hearing held on similar notice to the fund, issue an order that the discrimination be removed.*

That rates not be "excessive, inadequate or unfairly discriminatory" is a national standard in insurance rating. Rates are "unfairly discriminatory" if the price difference does not equitably reflect the differences in expected losses and expense. In other words, two insureds with identical risk characteristics will receive the same rate. This standard prevents an insurer from giving a "deal" to one insured for a purpose other than the risk insured (i.e., political influence). There is no specific definition of "unfairly discriminatory" in the Rhode Island workers' compensation insurance statutes or Beacon's enabling act. DBR's interpretation of this statutory standard is, in part, case law interpreting the identical phrase in other jurisdictions. Examples of court's declarations on the definition of "unfairly discriminatory" include:

- "…[A] rating factor will be deemed unfairly discriminatory and inequitable unless it has a causal connection to expected losses" *Florida v. Insurance Services Office*, 434 So.2d 908 (Fla. 1983); and
- Unfair discrimination prohibits "…preferential treatment with respect to the cost of the policy or the benefits allowed so that all policy holders that fall within the same class will pay alike and will be treated alike" *Mahoney v. Hartford Life & Accident Ins. Co*., 561 P.2d 142 (Okla. 1976).

Findings of this Examination, discussed in the "Premium Pricing" section, indicate that similar employers received different rates without justification of different risk, experience, or expenses. These findings constitute "unfair discrimination" in violation of R.I.G.L. § 27-7.1-4.1.

Multiple-Year Deals

Around 1997, Beacon management, led by Solomon, began offering multiple-year deals to insureds as a marketing tool. Between 1997 and 2000, the multiple-year deals uncovered during the course of the Examination (most often three-year agreements) appeared to follow the same general pattern. Often, they were accompanied by a letter sent from Beacon to the agent or insured. The following excerpts represent phrases used by Beacon in the boilerplate multiple-year agreements during this period:

- "We believe that our service combined with our commitment to provide the 'lowest sustainable pricing' to this account will result in a long term relationship for both parties."
- "We are pleased to commit to a stable premium approach to this account for the first three years."
- "While we are not able to guarantee rates for the three year period, we will guarantee the effect of the rates of [the insured]."
- "The only changes in the pricing during this period will be reflective of the changes in the payroll for [the insured]."

We discussed this terminology with underwriting personnel who explained that the language utilized was not subjected to the approval of internal or external counsel. Underwriting personnel explained that all multiple-year deals were based on the "absolute direction from Solomon or Clark."

These agreements were one-sided commitments. The insureds that benefited from these arrangements were under no obligation to remain with Beacon for the duration of the multiple-year deal, nor were they obligated to remain with Beacon for future coverage. One underwriter described these deals as "a horrible thing to do."

Although the substance of the agreements was committed to, in writing or verbally, by Beacon representatives, interviews and documents we read made it appear that the actual policies issued under these agreements had 12-month terms and followed the Book Method of pricing.[33] The underwriting paperwork during the period of the multiple-year deals did not represent the true substance of the commitment. Committing to a guaranteed pricing approach for three years represents a considerable increase in risk to an insurance carrier. Multiple-year policies are not a common practice in workers' compensation insurance. Carriers typically do not want to be tied down to a limited ability to recover an adequate rate on subsequent renewals. If such a program were to be utilized there would have to be enough "cushion" to assure a reasonable rate throughout the life of the agreement. From the opposite perspective, most insureds would not accept such a rating since it has the built-in "cushion" that could not be alleviated through favorable loss experience by the insured. There are few instances where an insured is willing to sign a multiple-year agreement unless that agreement is stacked very favorably in their favor, not the carrier's.[34]

[33] R.I.G.L § 27-7.1-2 requires that all insurance policies issued by licensed insurers are written on "forms" filed with and approved by the Department. Beacon could only write these deals if they had an approved form that included the agreement. This was not the case and, therefore, in entering into these contracts Beacon was in violation of R.I.G.L. § 27-7.1-2.

[34] The expert referenced in the Almond Report described multiple-year deals as "highly unusual and not customary."

Based on the financial performance of multiple-year deals identified during the Examination, it was apparent that the pricing of many of these accounts favored the insureds. Our procedures revealed at least 20 multiple-year deals during the Examination. Of the 20 multiple-year agreements identified, 17 resulted in loss ratios greater than Beacon's target loss ratio of 65%, and 13 resulted in loss ratios greater than 100% during the period of the multiple-year agreements. Based on Beacon's target loss ratio of 65%, actual incurred losses exceeded Beacon's target losses by approximately $21.6 million during the multiple-year commitment period for these 20 policies.[35]

During the period where Beacon offered these multiple-year deals, Beacon had adopted NCCI's filing, which included a multiple-year endorsement approved in 1984. The agreements reviewed did not include a copy of this endorsement. The approved NCCI form would allow multiple-year agreements but only with fluctuations in payroll, rates, and EMods so that loss experience would be considered via the EMod. The Beacon multiple-year commitments did not follow the NCCI-approved form.

Beacon's inclusion of the clause, "the only changes in the pricing during this period will be reflective of the changes in the payroll for [the insured]" in its agreements inferred that Beacon agreed to nullify the effects of changing EMods. In some of the earlier instances of multiple-year deals, the underwriters manually input the first-year EMods on the second and third years of the policies.

A senior underwriter explained that the multiple-year deal structure changed after Clark was hired on March, 20, 2000. The underwriter recalled that Clark felt that not entering the NCCI-promulgated EMods was inappropriate, and the policies under multiple-year agreements were made to reflect updated EMods. In order to meet its commitment of a stable pricing approach, however, the credit structure would be adjusted to negate the impact of the EMod change.

Two other variations of multiple-year deals were discovered during the course of the Examination.

- **Tiered Pricing Approach** – We found several instances where Beacon committed to a pricing agreement where the second and/or third years' credit structure depended on the loss ratio performance of prior periods.
- **Composite Rating** – We found at least two instances where Beacon committed to providing an insured pricing that conformed to a composite rate over multiple periods. See below for more information on composite rating.

Because Beacon did not follow a filed and approved program, the policies issued under multiple-year agreements constitute violations of R.I.G.L. § 27-7.1-5.1(a).

[35] See the "Overall Pricing Patterns – Loss Ratio" section for more information on Beacon's "target" loss ratios.

Composite Rating

A policy is "composite rated" if the underwriter develops a factor based on payroll with the intention to apply that factor for pricing purposes based on payroll variances. For example, if a composite rating plan had been filed and approved, an underwriter would have been able to determine that a $2.00 rate for every $100 in payroll might be appropriate for a particular risk and apply that "composite rate" to future fluctuations in payroll without regard to changes in classification. Beacon has not filed a composite rating program with DBR.

Beacon underwriters explained that "composite rate" was a term that was loosely applied to premium when it was expressed as a cost per payroll. Comparing the insurance cost to the cost of payroll was a marketing technique that Beacon used to facilitate insureds' understanding of their policies.

At least one underwriter indicated that he believed that Beacon had calculated a composite rate for a policy and then committed itself to maintain the composite rate on future renewals in a multiple-year deal. Some pricing was based on composite rates, but factors such as credits would be changed to affect the rates in future periods. However, even though this did occur, Beacon never formally issued a composite rated policy. The documentation in support of the pricing on these accounts and the policy declaration always appeared as if the Book Method approach was applied.

Any policy priced using a composite rating methodology constituted a violation of R.I.G.L. § 27-7.1-5.1(a) because Beacon did not file such a program for DBR approval.

Trend and Development (Loss Rating)

We discussed Beacon's application of the Trend and Development approach (a loss-rating methodology) in the section, "Underwriting at Beacon." This methodology represents a deviation from the approved schedule and experience rating plans on file with DBR and is, therefore, in violation of R.I.G.L. § 27-7.1-5.1(a).

Use of Incorrect EMods

We found 11 insureds during the course of our procedures for which an EMod other than the NCCI-promulgated EMod was used in pricing. Under R.I.G.L. §27-7.1-5.1(a), Beacon is required to use NCCI-issued EMods to price insureds. Any deviation from the issued EMods must be filed with and approved by DBR, which was not done.

Misclassification of Payroll

The Examination revealed nine insureds for which Beacon applied an incorrect Class Code to a portion of the insured's payroll. In each of these instances, the incorrect Class

Code had a lower rate than the one that should have been applied, sometimes resulting in significant decreases in premium. This is a violation of R.I.G.L. §27-7.1-5.1(a).

Incorrect Class Code Rates

The Examination also identified two insureds where the correct Class Code was applied to payroll, but Beacon did not use the 1998 filed rates for these class codes. R.I.G.L. § 27-7.1-5.1(a) requires that all "class rate[s]" must be filed with the DBR. The use of incorrect rates in these three instances constituted a violation of R.I.G.L. §27-7.1-5.1(a).

Out-of-State Coverage for Non-Rhode Island Employers

The Examination found two instances where Beacon provided insurance coverage through its fronting arrangement with Fairfield to out-of-state payroll exposure of employers that had no business affiliation with a Rhode Island employer. Extending this coverage is a violation of 2003 P.L. ch. 410 §3, which limits Beacon's voluntary writing to "employers in the state of Rhode Island."[36]

"Special" Shared Earnings Plans

In 1997 and 1998, Beacon filed and the DBR approved four "Shared Earnings Dividend Plans." These dividend plans were subject to the board of directors' approval and were filed with actuarial support provided by Beacon's actuaries. Three of the filed plans, SE-9601, SE-9602 and SE-9803 based their payouts on a "sliding scale" methodology. The percentage payout of the dividend in these programs increased based on (a) an increase in standard premium or (b) a decrease in "formula loss ratio."[37] The maximum formula loss ratio to qualify for payment according to the filings was 45% for all plans.

Based on the sliding scales for these plans, the minimum and maximum qualifying dividends were as follows:

Shared Earnings Plan	Minimum Standard Premium Range	Maximum Standard Premium Range	Minimum Dividend (45% Formula Loss Ratio and Minimum Standard Premium Size)	Maximum Dividend (0% Formula Loss Ratio and Maximum Standard Premium Size)
SE-9601	$0 – $19,999	≥ $300,000	6.0%	23.2%
SE-9602	$0 – $19,999	≥ $300,000	3.8%	17.4%
SE-9803	$0 – $24,999	≥ $150,000	0.0%	45.2%

[36] See the "Out-of-State" section for a full discussion of this issue.

[37] According to Beacon's filings, the formula loss ratio is different from loss ratio used elsewhere in the report. It is defined in the filing as: (Case Incurred Losses 18 months after policy inception (not including Allocated Loss Adjustment Expense) + Contingency Reserve) divided by (audited standard premium after schedule rating). The Contingency Reserve is based on a Factor for Future Loss Development supplied by Beacon's actuaries. We understand this factor to be 18%.

The fourth filed shared earnings plan was called SE – Level 10. This plan provided for a 10% dividend if the insured met a 45% loss ratio cutoff.[38] Based on Beacon's audited financial statements, shared earnings for 2002, 2003 and 2004 totaled $2.1 million, $3.0 million and $2.2 million, respectively.[39]

In addition to shared earnings dividends, Beacon's board of directors has the statutory authority to "declare dividends to its policyholders when there is an excess of assets over liabilities, and minimum surplus requirements" according to P.L. ch. 410 § 10(6). On January 1, 2006, Beacon issued a press release announcing a 12% dividend to "all eligible policyholders of record as of December 21, 2005." The press release indicated that the payment would amount to approximately $20 million. An article in the Insurance Journal dated March 6, 2006 reported that the dividend would be approximately $26 million. Beacon provided the percentages of dividend declarations by year:

Year	Dividend Declared
1998	10%
1999	3%
2000	3%
2001	5%
2002	0%
2003	0%
2004	0%
2005	12%

During the course of the Examination, references to "special shared earnings" agreements with certain insureds and agents were found. Specifically, we identified three accounts with these arrangements, discussed as Relevant Findings 5 and 7 in the "Selected Individual Insureds" section and as Relevant Finding 8 in the "VIP Accounts" section.

While performing procedures on Beacon's safety groups, we learned that Beacon developed three additional shared earnings plans only for certain safety groups that have not been filed with the DBR. See the "Safety Groups" section for more information on these plans. The underwriting department indicated that Beacon has not paid out shared earnings under these plans.

Other than the four filed and approved shared earnings plans and policyholder-wide dividends described above, Beacon was not statutorily allowed to pay dividends to its insureds. These "special shared earnings" agreements represent dividend payments (or the promise of payments) that modified Beacon's filed rates. These modifications were not filed with or approved by DBR, and this constituted a violation of R.I.G.L. § 27-7.1-5.1(a).

[38] The filing did not specify if this was a "formula loss ratio" or a standard loss ratio and did not specify the measurement date.

[39] These numbers tied to the "Dividends paid to policyholders" line item per the KPMG audited financial statements. Per a September 13, 2006 Email from a finance department employee, there were no other dividends declared during these periods.

Combined Pricing (In-State and Out-of-State Premiums)

During the Examination, we found numerous accounts with both Rhode Island and out-of-state ("OOS") policies that showed large credits on the Rhode Island policy but no credits on the OOS policies. In the "Out-of-State Policies" section, we describe the history of OOS coverage and the pricing limitations related to Beacon's fronting arrangements in more detail. Under Beacon's fronting arrangement with GenRe's subsidiaries (Fairfield and Genesis), which lasted from 1997 to 2005, OOS policies were generally not provided credits.

Emails and other documents, including Notepad and policy referral forms, included language that indicated the credits on the Rhode Island portion of these accounts were increased in order to offset the high OOS policy prices. Based on interviews with underwriting personnel, we confirmed that knowledge of this methodology was widespread and the practice was common. Several underwriters indicated that Beacon's philosophy was to price entire accounts as a complete package. Various underwriters explained:

- The Beacon philosophy was to look at the insured "as a whole" and all decisions on pricing considered the in-state and OOS policies together. Due to the pricing restrictions in the Fairfield fronting arrangement, excess credits were provided on the in-state policies to reduce the overall price inclusive of the OOS business.
- Beacon's philosophy was to price each insured's total premium (in-state and OOS) together, noting, "if we had to compete [on overall price] we would drop [our price]."
- Rhode Island policies were often adjusted to offset higher Fairfield OOS prices. This was not the preferred approach but it was an option that Beacon had according to Clark. No one questioned the appropriateness of this practice.
- In these cases, Beacon "takes a hit on the Rhode Island policy, but can profit on the whole thing" despite the fact that "the state gets screwed."
- The practice of combining policies for the purpose of pricing is "cheating Beacon to help Fairfield" but that there is "enough money in the pot" to cover the exposure. The underwriter understood that this policy would cause the losses for Rhode Island to look worse. The underwriter noted that this issue was discussed with underwriting management and an agent from one of Beacon's top agencies.
- The Beacon philosophy was to review the risk as "a whole program" and that the policies were combined, priced and collected as if they were one policy.

R.I.G.L. § 44-17-1 states:

> *Every . . .insurance company. . . transacting business in this state, shall, on or before March 1 in each year, file with the tax administrator, in the form that he or*

> *she may prescribe, a return under oath or affirmation signed by a duly authorized officer or agent of the company, containing information that may be deemed necessary for the determination of the tax imposed by this chapter, and shall at the same time pay an annual tax to the tax administrator of two percent (2%) of the gross premiums[40] on contracts of insurance . . . covering property and risks within the state, written during the calendar year ending December 31st next preceding….*

Beacon's practice of reducing its Rhode Island premiums through additional credits for the purpose of offsetting higher OOS premiums resulted in lower Rhode Island premiums. As of July 1, 2005, Beacon's premium tax exemption was repealed and they became subject to the above provision.[41] Artificially lower Rhode Island premiums resulting from this practice of combining policies for pricing purposes would have led to a lower tax basis for the assessment. This practice would constitute a violation of R.I.G.L. § 44-17-1 for each instance on July 1, 2005 and thereafter.[42]

In the same way that Beacon understated its gross premium for tax purposes, this practice of combining policies also understated gross premium for the purpose of calculating Beacon's assessment paid to the DLT. R.I.G.L. § 28-37-14 provides the calculation of gross premium for the assessment calculation. Gross premium is reduced by Beacon's underwriting credits. Therefore, the practice of applying additional credits on the Rhode Island policies to offset higher OOS premiums resulted in Beacon paying a lower proportion of DLT's assessment under 2003 P.L. ch.410 § 19(e). Other carriers writing insurance in the state paid a higher percentage of the DLT assessment as a result of Beacon's practices.

Net of Commission Pricing

The Examination identified two instances where Beacon, at the request of an agent, priced an account net of an agent's commission. Beacon did not file this pricing variation with DBR. DBR addressed this in Insurance Bulletin Number 2002-11 on November 14, 2002, which stated:

> *An insurance producer who receives a commission from a licensed Property & Casualty insurer for placing coverage cannot also charge a fee to the insured for*

[40] The Division of Taxation assesses premium tax based on amounts reported in the annual statement Schedule T Part 1 column 2 (for Rhode Island) "Direct Premiums Written." Certain credits (such as dividends to policyholders) are allowed but these credits are not related to Beacon's underwriting credits.
[41] Beacon's voluntary business was subject to premium tax prior to 1996 when its enabling act was amended to remove the requirement that voluntary and residual market business be segregated.
[42] Beacon switched carriers for its OOS fronting arrangements as of May 2005 to Argonaut. We understand that Argonaut's pricing is more flexible than Beacon's prior arrangement in terms of credits. Therefore, this practice of combining policies might have become less pervasive. We did not perform procedures related to the Argonaut policies because they are tracked offline in Microsoft Excel.

> *services that are customarily associated with the selling, soliciting or negotiation of the insurance. Commission expenses of the insurer are included within the operating expenses of the insurer and are considered in the rate making process. Any additional charges imposed on the insured are, therefore, in violation of the rate filing statutes and R.I. Gen. Laws § 27-29-8…Contracts which are 'net of commission' do not include commission expenses in rates and, therefore, a separate fee may be charged to the insured by the insurance producer. However, that fee must be fully disclosed to the purchaser, in writing, prior to the sale.*

Insurance Bulletins represent DBR's interpretation of existing laws and DBR policy. Failure to file "net of commission" filing constituted a violation of R.I.G.L. § 27-7.1-5.1(a).

Expenses

Beacon, unlike a private competitive insurer, is subject to statutory limitations on expenditures. The following excerpts from Beacon's enabling act are relevant to this section:

> **2003 P.L. ch.410 § 6:** The board is vested with full power, authority, and jurisdiction over the fund. The board may perform *all acts necessary or convenient* in the exercise of any power, authority, or jurisdiction over the fund, either in the administration of the fund or in connection with the insurance business to be carried on by it under the provisions of this act, as fully and completely as the governing body of all other domestic insurance carriers to fulfill the objectives and intent of this act. The board's authority to invest funds is subject to the limitations imposed on domestic insurance companies in chapter 11.1 of title 27 (emphasis added).
>
> **2003 P.L. ch.410 § 10:** For the purposes of exercising the specific powers granted in this act and effectuating the other purposes of this act, the fund may…(9) Perform all other functions and exercise all other powers of a domestic mutual insurance company that are *necessary, appropriate, or convenient to administer the fund* and to its members…(emphasis added).
>
> **2003 P.L. ch.410 § 13:** The chief executive officer may perform all other acts *necessary to exercise the powers*, authorities and jurisdictions of the fund, either in the administration of the fund or in connection with the insurance business to be carried on by the fund under this act, including the establishment of premium rates…(emphasis added).

In *Sims v. Hartman* 41 Ariz. 486, 19 P.2d 679 (1933), the Arizona Supreme Court held that the state compensation fund was not authorized to use funds in a fight to retain the commissioners' position with the Fund, even though the expenditure had been approved by the Commission. The governing statute provided that "[t]he commission shall have full authority over the fund, and may do all things *necessary or convenient in the administration thereof*, or in connection with the compensation business to be carried on by it hereunder…" *Id.* at 498 (emphasis added). The Arizona Supreme Court found that this language was "…a *limitation of the power of the commissioners and of their expenditures to a liberal, fair and honest administration of the compensation fund for the purpose for which it was created* … It is not necessary to cite any authority other than the compensation act itself to show that the commission had no right to spend the compensation fund for lawyers' fees to prosecute the action against the Secretary of State, or to influence the electorate" (emphasis added).

This limitation on the expenditures of state compensation funds is also expressed in the leading insurance treatise. "The revenues received from the contributions of employers are a trust fund in the sense that a moral and legal obligation is imposed upon the state to use the revenues for the declared purposes for which they are collected. And being a trust fund, or so called 'public money,' the commission cannot use it for purposes not expressed or necessarily implied in the act creating it…" (7B-193 Appleman on Insurance § 4592).

Although the statutory language upon which these cases are based is identical, a distinguishing factor is that Beacon is not an entity of the state government. Therefore, the assets of Beacon are not "public money." However, its enabling act establishes that the Board and management are only authorized to expend the funds for expenditures which are necessary to fulfill Beacon's purpose. This Examination found numerous areas where funds were expended for items that were not "necessary or appropriate" to Beacon's statutorily declared mission. These expenditures are violations of 2003 P.L. ch.410 §§ 6, 10 and 13. See the "Financial Controls and Cash Disbursements" section of the report for specific expenditures that the DBR finds as violations of these statutes.

Agent Commissions

In the "Agent Commissions" section of this report, we outline a number of instances where Beacon senior management or underwriting personnel modified the commission rates for certain agents in order to provide more commission than Beacon was obligated to pay. It does not appear that the board of directors was provided adequate information to determine the effect of these adjustments. 2003 P.L. ch.410 § 16 states, "The board shall by rule also establish a schedule of commissions for voluntary risk and residual risk coverage that the fund will pay for the services of an insurance producer."

Any decision by management or the underwriting department to pay commissions to agents in excess of the amounts owed under the contracts and rates approved by the board is a violation of 2003 P.L. ch. 410 § 16. Such payments also represent violations of 2003 P.L. ch. 410 §§ 6, 10 and 13, since such payments were not necessary for the administration of Beacon.

Backdating of Supporting Paperwork

We found Emails that suggested that underwriting management instructed personnel in the department to recreate documents and backdate signatures related to a request made by the DBR during its Market Conduct Examination. This instance is described in more detail as Allegation 4 in the "Original Whistleblower Allegations" section.

The SKM report on the whistleblower allegations, dated January 9, 2006, included an allegation that "the Underwriting Department worked late for several nights to 'dummy up' schedule credit forms in anticipation of the recent state audit." Our finding with respect to the backdating of the renewal form for the insured discussed in Allegation 4 was consistent with this allegation.

It appeared that underwriting management directed this document to be prepared in October 2005, but it was dated and signed by underwriting management as of November 2004. Beacon provided this document to the DBR two times during its Market Conduct Examination, and also provided it to the Almond Ad Hoc Review Committee. DBR included this document in its workpapers.

R.I.G.L. § 27-54-1 specifies:

> *Any person who knowingly and with intent to deceive the director of business regulation (referred to in this section as "director") about the financial condition of an insurance company, makes any false statement, representation or report to the director concerning an insurance company; or who knowingly and with intent to deceive the director about the financial condition of the company testifies or affirms falsely under oath or affirmation to any material fact relative to an insurance company in any matter which would materially affect the financial condition of the company; or who knowingly and with intent to deceive the director about the financial condition of the company makes any false entry or memorandum upon any book, paper, report or statement of any insurance company; or, who, knowingly and with intent to deceive the director or his or her designee or any agent appointed to examine the affairs of an insurance company, or knowingly and with intent to deceive, defraud or injure the stockholders, policyholders or any officer or director of an insurance company about the financial condition of the company makes a statement, representation or report to the director or the director's designee which the individual knows materially overvalues any asset, property or security of an insurance company; or who knowingly and with intent to deceive the director about the financial condition of the company fails to disclose material information, and any person who, with like intent, aids or abets another in any violation of any provision of this section, shall upon conviction, be fined not exceeding fifty thousand dollars ($50,000) or imprisoned not exceeding twenty (20) years, or both.*

Knowingly backdating this document and then providing the altered document to DBR in connection with its Market Conduct Examination constitutes a violation of this statute.

FINANCIAL CONTROLS AND CASH DISBURSEMENTS

Data Capture and Reconciliation Procedures

Reconciliation of MAS200 and PowerComp Data

We requested that Beacon provide us with electronic data extracts from its MAS200 and PowerComp systems in order for us to conduct our cash disbursements and premium pricing procedures. To ensure that the MAS200 and PowerComp data we were provided by Beacon was complete and accurate, we performed the reconciliation procedures detailed below.

<u>MAS200 Data Reconciliation</u>

Beacon's general ledger accounting system is called MAS200. We requested the entire general ledger ("GL") detail for all available periods, as well as all related trial balances.[43] We then performed the following reconciliation steps:

- Summarized MAS200 GL data by GL account and fiscal year,
- Compared summarized results to the respective fiscal year trial balances for 1997 through 2005:
    - Reconciled income statement accounts by comparing the GL detail summarized results for each year directly to the respective fiscal year trial balances,
    - Reconciled balance sheet accounts by comparing the summarized results of GL detail activity for each year to the difference between the respective fiscal year trial balance and the prior year trial balance,
- Compared trial balances to the KPMG audited financial statements for the years 2002, 2003, and 2004:[44]
    - Reconciled income statement account activity for 2002, 2003, and 2004,
    - Reconciled balance sheet accounts for 2003 and 2004.[45]

We noted no unexplained variances between the GL detail, trial balances and KPMG audited financial statements.

Per discussion with finance department personnel, the MAS200 data includes the detailed accounts payable disbursement data. All cash disbursements other than payroll, claims,

[43] We performed reconciliation procedures on the general ledger of Beacon Mutual Insurance Company, but did not perform these procedures on its subsidiaries, Castle Hill Insurance Company and BMIC Services Corporation.
[44] Beacon has not issued its 2005 audited financial statements as of the date of this report.
[45] Reconciliation of 2004 balance sheet account activity required 2005 audited financial statements, which Beacon has not issued as of the date of this report.

policy-related payments and base commissions to agents are paid out of accounts payable, and therefore included within MAS200.

PowerComp Data Reconciliation

Beacon's PowerComp system includes all policy-related transactions, such as premium earnings, billings and collections, claims handling and payment, base commissions calculations, and payments to agents. These transactions are recorded within PowerComp on a daily basis. At the end of each month, the monthly activity within PowerComp is summarized by GL account and posted to the respective accounts within MAS200. Beacon provided us with batch files containing the monthly data from PowerComp from October 2003, when the PowerComp system was implemented, through December 2005. We selected calendar year 2005 and performed reconciliations of the PowerComp data we obtained to Beacon's GL by performing the following steps for each month:

- We summarized the activity in the batch files by GL account for each month of 2005 and reconciled those amounts to the respective GL account information within the MAS200 data.
- We summarized the PowerComp data for each month in 2005 and reconciled the PowerComp financial data to the detailed batch files.[46]

Problems Related to the Acquisition of Data

We encountered several obstacles in obtaining and validating the MAS200 and PowerComp data. We identified inconsistencies within the Beacon data, and also found that there was an overall lack of detailed knowledge and appropriate documentation regarding Beacon's own systems. These problems contributed to extended delays in the delivery of accurate and complete data.

Issues Relating to Data

PowerComp Data Inconsistencies – We found inconsistencies in the formulas and calculations contained within the PowerComp system. The PowerComp data included calculations of figures such as written premium, earned premium and claims paid. We found that many of these pre-conversion (WINS system) calculations were not being performed correctly within the PowerComp system.

[46] All months between January 2005 and November 2005 reconciled without exception through this process. When we applied the identical logic to the December 2005 reconciliation, however, there were variances. Working with Beacon information systems personnel we found that all December variances related to claims reserves adjustments that were posted to PowerComp after the batch file was loaded into MAS200. Beacon identified this timing issue and manually posted the adjustments to the MAS200 and data warehouse systems.

Data Warehouse Discrepancies – Beacon maintained a data "warehouse" where it stored much of the data used to run several of its reports including Account Summaries for its policies. During our reconciliation and recalculation process, we found that the data for some polices in the data warehouse did not match the data stored in PowerComp. These discrepancies between PowerComp and the data warehouse indicated that the data warehouse information was not accurate. Specifically, when we recalculated the premiums for several policies based on logic provided by Beacon and compared the results to Account Summaries generated from Beacon's data warehouse, there were discrepancies. Beacon information systems personnel confirmed that our calculations, based on PowerComp data were correct, and that the data warehouse reports were incorrect. It is our understanding that the data warehouse drives many of the reports that management utilizes to operate and analyze Beacon's business.

Out-of-State Policies – The PowerComp system houses information for in-state and certain out-of-state policies. PowerComp contains the actual calculations of the premiums for the in-state policies, but does not contain the calculations of premiums for out-of-state policies. These premiums are calculated offline and then uploaded into the system. We found discrepancies in premium amount, premium calculation rates, claims and credits across much of the out-of-state data. Other instances arose where no data was found in PowerComp to support the out-of-state figures that Beacon provided on its hard copy Account Summaries produced from the data warehouse.

An underwriting manager explained that under the Fairfield fronting arrangement, Beacon had an interface with Fairfield to price the out-of-state policies, but underwriting had to manually input the results into PowerComp. They explained that when Beacon switched its fronting carrier to Argonaut, the information systems department was 80% of the way towards the completion of an interface to integrate Argonaut's data with PowerComp when the department's resources were reallocated to another project. The underwriting manager confirmed that Argonaut policies are not included in PowerComp, but are tracked using Microsoft Excel and billed manually by the finance department.

<u>Issues Related to Personnel</u>

Unavailable Code Definitions – Beacon finance personnel were unable to explain many of the fields within the MAS200 data Beacon provided. As part of the process of receiving and validating data, we asked questions of Beacon regarding the content of the files they provided. In some cases, they were unable to answer our questions. Ultimately, we resolved the issues that were critical to our specific procedures, but there remained certain fields within the data for which Beacon could not provide an explanation. This issue did not inhibit our reconciliation process, though it showed Beacon's overall lack of detailed knowledge and documentation regarding its systems and data.

Unavailable Data – We found that certain information within Beacon's MAS200 system was periodically purged. Much of the data required for reconciliation of accounts payable disbursement data for periods prior to 2003 had been purged from the system and Beacon personnel did not know if that data was backed up or where the location of the backup might have been. As a result, we were generally limited to 2003 through 2005 data for our accounts payable disbursement procedures.

Multiple Iterations of Data Files – Some of the variances we encountered in our reconciliation process, along with general questions we asked about the data, resulted in Beacon supplying us with new versions of data files they had previously provided. Multiple versions of data files led to delays from import and validation procedures.

Incorrect Control Totals – We requested control totals, or the total number of records or transactions that existed in the data extracts provided to us. We counted the number of transactions we received in the data files and compared those totals to the control totals we were given separately by Beacon to confirm that we had correctly uploaded and processed all transactions in the files. Some of the control totals provided by Beacon for both the MAS200 and PowerComp data were incorrect, resulting in variances between our numbers and the control totals. When we inquired about these variances, Beacon finance personnel discovered they had incorrectly recorded the control totals when they had provided them to us, resulting in the appearance of variances when there were, in fact, no variances. This caused additional delays in processing our data.

Beacon Personnel's Lack of Detailed Knowledge of Systems and Data – Beacon personnel had limited knowledge of the PowerComp system. PowerComp was developed and implemented by a third-party contractor, and Beacon personnel had limited knowledge of the system and its data structure while responding to our questions related to the system. Beacon maintained a general understanding of the system, but could not provide details necessary to explain the data files they were providing. We came to understand these data files only through a long process of (1) obtaining a theory from Beacon personnel, (2) testing that theory on the data, (3) identifying exceptions to that theory, and then (4) meeting with Beacon again to revise the theory. This process continued for weeks during our attempts to obtain, process, and reconcile the PowerComp data.

One of the main delays we encountered related to the completeness of data we requested. The PowerComp data is organized in tables, and we were often not provided with all the tables necessary to perform the procedures we developed. Our initial meeting with the information systems department involved an in-depth discussion of the specific data we would need for our procedures. Often throughout the data acquisition process referred to previously, we noticed that we were missing information related to tables required for our procedures.

It was apparent early in this process that Beacon personnel did not have detailed knowledge of the PowerComp system and each response to our inquiries had to be thoroughly tested. After consultation with PowerComp personnel, Beacon would at times provide explanations to us that were different from their original explanations. In addition, Beacon's explanations often solved part of the problem rather than the entire problem itself. In other words, we would provide Beacon with examples of cases that did not apply to the current methodology and they would find logic to address our examples. When their solution was applied to the entire population, there were still many exceptions and we would have to provide them with a new set of examples. This process continued throughout the entire data receipt and load process, causing delays.

Beacon's Finance Department and Internal Controls Environment

As part of the Examination, we performed a series of procedures on Beacon's cash disbursements. We focused our procedures on Beacon's vendor master file and accounts payable disbursements between 2003 and 2005. We performed several procedures to gather an understanding of the data integrity of Beacon's general ledger system, MAS200, and to identify potentially improper payments made by Beacon during this time period. Our procedures are explained in more detail in the "Accounts Payable Disbursements" section below. Our procedures did not constitute an assessment of Beacon's internal controls; however, we did note several areas of concern regarding the financial controls during the Examination.

As we discussed in the "Corporate Structure" section, the CFO position was a formality. The responsibilities of the CFO were limited to that of a vice president. In this position, the CFO was responsible for overseeing the finance and premium audit departments. The CFO explained that the CFO's role did not include the overall design and effectiveness of internal controls at Beacon. Each vice president was accountable for the policies, procedures and controls in their respective areas.

Members of senior management interviewed referred to Beacon's corporate structure as several "silos" working independently of one another. We learned that this silo structure extended to the accounts payable ("AP") disbursements area. The finance department was not responsible for challenging the reasonableness or validity of expenses. As long as any vice president approved them, the finance department served as a bookkeeping function for most disbursements (subject to the approval limits below).

Based on the results of our procedures detailed below, we found several areas within the AP disbursements cycle where expected internal controls were not in place, or where existing internal controls were not operating effectively. During informal discussions with finance personnel, we found internal controls around the check signing and approval process were lacking. The written policy for the approval of check requests was:

Approval Limit	Level of Approval
Approval up to $250	Supervisors
Approval up to $500	Managers
Approval up to $2,000	Facilities/Shared Service Managers
Approval up to $2,500	Directors
Approval up to $5,000	Vice Presidents and Department Head of Human Resources
Approval up to $10,000	Chief Financial Officer
Approval over $10,000	President

We found there was no similar written policy governing the signing of the actual checks issued by the finance department. Based on discussion with finance personnel, Beacon's PayBase check printing software has the CEO and CFO signatures stored electronically and automatically prints one or both signatures on every AP check issued by Beacon, depending on the dollar amount of the check. All checks of $5,000 or less are automatically printed with both signatures. These checks require no manual signature by any other vice president and are not reviewed further by anyone in the finance department for approval once they are printed.

Based on this practice for checks of $5,000 or less, a request for payment of $5,000 to an improper vendor, or request for payment of an improper amount, would be paid without any level of review by the finance department, as long as the check request was approved by someone with the appropriate level of authority.

Checks over $5,000 are automatically printed with either (but not both) the CEO or CFO signature,[47] and are required to be manually signed by another vice president. This manual signature requirement serves as one level of review for checks over $5,000.

Many of our findings in the controls area related to the maintenance of the vendor master file. First, finance department personnel explained that most finance employees have access to the MAS200 system, and that there did not appear to be hierarchies of access within the system. This access allowed employees to make additions and edits to MAS200 data including the vendor master file as well as the access to add new vendors that had not been properly approved.[48]

Beacon does not have a formal vendor selections process and does not regularly extend requests for proposals ("RFP") for goods or services. Also, Beacon does not appear to formally evaluate the performance of its existing vendors and solicit bids from competitors to ensure they are paying market value. The lack of an independent review of contracts and vendor performance, as well as the lack of a formal RFP process may

[47] Finance personnel have the ability to set either the CEO or CFO signature as the default signature on all checks. Per discussion with finance personnel, it was common practice to set the CEO as the default signature if they were going to be away on vacation or business travel, so that checks over $5,000 requiring a manual signature could be automatically printed with his signature and the CFO can serve as the second, or manual, signature and vice versa.

[48] Finance personnel claimed that the purchase order system Beacon implemented in 2005 limited the ability to add new vendors to the system, however prior to this system implementation, any vice president could approve a vendor for payment.

contribute to the risk of improper relationships and non-arms length transactions. This may also contribute to overpayment for certain goods and services.

Beacon does not have a central purchasing department and it does not effectively utilize a purchase order system. Most AP payments are initiated solely through check requests. Finance personnel explained that Beacon implemented a purchase order system in 2005, but that only a small number of purchases are processed by this program. There is no comparison check performed to ensure that the goods and services that are ordered are consistent with what is delivered. Utilizing a purchase order system with built-in functions that require vendor invoices to match purchase orders and/or receiving reports before payment allows for greater control over purchasing and reduces the risk of disbursement abuse.

According to finance personnel, certain employees were designated to perform individual functions related to the vendor master file. For example, one particular employee was designated to handle the additions of new vendors to the vendor master file.[49] However, this policy was strictly the assignment of responsibility and it did not represent a system control that restricted other finance personnel from adding other vendors to the master file.

In addition to concerns regarding the editing and adding of vendor information, we found that temporary vendors are not deleted from the system in a timely manner. Based on discussions with finance personnel, when Beacon's accounting system, MAS200, was implemented, it was set up to automatically purge temporary vendors on a monthly basis. This mechanism stopped working properly at some point, however, and the issue was never resolved. The finance manager estimated that it had been multiple years since the system's purge mechanism had been working properly. As a result, the vendor master file had an excessive number of authorized vendors with whom Beacon did not actually conduct business anymore. Lack of timely maintenance including the deletion of temporary or dormant vendor accounts increases the risk of unauthorized disbursements. We found 7,149 unique vendor identification numbers in the master file. Based on queries we performed on this data, 3,637 (51%) of these vendors did not receive a payment during calendar year 2005.[50]

We found that there was no process in place to assess the accuracy and completeness of vendor information, as well as the business purpose for each vendor. For example, we found several instances where the same vendor was listed more than once with different vendor identification numbers. This makes it difficult for Beacon to analyze payments to a single vendor, or to maintain proper accounts payable history, as the vendor might be paid once using one identification number, and another time using a different one. We understand finance personnel who could not find the correct vendor in the system might

[49] Per discussion with finance personnel, this process was implemented in April 2005. Prior to this time, there was no formal process in place.
[50] In addition, 2,465 (34%) of these vendors did not receive a payment in the two years 2004 through 2005, and 1,573 (22%) did not receive at least one payment in 2003 through 2005.

add a new vendor in order to process a payment. We also found instances where the same address was listed for multiple vendors. In some cases, this resulted from the merger of two companies where the old entities were not removed. The failure to identify and correct duplicate vendors in the master file may be a disbursement risk. Anyone with access to the master file could change the address of a payee and send payments to incorrect addresses.

We identified instances where the payee name on an AP disbursement check did not exactly match the vendor name in the vendor master file. The explanation provided by the finance department was that the vendor name had been changed at some period in time. Changing a vendor name in the vendor master file automatically updates all transactions with the new vendor name when the disbursement data is retrieved, as it was when Beacon provided us with its MAS200 data. As a result, our vendor name field shows the current vendor name in the vendor master file at the time the data was retrieved, while the payee field in the cash disbursements data remained the same, causing a variance.

Without a control to ensure the payee name on checks being issued matches a vendor name in the vendor master file, the name of the payee could be changed in order to facilitate an unauthorized disbursement while reports run using AP data would not show the actual recipient.

Accounts Payable Disbursements

Summary of Findings

During the course of the Examination, we performed several procedures detailed in the following sections on the vendor master file and AP disbursements. We requested and read supporting documentation for 390 payments between 2003 and 2005 totaling approximately $7.0 million. The following table summarizes our payment selections by categories. Based on the results of the procedures performed on our selections we performed additional queries on the AP disbursements data in order to quantify the total amount Beacon spent on each category for the years 2003 through 2005. The right-hand column in the following table represents the results of these queries. Descriptions of each category are provided in the section below the table.

Category	Number of Payments Selected	Dollar Amount of Selected Payments	Total Payments Identified
Corporate Credit Card Payments	111	$ 624,835	$ 624,835
Golf Payments	46	$ 509,645	$ 1,109,491
Charitable Contributions	45	$ 331,004	$ 1,149,350
Cornerstone Payments	11	$ 209,212	$ 460,579
Agent Benefits	12	$ 185,735	$ 1,730,777
Beacon Senior Management Benefits	18	$ 121,838	$ 150,869
Safety Group Payments	4	$ 90,111	$ 607,076
Other Payments	143	$ 4,958,131	N/A
TOTAL	**390**	**$ 7,030,512**	

Corporate Credit Card Charges

Beacon maintained two corporate credit cards. One card was used for employee business travel expenses and the second card was held on site by Solomon's administrative assistant for miscellaneous items. Solomon had a third personal credit card that he would use for business expenses as well. We looked at support for payments to these three credit cards. Over the three-year period 2003 to 2005, Beacon paid approximately $625,000 for charges to these credit cards.

Golf Payments

Forty-six of the 390 selections we made from the AP disbursements population were for golf-related charges totaling approximately $510,000. These charges generally related to events including Beacon's top agents and Beacon's senior management team. There were three types of golf-related payments in our selection population:

- Payments made to country clubs for golf outings and other events,
- Payments made for domestic and international golf trips, which included Beacon personnel and agents, and
- Payments made for Beacon personnel participation in local golf outings for various organizations.

We performed additional queries on the AP disbursement data based on these 46 selections and identified at least $1.1 million in golf-related payments made by Beacon during the 2003 through 2005 period. These payments consisted of approximately $911,000 in payments to country clubs, $109,000 for golf trips, and approximately $90,000 for local golf outings.

Country Clubs – Through our selections and subsequent queries of AP disbursement data, we identified payments to three different country clubs in Rhode Island and Massachusetts for golf outings and other events.

- Beacon's AP data indicated that Beacon paid approximately $542,000 to a private country club in Massachusetts over the period 2003 through 2005. Beacon had a corporate membership at the club and held numerous golf outings and hosted events for agents. Payments included annual membership dues, golf charges for Beacon employees and agents, purchases of golf equipment and attire and other entertainment charges. See the "Golf Club in Massachusetts" section for more information on these charges.
- Payments to a country club in Rhode Island for the three-year period totaled $344,965 for agent outings and purchases of golf equipment and attire.
- Beacon made one payment for $23,774 to another country club in Rhode Island for an agent golf outing in 2005.

Golf Trips – Beacon's senior management and certain major agents incurred costs of travel and golf-related expenses related to various golfing trips across the country and internationally. Our selections included costs related to golf trips to Palm Springs, California; Miami and West Palm Beach, Florida; Pinehurst, North Carolina; Kohler, Wisconsin; and St. Andrews, Scotland. Attendance for each of these trips varied, but Solomon was always involved. Clark often participated in the trips as well. We found that Beacon often invited the same agents. Most of the trips included many agents from Beacon's top agencies, as well as a key political lobbyist who was also the owner of Cornerstone Communications Group.

Charges for these golf trips included payments made directly to vendors, charges to Beacon corporate credit cards, payments made to agents for reimbursement of their expenses, and employee expense reimbursements to Solomon and Clark. In total, we identified $108,619 in payments made by Beacon related to these golf trips during the 2003 to 2005 period. The following table illustrates the date, location and costs to Beacon for golf trips we identified during the Examination:

Date	Location	Costs To Beacon
May-03	Scotland	$ 33,642
Apr-04	Miami, FL	$ 20,096
Nov-05	Palm Beach, FL	$ 18,474
Oct-04	Palm Beach, FL	$ 18,081
Apr-03	Palm Springs, CA	$ 12,846
Apr-05	Pinehurst, NC	$ 2,841
Sep-05	Wisconsin	$ 1,624
Nov-03	Palm Beach, FL	$ 1,015
TOTAL		**$ 108,619**

Local Golf Outings – Eighteen of the payments we selected through the procedures described below were to local Rhode Island organizations for fundraising or charity-related golf outings. Sixteen of these payments were $5,000 each, totaling $80,000, with two other payments of $8,000 and $2,000, over the period 2003 through 2005.

Charitable Contributions

Forty-five of the payments we selected were related to charitable contributions and totaled approximately $331,000. These contributions included a large payment that was not properly authorized by the Board, in the amount of $25,000, paid to a local hospital. Beacon also made other contributions to organizations with close ties to Beacon senior management or board members. Beacon's accounting data indicated that they charged $462,883, $297,434, and $389,033 to the charitable contributions account in 2003, 2004, and 2005, respectively, totaling approximately $1.1 million during the three-year period. This amount included payments made for participation in golf outings referred to above as well as other non-golf contributions.

Cornerstone Communications Group Payments

Eleven of the disbursements we selected were paid to Cornerstone Communications Group totaling approximately $209,000. Beacon's accounting data indicated that a total of approximately $461,000 in payments were made to Cornerstone during 2003 through 2005. See the "Cornerstone Communications Group" section within this report for more information on this relationship.

Agent Benefits

Twelve of the payments we looked at related to benefits extended to agents, totaling approximately $186,000. These charges were for tickets to sporting events and concerts, banquet dinners, and, in one case, payments made to the son of an agent in sponsorship of his PGA golf career. The sporting events included New England Patriots, Boston Red Sox, and Pawtucket Red Sox games, including a luxury box at Gillette Stadium in Foxborough, Massachusetts that Beacon shared with one of its insureds (see Allegation 4 in the "Original Whistleblower Allegations" section for more information on this insured)..

We found that Beacon paid approximately $340,000 to this insured for use of the luxury box during the three years 2003 through 2005. The CFO of this insured was also a member of Beacon's board of directors as of September 2004 through the date of his resignation on 4/14/2006.[51] We also found approximately $19,000 paid to an individual for Boston Red Sox tickets during the period.

[51] This board member was named chairman of Beacon's audit committee effective as of 6/15/2005 and remained in this position up until his resignation date in April 2006.

Most of these payments were charged to a general ledger expense account called "Allowances to Agents." Queries we performed on Beacon financial data showed charges to this account of $580,597, $604,506, and $545,674 in 2003, 2004, and 2005, respectively, totaling approximately $1.7 million during the three-year period, inclusive of many of the golf events and agent benefits mentioned above.

Beacon Senior Management Additional Benefits

Eighteen of the 390 payments we selected, totaling approximately $122,000, related to additional benefits for Beacon senior management. These included car allowance charges for Solomon, reimbursements to senior management for personal country club memberships, as well as wealth and retirement planning consulting services.

Safety Group Payments

Four of our selections related to Beacon safety group payments. These selections totaled approximately $90,000 for administrative and marketing fees paid in accordance with safety group agreements. See the "Statutory Violations" and "Safety Groups" sections of this report for more information on these expenses.

Other Payments

Some of the payments we selected did not yield relevant findings for the purpose of this report. These payments constituted 143 of our 390 selections, totaling approximately $4,958,000.

Summary of Procedures Performed

We found that detailed AP disbursement information was included within the MAS200 data. The detail of cash disbursements generated out of Beacon's insurance system, PowerComp, are not included in the MAS200 data. See the "PowerComp Cash Disbursements" section for more information on non-AP payments.

We obtained and reconciled the MAS200 general ledger data to Beacon's trial balances and audited financial statements (see the "Data Capture and Reconciliation Procedures" section). We isolated all AP cash disbursement activity for the period 2003 to 2005 within MAS200, and performed our procedures on the resulting data set.

The population of AP disbursement activity included payments to vendors, employee expense reimbursements, dividends and shared earnings distributions to insureds, and contingent commission payments to contract agents. This population did not include claims payments, base commission payments to contract agents, return of premium payments, and employee payroll disbursements. See the "PowerComp Cash Disbursements" section for procedures performed specific to these disbursements.

The data showed that there were approximately 22,000 AP disbursements during this three-year period totaling approximately $155.7 million. The 390 disbursements we selected based on the procedures outlined below accounted for approximately 1.7% of the total number of AP disbursements and approximately 4.5% of the total dollar amount of AP disbursements during the three-year period. We performed the following procedures to identify AP disbursements for additional procedures:

Selections Related to Data Integrity:

- Using the vendor master file and AP disbursement data, identified:
  - Duplicate vendor identification numbers ("Vendor ID"),
  - Different Vendor IDs with the same vendor name,
  - Different vendors with same mailing address,
  - Different vendors with same phone number,
  - Different vendors with same federal tax identification number or social security number and
  - Vendors with missing address information.

Selections Related to Controls:

- Located payments to vendors with missing or invalid Vendor IDs,
- Isolated Beacon employees listed in the vendor master file using name, address, phone numbers, or social security number information obtained from Beacon's third-party payroll administrator's data,
- Isolated all AP disbursement amounts that were immediately below Beacon check request approval limits,
- Identified instances were there were variances between the disbursement amount and the related invoice amount,
- Isolated all AP disbursements which were generated outside of the weekly AP check run. (Beacon refers to these as "manual" disbursements.)[52]

Selections Related to Vendor Information:

- Identified the largest 50 vendors by total payments and the 50 most frequently paid vendors,
- Isolated vendors with post office box addresses,
- Identified vendors which received only one payment in any of the three calendar years 2003 through 2005,
- Isolated vendors that received structured payments, defined as:

[52] All Beacon AP disbursements are processed using PayBase check printing software. There are no handwritten or typewritten checks issued.

    - Four or more identical payment amounts within one year or
    - Ten or more identical payment amounts over the three-year period,

- Identified vendors that had five or more payments within the same calendar month.

<u>Selections Related to Employees, Senior Executives, and Other Related Parties:</u>

- Identified non-payroll disbursements to members of senior management,
- Identified expense reimbursement payments to Solomon and Clark for the 2003 to 2005 period,
- Performed a public records search for a number of Beacon employees, board members, agents and insureds and compared the resulting data to the AP disbursements and vendor master file data.

<u>Selections Related to Agents:</u>

- Identified AP disbursements which were charged to the "Allowance to Agents" general ledger account.

<u>Selections Related to Other Sources:</u>

- Isolated AP disbursements used to pay off balances on Beacon's corporate credit cards.
- Applied Benford's Law, a probability formula to identify certain unexpected patterns of AP disbursements.

<u>Procedures Performed on AP Disbursement Selections</u>

Based on the results of the procedures above, which identified a number of distinct populations of disbursements, we judgmentally selected certain vendors and disbursements for further procedures. The specific procedures applied to each individual vendor and payment may have varied based on the level of complexity and risk of each issue. Generally, we performed the following procedures:

- Obtained an understanding of the vendor through discussions with Beacon finance personnel including:
    - The type of goods or services provided by the vendor and
    - The business purpose for the vendor's goods or services.
- Requested and read supporting documentation for each selected AP disbursement including:
    - Copies of the cancelled check, including payment signatures,
    - Copies of the check request submitted to the finance department,
    - Copies of the vendor invoice, including approval signatures (if applicable),
    - Copies of internal memos, Emails, or other related correspondence (if applicable) and

  - Any other supporting documentation provided by Beacon, including consulting agreements, contracts and others.
- Performed Email searches and follow-up interviews of Beacon personnel based on our findings from initial discussions with Beacon personnel and upon reading supporting documentation for payments.

Detailed Procedures and Relevant Findings

The following sections detail specific procedures performed in each area of the AP disbursement procedures described above and the findings relevant to this report.

Data Integrity

We performed a series of procedures on the MAS200 vendor master file and the AP disbursement data to identify gaps and inconsistencies within the data we were provided. We performed these procedures to identify missing or duplicate information in both the vendor master file and the AP disbursement data. We have grouped these procedures and their findings under two subcategories: Duplicate Information and Missing Information. Detailed procedures and relevant findings of each of these tests are explained below.

Duplicate Information – We obtained Beacon's vendor master file, which served as the master listing of all authorized vendors and included information such as Vendor ID, vendor name, address, phone number, and federal tax identification number or social security number. We also obtained all AP disbursement data.[53] We described the procedures for making our selections above. The following represent relevant findings to our report:

- Duplicate Vendor IDs – We found one instance where a Vendor ID appeared more than once within the vendor master file. The vendor name associated with this Vendor ID was the same in both instances.
- Duplicate Vendor Names – We found 248 duplicate vendor names in the MAS200 data. In other words, 248 vendor names were each associated with two or more different Vendor IDs. Twenty-seven of these vendor names received $50,000 or more in AP disbursements between 2003 and 2005. We isolated these 27 vendors and looked at them further.

[53] The MAS200 data subject to the "duplicate information" procedures included (1) the vendor master file, (2) all 2003-2005 AP disbursement data, including check and invoice information, and (3) vendor history data, which included all transactions where a vendor was added to or revised within the vendor master file (the vendor history data did not contain transactions where vendors were deleted from the vendor master file.) Some of our findings in the Data Integrity section were false positives due to the variety in data sources utilized.

Based on discussion with finance personnel, 10 of these vendors had duplicate Vendor IDs in order to track multiple types of payments Beacon made to them. Different types of vendor payments were made to different Vendor IDs for tracking and reporting purposes. For example, Blue Cross and Blue Shield of Rhode Island ("BCBSRI") had three different Vendor IDs in Beacon's vendor master file, representing three types of payments that were made to BCBSRI: claims management fees (according to an agreement between Beacon and BCBSRI in which BCBSRI processed claims for Beacon), group health insurance payments for Beacon employees, and insured policy dividends.

Two of these 27 vendors were duplicates as a result of merger and acquisition activity between vendors. These were instances where two vendors merged or one acquired the other, and the result was a single vendor. In these instances, Beacon did not make the adjustments in the vendor master file, and as a result, the master file contained outdated Vendor IDs.

The remaining 15 vendor names resulted from the lack of vendor maintenance. There were data entry errors that were not identified and corrected by Beacon, such as someone adding a vendor that already existed in the system with a different Vendor ID.

- Duplicate Vendor Addresses – We found 774 duplicate addresses in the MAS200 data. Eighty-two of these addresses had $50,000 or more in AP disbursements between 2003 and 2005. We isolated these 82 addresses and judgmentally selected 17 addresses to look at further.

  Three of the addresses were duplicates due to the multiple payment type issue discovered in the "duplicate vendor names" procedure, whereby certain vendors had multiple Vendor IDs to account for different types of payments. Two of the duplicate addresses resulted from instances where different vendors merged, resulting in a single vendor, or one vendor was doing business under a different name.

  Three duplicate addresses were false positives. Due to the nature of our search and the keywords we used, some of our results were false positives. For example, some addresses were displayed as duplicates, because of two different Vendor IDs with the same street address, but different cities or states. Other duplicate addresses were the result of vendors with the same street address, city, and state, but different suite or office numbers, indicating the vendors were located in the same office park or complex. Five addresses were displayed as duplicates due to simple vendor maintenance issues, whereby a single vendor had multiple Vendor IDs in the vendor master file. The final four duplicate addresses were associated with seemingly different vendors, and Beacon was unable to provide any explanation for these matches.

- Duplicate Phone Numbers – We found 267 duplicate phone numbers in the MAS200 data. These were all phone numbers which had two or more Vendor IDs associated with them. Thirty-two of these phone numbers had aggregate vendor disbursements of $50,000 or more during the three-year period. We isolated these 32 phone numbers and judgmentally selected 11 to look at further.

Two of the phone numbers were displayed as duplicates due to vendors that merged with one another or vendors doing business as ("DBA") a different name. When these vendors merged or began doing business under a different name, the vendor master file was not updated accordingly, resulting in outdated vendors in the file. Seven other duplicate phone numbers were simply the result of the lack of file maintenance – multiple Vendor IDs related to the same vendor.

The remaining two duplicate phone numbers were associated with seemingly unrelated vendors. Beacon was unable to provide explanations as to why the phone numbers were shared by different vendors.

One of these three phone numbers was the main phone number associated with Beacon's previous office location in East Greenwich, Rhode Island.[54] This duplicate phone number was associated with 87 current and former Beacon employees in the vendor master file.

- Duplicate Federal Tax Identification Numbers or Social Security Numbers – We found 11 duplicate social security numbers and federal tax identification numbers. Each one of these numbers was associated with multiple Vendor IDs in the MAS200 data. We judgmentally selected five of these numbers to look at further.

  One of the five duplicate numbers resulted from the previously identified issue of vendor maintenance – individual vendors listed multiple times within the vendor master file. The remaining four duplicate numbers were associated with seemingly unrelated vendors, with different address information for which Beacon was unable to provide explanations.

- Missing Address Information – We performed queries of the vendor master file for all vendors that had missing address information. The finance manager explained that the department mails AP disbursement checks directly to the vendors, to the address listed in the vendor master file, on the same day as the check run. They explained that a small number of checks, such as contingent commissions, are given to Beacon departments to hand-deliver to the respective vendors. Based on this information, the existence of missing address information from the vendor master file would not allow finance personnel to mail the payments directly to the vendors.

  There were 1,411 Vendor IDs in the vendor master file that did not have complete address information. These vendors had no street address information in the vendor master file, and most had no city or state information either. We found 17 of these vendors were paid $10,000 or more over the three-year period. We

[54] Beacon moved into its Warwick, Rhode Island offices in September 2000, indicating that this data had not been updated for approximately six years.

judgmentally selected five of these vendors for further procedures. We selected a disbursement made to each of these five vendors and read the related supporting documentation for each. We found that each of our selected disbursements was either a shared earnings distribution to a policyholder or the return of a premium deposit paid for an applicant whose coverage was rejected.

Controls Procedures

Similar to the procedures performed to address the data integrity of the MAS200 vendor master file and AP disbursement information, we performed procedures to address identified control risks related to the AP disbursement cycle.

Invalid Vendor IDs – To further gauge the completeness of the data in the vendor master file, we searched for disbursements to vendors that did not have a valid Vendor ID in the vendor master file.

We found 134 payments, totaling $63,682 over the three-year period to vendors that did not have a corresponding Vendor ID in the vendor master file. These disbursements accounted for 0.60% of the total number of AP disbursements between 2003 and 2005 and 0.04% of the total 2003-2005 dollar amount of AP disbursements. We judgmentally selected three of these disbursements, totaling $16,199, and read supporting documentation. Based on the supporting documentation, one payment was a shared earnings payment made to a member of one of Beacon's safety groups and the two remaining payments were return of premium deposits to policyholders whose applications for coverage were rejected.

The finance manager explained that the MAS200 system does not allow disbursements to be issued to vendors not listed in the vendor master file. The explanation provided for the absence of these Vendor IDs from the vendor master file was that these Vendor IDs were potentially in the vendor master file at the time the payments were made and were removed from the vendor master file at some point in time after the payments were made.

We reviewed the "Vendor History" data within the MAS200 system, which included records of when all vendors were added to or changed in the vendor master file. We selected five vendors that were not in the current vendor master file, but received an AP disbursement during the 2003 through 2005 time period. We compared the date each of the vendors was added to the vendor master file to the date of the first payment to each vendor during this period.[55] All vendors were added to the system before receiving payments, which was consistent with Beacon's explanation.

[55] The MAS200 vendor history data did not include information on when vendors were deleted from the vendor master file. As such, we were unable to verify that vendors were not deleted from the vendor master prior to receiving payment.

Employees in Vendor Master File – We performed queries to identify potentially improper disbursements to Beacon employees. We searched the MAS200 vendor master file for all instances where an employee name, address or social security number matched the information of one of the vendors in the vendor master file.

We obtained all employee information from the payroll disbursement data within the MAS200 system. We then compared that information to the name, address and federal tax identification numbers[56] of all vendors in the vendor master file and looked at all results where there was a match to a vendor. We conducted the search based on text strings and keywords in order to avoid missing relevant matches due to common variation (i.e., "Joe" versus "Joseph," etc). This process also resulted in several false positives. We scanned the data and removed false positives from our population.

We isolated all matching vendors with total AP disbursements of $10,000 or more over the three-year period, which reduced the population of records to 31 vendors. We removed all false positives from the population of 31, then looked at the remaining 25 vendors and judgmentally selected six vendors for further procedures. We requested and read the supporting documentation for one payment to each of these vendors and found the following:

- One of the matches was not an employee of Beacon. This individual was listed in Beacon's employee register and was associated with a consulting company that received several large payments. The vendor is an ergonomics and claims consulting company. Based on discussions with Beacon personnel, this individual briefly became an employee of Beacon, but soon after quit and returned to his consulting practice.

- We found that employees were listed in the vendor master file for the purpose of processing employee expense reimbursements. It is our understanding that Beacon does not have a separate software program or module to track employee reimbursement activity. Therefore, it is not possible to easily distinguish between employee reimbursements approved based on Beacon policy, and miscellaneous payments made to Beacon employees. We judgmentally selected five employees included in the results of this procedure and selected the largest disbursement to each of them during the 2003 through 2005 period and read the related supporting documentation. Four of the five payments represented employee expense reimbursements. Our findings are detailed below.

    - **Purchase of Solomon's Lexus** – The payment, which was not an expense reimbursement, was for $33,917 to a finance department employee in August 2004. Supporting documentation showed that Beacon bought a Lexus at the end of its lease. According to Solomon's employment agreement with Beacon, effective as of 9/19/2003, "[Beacon] shall lease

[56] Within the MAS200 system, the federal tax identification number field contains social security numbers for those vendors who are individuals.

an automobile for use by Executive. Such automobile shall be of a quality commensurate with the automobile leased by the Company as of the date hereof." At the end of the two-year lease, Beacon purchased the car.

According to the finance manager, the Lexus dealership would not accept a check from Beacon as final payment for the car. As a result, Beacon cut a check to this employee, who converted that check into a certified bank check in order to pay the dealership. The supporting documentation included a copy of the lease agreement, which listed Beacon as the lessee, and copies of both the check from Beacon to the employee and the certified bank check from Fleet Bank to the Lexus dealership. According to the lease agreement dated 10/09/2002, the car was a 2003 Lexus GS430 sedan. The lease agreement indicated that $12,496 was paid at signing, followed by 23 monthly installments of $639. According to an Email from a member of senior management to the finance manager, the $33,917 final payment included the buyout price of $31,209 and repairs of $2,708.

We also noted a copy of a personal check from a member of senior management to Beacon for $22,554 dated 8/29/2004 included as support for this transaction. We interviewed this employee who explained that they purchased the car from Beacon and that the $22,554 was his payment. The amount paid was $8,655 less than the $31,209 buyout price. A handwritten note that reconciled the purchase price to this executive's payment indicated that a $10,000 "deposit" was paid.

The executive said he never paid a deposit of $10,000 to Beacon. He explained that Solomon authorized this as a "discount." When we asked the CFO about this $10,000 deposit, she said she was the person who had handwritten the reconciliation, but stated that no deposit was paid by the executive and she had written the note at the instruction of Solomon.

We looked at the accounting entries made to the Beacon general ledger to record this series of transactions. We noted the net impact of these entries was an expense of $11,363 charged to Beacon's "Auto Rental/Lease/Maintenance" expense account representing the difference between the amounts Beacon paid to the dealership and the amount recovered by the vice president's payment. We also inquired with the human resources department, who was not aware of the transaction and stated that this benefit was not included as income in the vice president's tax form.

- **Purchase of Cameras for Agents** – Two of the four expense reimbursements we looked at were reimbursements for items such as telephone charges, mileage, tolls and similar items. The third expense reimbursement was a $4,194 reimbursement to an employee for expenses related to the 2003 agents' appreciation golf outing, including the purchase of televisions and digital cameras. The fourth expense reimbursement was a $3,593 reimbursement to Solomon's administrative assistant. We read the related expense report that included the purchase of eight cameras and accessories for a total of $3,537.[57] The expense report, approved by the CFO, included a handwritten note indicating "Cameras purchased for Agents Advisory Council members." There was no further explanation of the purpose for these camera purchases.

Payment Approval Limits – Another procedure we performed to address the risk of potentially improper payments was the identification of vendors that received frequent payments in amounts that fell immediately below Beacon approval limits. Specifically, we identified vendors who received multiple disbursements in amounts immediately below approval limits, within a certain time period. We searched the AP disbursement data for all vendors that received disbursements in amounts immediately below Beacon approval limits for vice presidents ($5,000) and the president ($10,000).

We searched the AP disbursement data for vendors that received two or more payments in amounts between $4,500 and $4,999, or between $9,500 and $9,999. Thirty-three vendors received two or more payments between $4,500 and $4,999 and five vendors received two or more payments between $9,500 and $9,999. None of these 38 vendors received these payment amounts more than once in a seven-day period. One vendor received four payments in amounts between $4,500 and $4,999 during a 30-day period. We selected one of these four payments, a $4,836 disbursement, and read the supporting documentation. This payment was for information services consulting, and it was approved for payment by the vice president of information systems. Per discussion with the vice president, this vendor provided consulting services to Beacon related to its AuditLynx software – used by Beacon for its premium audits – and payments to this vendor were for such services.

Check and Invoice Variances – Earlier in this section, we discussed the fact that Beacon did not incorporate a purchase order system until 2005, after which it has only been used for certain tangible asset purchases. Therefore, Beacon did not have a policy requiring that all incoming invoices needed to be matched to purchase orders before authorizing payment. We performed a search of the data to return all instances in which the disbursement amount did not match the vendor invoice amount to see the frequency with which the absence of this control resulted in incorrect payments.

Our search resulted in 635 instances where the disbursement amount differed from the vendor invoice amount listed in the MAS200 system; however, the list included 506 false

[57] This expense report included $56 of additional charges which were not related to the camera purchases.

positives resulting from check reversals.[58] We judgmentally selected nine of the remaining payments totaling $22,041 and read the supporting documentation.

The supporting documentation for the selected disbursements showed that our selections were payments of shared earnings distributions, employee expense reimbursements, payments for third-party bill collection services, and payments for Beacon property and maintenance expenses. Beacon was not able to provide explanations for the discrepancies.

During this procedure, we discovered two check numbers that had been issued twice by Beacon – two payments with the same check number, issued to two different vendors, for different amounts, and on different dates. Based on this finding, we performed an additional query on the MAS200 AP disbursement data to identify all instances of duplicate check numbers and found a total of eight in the disbursement data population from 2003 through 2005. Finance personnel explained that the issue resulted from their department issuing checks outside of the weekly check run and not manually entering the check number into the MAS200 system. As a result, when the subsequent weekly check run was initiated, the MAS200 system automatically started with the last check number on record from the previous run. Beacon's MAS200 data showed that, for each pair of duplicate checks, one of the payments was classified as a manual check.

Based on discussions we held with finance personnel, it is possible for someone with access to the PayBase check writing program to generate a check using the program without having a record of that payment in the MAS200 accounting system. In these cases, finance would not know that a check had been generated, sent, or cashed until the bank statement was delivered, or if the bank called to inquire about the duplicate check numbers. According to the finance manager, four finance employees have access to the check printing function of the PayBase program. The existence of duplicate check numbers and the ability to generate checks with no resulting effect on Beacon's accounting represent internal controls issues, making it difficult to track outstanding checks and to perform timely and accurate cash reconciliations. There is also a risk that unauthorized checks could be generated.

Checks Cut Outside of Normal Procedures – Beacon issues AP disbursements on a weekly basis as part of an AP check run, during which checks are issued automatically by the system. Occasionally, urgent check requests are processed outside of the normal check run. Beacon refers to these payments as "on demand" checks. Though these checks are processed outside of the weekly check run, they are still issued through the

[58] When a check is reversed, or voided, in MAS200, the check amount displays as a negative number. If a check to a vendor is voided, the amount would appear negative, but the corresponding invoice amount would remain the same, resulting in a false positive in our search.

MAS200 system. When an "on demand" check is issued, it is issued through an AP check run separate from the standard weekly run on Fridays.[59]

Prior to 2005, finance personnel did not issue "on demand" checks through the aforementioned ad hoc AP check runs. Instead, finance personnel issued "on demand" checks outside of the MAS200 system altogether, using only Beacon's check printing program. This is the same process referred to above which caused the eight instances of duplicate check numbers. "On demand" checks were issued using the check printing program, and then the respective information, such as check number, payee, check amount and check date, was manually input into MAS200. These checks were coded as "MC" in the MAS200 data, indicating manual checks.

We isolated this "manual" payment activity for 2003 through 2005. Based on direction from Beacon information systems personnel, the data field, "Source Journal" would indicate a "CD" or "MC" code for check run and non-check run payments, respectively. There were 316 "MC" checks during the three-year period, totaling $8,872,180. We judgmentally selected 22 of these disbursements, totaling approximately $3.0 million, and performed additional procedures. The relevant findings are listed below:

- **Safety Group Payments** – We identified a $25,000 disbursement to one of Beacon's top producing agencies in January 2003 related to "MCGRI 2002 Consultant Fees." See the "Safety Groups" section for more information on this arrangement.

  We also found a $16,116 disbursement to the Jewelry Industry Safety Group ("JISG") in November 2004. According to the supporting documentation, this payment represented a marketing and administrative fee to JISG in accordance with its safety group agreement dated 1/1/1999. According to underwriting personnel, Beacon paid JISG an annual fee for marketing and administrative services performed by JISG related to the safety program. The fee equaled 2% of the aggregate premiums for JISG members. This percentage was subsequently negotiated down from 2% to 1%. See the "Safety Groups" section for more information on these fees.

- **Scotland Golf Trip** – We identified a $15,534 disbursement to one of Beacon's top producing agencies in June 2003. The supporting documentation indicated that this payment related to a golf trip to Scotland taken by Solomon and three agents in May 2003. This payment represented the reimbursement of expenses incurred by one of the agents related to the Scotland golf trip. Included in the supporting documentation provided by Beacon for this payment was a letter from this agent to Solomon thanking him for the trip. In this letter dated 6/20/2003, the

[59] This manual check population included only "on demand" checks that were issued outside of MAS200. "On demand" checks issued through ad hoc AP check runs were displayed in the MAS200 data as "CD" rather than "MC." Finance personnel explained that this practice of issuing checks outside of MAS200 using the check printing software was discontinued in 2005, however the ability to generate checks using only the check printing program continued.

agent wrote, "...here's all of the bills from Scotland. I'd wish you'd let us pitch in a little but if it means getting kicked off the invite list, then you win." The agent also referred to the expenses as "the two British Air tickets from London to Scotland and back and then the big (really big!) bill is for everything else – Virgin Atlantic, green fees, hotel, etc." Supporting documentation also included the agent's American Express credit card statement showing charges for airfare, golf, and hotel. The Almond Report indicated that the costs of this trip were approved by Sollosy, but not until the expenses were incurred. We performed additional procedures to identify the full cost to Beacon of this trip and found the following disbursements that related to the trip:

- $15,534 payment to an agent,
- $ 9,437 payment to another agent,
- $ 7,116 in golf, hotel, auto rental, and other charges to Beacon corporate credit cards:
  - $5,688 to the Bank of America card maintained by Solomon's administrative assistant,
  - $1,428 to Solomon's credit card,
- $ 1,555 employee expense reimbursement to Solomon for trip-related costs.

In addition to the $15,534 payment to one agent, another agent was reimbursed for his expenses in the amount of $9,437. This agent provided Solomon with a schedule of expenses that included golf and airfare costs, along with a copy of his credit card statement supporting the charges. The airfare charges were for this agent and a third agent. Solomon's signature was on the supporting documentation approving both of these payments to the agents.

The credit card charges of $7,116 were incurred on both the corporate card used for miscellaneous company purchases and Solomon's credit card. In addition, Solomon submitted expense reimbursement vouchers for $1,555. His expense report dated 5/30/2003, related entirely to charges incurred for Scotland golf trip and included $1,176 in gratuities paid for airport transportation, golf, and hotel, with the remaining amount relating to meals and transportation charges.

In total, we identified $33,642 in expenses incurred by Beacon related to this trip.

We found an Email exchange among the attendees of the trip in June 2003. Solomon wrote to the three agents, "…please send me a total of all the charges for our trip…I would like to get you your money and close out my records as well. I expect and most definitely want all the charges. This trip has been accounted for and all expenses are paid for. Please do not incur any expense on your behalf. You are all wonderful friends and important business associates. I will not accept anything but full reimbursement of all expense you have incurred (else we will never go again…). Please do not make this an issue…"

One of the agents responded and indicated that he and one of the other agents had talked and were "…not totally comfortable with you paying everything but [we are] not going to fight you on this either and certainly don't want to be kicked off the future invite list so we're going to send you everything other than the couple of dinners and lunches we…already picked up and put on our personal cards. We figured that's the least we could do and in the big scheme of things it's only a drop in the bucket compared to the hotels, golf and airfare you're paying. Is that okay with you?" Solomon responded, "No. Your [sic] all off the future list unless you submit everything…" and the agent wrote, "I give up, you win…"

We found a memo that was written by Solomon and sent by fax to the board of directors on 4/13/2006 that addressed several concerns from the Almond Report. Solomon addressed the Scotland trip and explained that he and the agents won a trip to Scotland as part of a charity event for a local youth organization, of which he was a board member. He claimed that:

- Arrangements were made to extend the trip beyond which were approved by Sollosy during 2002, before the trip took place.
- "The trip was considered a business/relationship development with three key agencies that provided Beacon with more than $25 million in business."
- "The cost of this trip to Beacon was $20,969. I recognize the inappropriate appearance of this trip today. I have offered to repay Beacon for my portion of this expense."
- "This was truly a unique occurrence and no such trip has occurred at the company's expense."

According to one Beacon employee, "Accounting did some investigating and Joe did not ever pay the company back for his Scotland trip."

Specific Vendor Procedures

We performed several procedures focused on specific vendor relationships with Beacon. We performed specific procedures to identify vendors that received large, frequent, or unusual payments.

Top 50 Vendors – We identified the 50 highest paid vendors and 50 most frequently paid vendors from Beacon's disbursement data for the period 2003 through 2005. Based on the results of these queries, we judgmentally selected certain vendors and inquired with finance personnel to gain an understanding of the business relationship with Beacon. We also made several disbursement selections based on these procedures and identified the following relevant findings:

- **Golf Club in Massachusetts** – Ten of our disbursement selections totaling $250,362 were paid to this golf club. See "Summary of Findings" for background information on this corporate country club membership. Beacon's membership was under the name of three members of senior management. Supporting documentation included monthly account statements from the golf club. Charges included annual membership dues, greens fees for Beacon employees and agents, several golf outings (including up to 124 people for a single outing), purchases of golf equipment and attire, banquets and other dining charges, and lodging charges. Beacon paid $542,134 to this golf club during the three-year period, of which $458,679 was charged to the "Allowances to Agents" expense account. The remaining charges were booked to Meals & Entertainment, Organization Dues, Training Expense, and Hotel Expense accounts.

  A Beacon employee explained that a number of agents hosted their own events at this club using Beacon's membership. We found an Email dated 6/28/2004 between Solomon and two other employees, where Solomon instructed them to make sure that Beacon's name was not associated with a certain agency's event (although Beacon covered the cost). The employee explained that Beacon's name used to be predominantly displayed at these events as the sponsor, but that practice changed over the past few years and there was an effort to remove Beacon's name from signage despite Beacon's financial contribution. The employee could only recall one instance where Beacon was reimbursed by an agency. These events were for agencies and their clients, but were not limited to Beacon insureds. We discussed this with a member of senior management, who said that "business people don't want to see Beacon spending money on golf."

  Solomon's administrative assistant explained that a file folder containing information on several golf events from 2005 had been taken from her desk area. She discovered it was missing when a vice president asked her to look up support for a payment. She did not know who removed the folder or where its contents were located.

- **BCBSRI** – We found 73 disbursements to BCBSRI during the period totaling $5,821,227 to three separate Vendor IDs. Beacon entered into an agreement with BCBSRI in 1996, whereby BCBSRI processed medical claims on behalf of Beacon. We did not perform procedures on Beacon's or BCBSRI's compliance with the terms of this contract and claims processing was not a focus of the Examination. We found that SKM, under its engagement as Beacon's internal auditor, did perform some procedures related to this relationship. We read the SKM internal audit reports on this relationship dated 6/20/2003 and 11/17/2005, which explained that BCBSRI processed and paid medical bills and provided some case management for claims filed under Beacon policies. BCBSRI also maintained a preferred provider network ("PPN"), where providers agreed to charge reduced service fees related to claims. Payments to BCBSRI include:

- o A monthly $19,250 fee,
- o A fee for every payment to PPN and non-PPN providers,
- o A percentage of shared savings when BCBSRI's rates were below State of Rhode Island rates,
- o An administrative fee of $2.30-5.00 for every processed bill,
- o A fee of $5.00 for every denial.[60]

The SKM report indicated that, in 2004, Beacon paid $36.2 million in allocated medical losses and expenses and BCBSRI was reimbursed $27.4 million for these costs (75.7% of all medical loss and expense payments for Beacon). For its services, SKM reported that Beacon paid BCBSRI $1,353,365, broken down as follows:

- o $259,650 for denials,
- o $862,711 for administrative fees,
- o $231,004 for "staff labor and overhead dedicated to the BCBSRI and [Beacon] relationship."

As of the 11/17/2005 report, SKM concluded that "the controls governing the relationship between [Beacon] and BCBSRI need improvement."

Vendors with Only One Disbursement in a Year – We identified all vendors that received only a single AP disbursement in any given calendar year during 2003 through 2005. Based on these procedures, we judgmentally selected 60 individual disbursements from the population of 1,597 and requested and read the supporting documentation. Relevant findings are listed below:

- **PGA Tour Sponsorship –** We noted two $10,000 payments to an individual who is believed to be the son of an agent, who was affiliated with one of Beacon's top agencies. These payments were made in January 2003 and another in January 2004. Supporting documentation indicated these payments were made in support of the recipient's professional golf career. We read personal letters from the golfer to Solomon thanking him for "Beacon Mutual's continuing support of my carrier [*sic*]." These payments were charged to the "Allowances to Agents" expense account. We found an Email where Clark referred to the golfer as "the son of an agent friend." One vice president expressed concern that Beacon had been paying $10,000 a year to sponsor this individual's PGA career. These two payments were the only AP disbursements made to this individual during the period 2003 through 2005.

[60] According to the SKM report, denial payments were suspended in 2004 due to "internal issues with this process at BCBSRI." SKM's 6/20/2003 report identified certain deficiencies in the denial payment procedures.

- **Donations to a Local Library** – Our selections included two $20,000 AP disbursements to a local public library – one in May 2003 and another in September 2004. We performed a search of public records that showed that Sollosy was a "Trustee Emeritus" of this library. We read the related supporting documentation for these payments, approved by Solomon, noting both of these were installment payments toward a total capital campaign pledge of $100,000 made to the library by Beacon in 2001. A vice president explained that this $100,000 pledge was not consistent with Beacon's typical focus on charitable contributions to safety organizations. We discuss this library in more detail within Relevant Finding 7 in the "VIP Accounts" section.

- **Wealth & Retirement Planning for Senior Management** – We discovered two $10,500 payments to an investment management consulting firm that provides services to high net worth individuals – one in October 2003 and another in July 2004. Invoices for these payments indicated that this vendor provided consulting services to Beacon's senior management team. According to human resources personnel, this vendor provided Beacon senior management with consultation on personal financial management, particularly as it related to retirement planning. Beacon paid for this service as an executive benefit. These services were not included in the senior management employment agreements, but the amount paid to the consulting firm on the employees' behalf was considered additional compensation and was included in their annual taxable income and W-2's for the respective years according to human resources.

- **Boston Red Sox Tickets** – There was a $6,000 payment to an individual in December 2003, and the supporting documentation for this payment was an Email from Solomon indicating that the payment was for Boston Red Sox tickets: "20 Games @ $300 per game plus parking totaling $6000." The supporting documentation did not indicate who attended these games. In total, there were three payments to this individual during the period 2003 to 2005 for Boston Red Sox tickets. These payments totaled $19,140 and were charged to the "Allowances to Agents" GL account.

- **Non-Profit Organization and Palm Beach, Florida Golf Trips** – We found two $15,000 payments to a non-profit organization – one in August 2004 and another in September 2005. Supporting documentation showed that these payments related to Beacon's sponsorship of and participation in a golf fundraising event hosted by this organization in Jupiter, Florida. Both of these payments were over $10,000, which would have required the approval of the board of directors in accordance with the charitable contribution guidelines. These expenses, however, were charged to the "Allowances to Agents" account and therefore were not subjected to board approval on an individual basis. A vice president explained that these costs were treated this way because agents attended the event. We performed additional procedures to identify additional charges related to these trips and found $1,015, $18,081, and $18,474 in costs incurred by Beacon related to this annual event for 2003, 2004, and 2005, respectively, totaling $37,570. We explain the charges for each year below.

- **2003** – There were no AP disbursements in 2003 made directly to this organization, although Email correspondence indicated that Solomon and certain agents attended the 2003 event. We discovered Email correspondence among Solomon and three agents discussing logistics related to this event. An Email dated 7/9/2003 from one of the agents to the other parties discussed the trip itinerary, which included attending a "Reception and Dinner." We found airfare charges to Beacon corporate credit cards related to flights for Solomon and two of the agents to West Palm Beach, Florida, totaling $1,015.
- **2004** – We identified $18,081 in charges incurred by Beacon related to the 2004 trip. These expenses were incurred via four different transactions, including the $15,000 payment to the non-profit organization noted above. Three other charges were incurred on Beacon corporate credit cards totaling $3,081, including airfare for Solomon and three agents, rental car charges, and golf-related charges at another golf course separate from the event location.
- **2005** – We identified a total of $18,474 incurred by Beacon related to the 2005 trip. These expenses were incurred via three different transactions including the $15,000 payment to the non-profit organization. The other charges included $1,483 in charges to Beacon's American Express card for airfare for Solomon and four agents, and $1,991 in charges to Solomon's credit card for golf and restaurant items for three agents while in Florida.

- **A Yacht Club, Newport, Rhode Island –** We discovered a $16,041 payment to a yacht club in Newport, Rhode Island in October 2004. Included in the supporting documentation was an invoice indicating that this was payment for a board of directors and Agents Advisory Council meeting at the yacht club. We also noted a copy of an agenda among the supporting documentation entitled "Board of Directors/Agents Advisory Council Joint Business Meeting...September 20, 21, and 22, 2004." The invoice for this event was approved for payment by Solomon. A vice president explained that this was a joint board of directors and senior management team event and that this charge related to the dinner they had at the yacht club. The invoice we read included charges entirely related to dinner, and indicated attendance of 65 people. Excluding the board members (nine), and senior management team (eight), approximately 48 additional participants attended the event. Assuming all 65 participants attended, the per-person price for the event was approximately $250.
- **A Private Golf Club in Rhode Island** – Our selections included a $23,774 payment in September 2005 to a private golf club in Rhode Island. The check request dated 10/3/2005 indicated it was payment for the "September 26, 2005

Agents' Appreciation Golf Outing." Additional support for this payment included an invoice from the golf club dated 9/28/2005, which detailed charges for food, golf, and gift certificates. According to discussions with finance personnel, Beacon holds an annual golf outing for its contract agents.

- **A Country Club in Rhode Island –** We selected a payment in the amount of $4,000 in November 2004 to a country club in Rhode Island. According to the check request approved by Solomon, the payment was a deposit for a "2005 Agents' Annual Appreciation Golf Outing." The supporting documentation also included a copy of an "Outing Confirmation" form received from the country club, which detailed the costs and required minimum payments for a September 6, 2005 golf outing ($15,680 for minimum of 112 players). We performed additional searches to identify payments for this event and found a payment of $40,328 in September 2005, which was charged to the "Allowances to Agents" account. Based on these results for this club and the golf club discussed in the bullet above, it appeared that Beacon hosted two separate agent appreciation outings in 2005.

  We performed an additional search for payments to these golf courses. There were no other payments made to the private club discussed in the bullet above during 2003 through 2005. We found that Beacon paid a total of $142,087 to the country club between 2003 and 2005. In addition to those payments, we found 19 additional payments to the head golf professional at this country club totaling another $202,878 during the same period. We selected two of the payments to the golf professional totaling $57,622, which showed charges for golf attire, including golf jackets, fleece pullovers, golf shoes, and other items from the club's pro shop.

Vendors that Received Structured Payments – We performed procedures in order to gain an understanding of vendors that received "structured," or recurring payments from Beacon. We searched the 2003 through 2005 AP Disbursement data for all vendors that received either of the following:

- Four or more payments of the same dollar amount in any given calendar year or
- Ten or more payments of the same dollar amount over the three-year period from 2003 through 2005.

Based on these queries, we found 119 vendors that met either one or both of the criteria above, judgmentally selected 11 vendors for further procedures and requested support for one disbursement for each selected vendor. Based on these procedures, we identified the following relevant findings. Nine of the 11 vendors we selected received payment for such items as advertising, information systems, and human resources and loss prevention consulting services. One of the 11 vendors was Cornerstone Communications Group.

See the "Cornerstone Communications Group" section for more information on this vendor and its relationship to Beacon.

- **Lexus & Volvo Leases for Solomon –** Beacon included a car allowance as part of Solomon's employment contract. We identified 20 monthly payments of $639 between 2003 and 2005 totaling $12,788. We also identified 17 monthly payments of $724 payments between 2003 and 2005 totaling $12,308. Payments for the two leases did not overlap; the payments for the Volvo lease began when the Lexus lease ended. Beacon provided supporting documentation, including Email correspondence between Solomon and finance personnel indicating that Solomon extended the Volvo lease through August 2006. Upon Solomon's termination, we asked the finance department about the disposition of the Volvo, as there were still payments left on the lease at the time he was terminated. Finance personnel explained that the Volvo lease was in Solomon's name, so the car was not retained by Beacon, but that they stopped making payments on the lease upon his termination – the final payment was made 3/31/2006. In addition to the monthly lease payments made by Beacon for these cars, we also noted several thousands of dollars charged to Solomon's corporate card or reimbursed to Solomon through expense reports for gasoline, auto maintenance and repairs, and auto insurance related to both cars.

Vendors with Five or More Disbursements in One Month – We identified vendors that had five or more payment transactions in any given calendar month. From our search results of 48 unique Vendor IDs, we judgmentally selected 15 vendors to look at further. For each selected vendor, we selected an individual disbursement and requested the supporting documentation. Based on these procedures, we identified the following relevant findings:

- **Payments to One of Beacon's Top Producing Agents –** In addition to an annual $25,000 consulting payment to this agency for services related to the MCGRI safety group (see the "Checks Cut Outside Normal Procedures" and "Safety Groups" sections for more information), we identified another annual payment of $3,500 to this agency charged to the Consulting Fees general ledger expense account. There were seven disbursement transactions for this agency in December 2004, of which this $3,500 payment was the largest. Finance personnel indicated this annual $3,500 payment was for consulting services provided by the agency related to assessment of Beacon's own insurance coverage. The six other payments to this agency were charged to the Commissions Payable account, indicating they were payment of contingent commissions. See "Contingent Commissions" section for more information.

- **Payments to Independent Insurance Agents of Rhode Island –** We noted three separate months where there were five or more payment transactions to IIARI. Total payments to IIARI for the period 2003 to 2005 totaled $85,756. Based on discussions with underwriting personnel, $60,132 (70%) of the payments were for annual fees that Beacon paid to IIARI related to administrative fees for the two RIBA Safety Groups. See the “Safety Groups” for more detailed discussion about these payments. We noted $17,000 (20%) of the total payments during this period were related to Beacon sponsorships of IIARI events or outings, and the remaining 10% of payments were all under $1,000 and appeared to be related to course registration and license renewals.

- **Payments to Another Agency –** We noted seven AP disbursement transactions in October 2005 involving a contract agency totaling $54,130. Two of these payments were for the same exact amount of $17,263. The supporting documentation revealed that one of these checks was issued on 10/20/2005, payable to the agency, but was accidentally sent to a completely different vendor that is not affiliated with the agency. The incorrect vendor was able to cash this check even though a different entity was the payee. Beacon subsequently issued another check to the agency to replace the first. Supporting documentation provided by the finance department showed that Beacon was reimbursed by the incorrect vendor on 11/2/2005. The finance department explained that Beacon’s own workers’ compensation insurance policy is written by another insurance company and the agency that received these checks is Beacon’s agent. The multiple payments made to the agency in October 2005 were for Beacon’s multiple policies, including workers’ compensation, auto, property and casualty. According to an invoice dated 10/6/2005 from Beacon’s insurance company, the initial disbursement to the agency was payment of Beacon’s own workers’ compensation coverage.

  This payment error might not have occurred if the address information in the MAS200 system was complete and accurate and check mailing duties were handled by the finance department.

Employees, Executives and Other Related Parties

Business Intelligence Procedures – As part of the Examination, we conducted public records searches on a number of employees, board members, and third parties mentioned in the original whistleblower allegations. Deloitte FAS’ Business Intelligence Services group performed these searches. The level of research varied by subject depending on the complexity of the subject and the subject’s level of involvement according to the original allegations and additional information we gathered throughout the Examination and may have included:

- Online and manual public record research, including online searches covering litigation, bankruptcies, business affiliations, judgments, federal and state tax liens, UCCs, assets, regulatory filings, and news media and trade sources, as well as manual civil and criminal litigation searches conducted on-site in relevant jurisdictions. Note that we focused primarily on records positively identifiable with the subjects via known social security numbers, addresses, dates of birth or other identifying information.

- Our online research also included a nationwide search of relevant Secretary of State records, limited partnership filings, fictitious business name filings, business reports and media sources to identify businesses with which the subjects have been affiliated as officers or directors.
- Online searches conducted for assets included a search for real property, watercraft, aircraft, and motor vehicles for any records naming the subjects. Note that these searches did not include a review of non-public information, such as banking and brokerage accounts.
- In addition, a review of nationwide online media coverage from numerous sources including newspapers, magazines, trade and industry journals, broadcast transcripts, and wire services was conducted for any references to the executives, with a focus on adverse media.

We read the results of these public records searches and incorporated them into our procedures to identify AP disbursements made by Beacon to vendors that were potentially affiliated with these subjects.

We performed the following procedures to identify vendors that were potentially related to these subjects:

- We developed a listing of keywords for each possible related party from the public records search results,
- We searched the AP vendor master file and 2003 to 2005 AP disbursement data for the keywords,
- Scanned the results of the keyword match procedures and eliminated false positive records,
- Scanned the remaining records and selected all vendors with valid matches to our subjects and read the supporting documentation for each payment. We selected vendors with both known and unknown relationships.

Based on the procedures described above, we found the following relevant transactions:

Charitable Contributions to Related Parties – We identified several individuals and organizations related to the hospital organization mentioned in the original whistleblower allegations (see Allegation 5) that received charitable contributions from Beacon. Solomon’s wife was a member of the Board of Trustees for one of the hospitals included in this family of hospitals, according to a press release issued on 4/4/2005.

We identified $61,950 in payments from Beacon to this hospital during 2003 through 2005. Among these payments, we noted two individual $25,000 payments – one in December 2003 and another in December 2005. We selected the 2003 payment and found it to be a donation to this hospital. We read the minutes of the Beacon board of directors meeting on November 25, 2003, noting this payment was made in support of the hospital's annual fundraising event and was approved unanimously by the board.

We read the minutes of the board of directors meetings in 2005 in search of similar approval of the 2005 payment, but we found no discussion of another contribution. Beacon's vice president of community relations stated that the 2005 payment was unauthorized and was not approved by the board of directors. We read Beacon's policy regarding approval of charitable contributions, which was implemented upon recommendation of SKM in June 2005. The policy stated that all contributions over $5,000 to one entity in a single year required approval of the marketing committee of the board of directors. Contributions over $10,000 to one entity in a single year required approval of the board of directors.

We understand that the $25,000 donation that Solomon paid to the hospital in December 2005 was for Beacon to be a "presenting sponsor" at an event hosted by the hospital in 2006. Support provided for the payment showed that Solomon signed up for a "Presenting Sponsor" donation of $25,000 for the hospital's 2006 event on 12/15/2005.

We requested documentation of all board of directors and marketing committee discussions of this payment. Beacon provided us with copies of the minutes for the 4/4/2006 marketing committee meeting and the 4/26/2006 board of directors meeting. According to the marketing committee minutes, the vice president of community relations raised this issue to the committee on 4/4/2006, and the matter was brought to the attention of the full board on 4/26/2006. The 4/26/2006 board of director minutes indicated that this payment had been approved by the board, contradicting the vice president's statement that this payment was unauthorized. These minutes stated, "A single commitment of $25,000 was made and approved by the Board in early 2005 for the 2005 [event]. At the end of 2005, the Board once again approved a single commitment of $25,000 to be paid out in 2006 for the 2006 [event]." The minutes later stated, "[the vice president of community relations] indicated that Mr. Solomon asked him to make the contribution."

We asked the vice president about this discrepancy and his response was that the minutes did not accurately reflect what took place at the 4/26/2006 board of directors meeting. He reiterated his previous comments that the payment was not approved by the board and that he did not have knowledge of the payment until after it had been made. He said he became aware of the payment sometime in late January or early February.

The vice president clarified his position via Email on 10/11/2006 in which he explained:

- "…the 4/26/06 minutes seem to contradict themselves. It is not a normal practice for me or other senior staff members to see board [meetings]."
- "…there were two issues here, one a timing issue that [the hospital] wanted the 2006 [event] funding in 2005, and second, an unapproved donation due to the size. The timing issue was minor, and more informational to the board."
- "The second sentence: 'A single commitment of $25,000 was made [and] approved by the Board in early 2005 for the 2005 [event].' I think it should read

‘approved by the board in 2003 for the 2004 [event].’ The word ‘single’ was used as it was Joe Solomon’s impression that he had board approval for $25,000 each year. Although I could not find any support for that position in the written documents. 2004 was the year Joe was on the [event] committee. I don’t recall him being involved in the 2005 [event]. In my mind that’s why we dropped down to $10,000 in donation for the 2005 [event].”

- “Next sentence: ‘At the end of 2005, the Board once again approved a single commitment of $25,000 to be paid out in 2006 for the 2006 [event].’ I am not aware of the board approving of this or a request to approve.”
- “The [hospital] committee did request the money in Dec. of 2005 directly to Joe and he sent to accounting to pay on Dec. 19th. When I was doing the Dec. accounting close on donations I saw the $25,000 [event] donation on the ledger. I went to account[ing] and asked where that had come from, and they gave me Joe’s request…”
- “We did have the $10,000 2005 [event] donation and the $25,000 2006 donation made in 2005, which is noted by the sentence: ‘However the [hospital] planning committee requested the money at the end of the 2005 year, therefore resulting in two $25,000 commitments being paid out in the same year.’ Although it was not two $25,000 commitments.”
- “The last sentence: ‘[The vice president of community relations] indicated that this did not come before the Board (meaning an unauthorized payment)…[a former board member] asked who approved that the 2006 payment be made at the end of the year in 2005. ‘[The vice president of community relations] indicated that Mr. Solomon asked him to make the contribution.’ I did advise the board, as did [another former board member], that is why we were bringing this to the board as it was a payment that was made but not authorized by the marketing com. nor the board. Mr. Solomon did not ask me to make the payment, he asked accounting to make the payment. I found out about it when I closed the Dec. month sometime between Jan 5th and March. At which time I discussed with Joe and he remembered that the board had approved the $25,000 donation for each year. I did not have the same memory. So I [went] back to look at the records and found the 2003 reference to a $25,000 donation, not for multiple years. I advise[d] Joe of this and that I had to bring it to the Marketing committee, so they could bring it to the board as it was beyond the committee’s authority. The board as I recall did not approve retrospectively the $25,000 payment for the 2006 [event], but [referred] it to the Audit committee of the board.”
- “I am not aware of any board approval of a $25,000 payment for the 2006 [event] in 2005 or after.”

The board minutes of the April 26, 2006 meeting did not indicate any disciplinary action taken against Solomon, as he had been terminated from Beacon at that point.

Payments to the Company of an Agent/ Palm Springs Golf Trip – Beacon made two payments to a particular vendor during the three-year period totaling $8,324. Our public records search indicated this entity was related to a certain contract agent who is also a member of the Agent Advisory Council. We selected a $5,000 disbursement to this vendor and found that it related to a golf trip to Palm Springs, California in April 2003. Supporting documentation included an invoice from the vendor that detailed expenses for a week of golf in Palm Springs for Solomon, Clark and four agents. The charges on this invoice included six plane tickets totaling $3,324, and five nights lodging and six rounds of golf totaling $8,878 for total charges of $12,202. The airfare charges were supported by copies of one of the agent's American Express credit card statements, dated 1/11/2003, though no supporting documents beyond the vendor's invoice were provided for the golf and hotel charges.

The invoice indicated the $3,324 in airfare charges had previously been paid by Beacon in January 2003, resulting in a balance of $0 for these charges. The second payment made by Beacon was for $5,000, which was applied to the $8,878 in golf and lodging charges, resulting in an unpaid balance of $3,878. We searched the MAS200 AP disbursement data for other payments to this vendor or the agent for this unpaid balance, and found that there were no other payments made during 2003 through 2005.

We found an Email between Solomon and the agent regarding these expenses. In an Email dated 2/6/2003, Solomon wrote to the agent "I would like to send you a check for the remaining $6000 contribution. Can you send me an Email or something on your letterhead or from the travel agent (audit reasons) and I will get the check to you or the travel agent." The agent responded to this Email the same day with, "I'll give you [a] copy of [the] American Express statement for [my company] for plane tickets for audit purposes and makeup [sic] letterhead for the $6000...for [the] Palm Springs trip."

In total, we identified $12,846 in expenses incurred by Beacon related to this golf trip:

- $8,324 reimbursed to the agent's company,
- $2,066 in golf and rental car charges to a Beacon corporate credit card and
- $2,456 on Clark's expense reimbursement statements.

Clark's expense report dated 5/4/2003 included $2,456 in charges related to this golf trip, $495 of which was a direct payment made by Clark to the agent's company. Included in the supporting documents was a copy of Clark's personal check, including a handwritten note on the reimbursement request indicating a "deposit" for the trip.

Senior Executive Disbursements – We identified all AP disbursements made to Solomon and the six vice presidents during the three-year period 2003 through 2005. We compared expense report summaries prepared by Beacon's finance department to the total AP disbursements for the three-year period noting no significant variances. We selected a total of 15 disbursements to these individuals, totaling $64,859, and read the supporting documentation for each. Relevant findings related to these procedures are outlined below.

Reimbursement of Club Membership Costs for Senior Management – Several of the expense reports we looked at included reimbursement of charges related to personal country club memberships for Solomon and three Beacon vice presidents. Of the total $64,859 in AP disbursements we looked at for these individuals, $41,080 related to these memberships. Solomon was reimbursed $11,090 for his family golf membership at a country club in North Kingstown, Rhode Island. One vice president was reimbursed $22,628 for a family membership at another country club. Another vice president was reimbursed $4,079 for his annual membership dues at a country club in Rehoboth, Massachusetts. Finally, another vice president was reimbursed $3,283 for costs related to his membership at a club in Providence, Rhode Island.

Human resources personnel explained that some members of senior management had corporate country club memberships under their personal names. These memberships were not included in their employment agreements. The human resources department would inquire with these executives about the level of personal versus business use for each employee at the end of each year, and the portion of the membership costs that the employee deemed to be personal would be added to IRS Form W-2 as income. According to one vice president, these were considered a perk for senior management, and it was understood that they would be used for business purposes. This vice president recalled telling Solomon about an opening for membership at a country club in Warwick, and he approved the reimbursement of the $18,000 initiation fee. This vice president stated to have reported the membership as 100% personal and had the W-2 adjusted accordingly, though the income figure was grossed-up to eliminate the tax effects. According to human resources personnel, all income declared for these memberships was grossed-up for all employees.

According to the human resources department, Solomon's country club membership costs were $5,095, $5,340, and $5,750, for 2003, 2004, and 2005, respectively. Solomon claimed 27% of the cost of his membership was for personal use each year from 2003 through 2005, with the remainder used for business purposes.

Solomon Reimbursed for Spouse's Travel Expenses – We found that Solomon was reimbursed for his wife's expenses for a flight to Colorado in May 2004. The expense report, dated 3/26/2004, included $2,789 in airfare for Solomon and his wife for travel from Providence, Rhode Island to Colorado Springs, Colorado for four days in May 2004, according to a copy of the trip itinerary. The purpose of the trip was not noted in the expense report. Finance personnel said Beacon had an unwritten policy whereby senior management personnel were allowed to expense the costs associated with spouse travel in accompanying the Beacon executive on a business trip. We also found a reimbursement that was made to the CFO related to a trip taken to Montana in May 2004, where the

CFO's spouse and two children came along. The CFO reimbursed Beacon for the cost of two of the four tickets.

Expense Reports – We requested and read all of Solomon's and Clark's expense reports submitted during 2003 through 2005. We judgmentally made selections of individual disbursements and performed additional procedures.

We read an internal audit report by SKM dated 4/26/2005 related to Travel & Entertainment Expenses. According to this report, SKM found:

- "while no inappropriate activity was identified, procedures and controls governing the travel and entertainment expense reimbursement process need improvement"
- "there is no written policy that outlines the custody, handling, approval and utilization of corporate credit cards for business related purposes"
- "in certain instances, documentation relating to the nature of the [CEO's] business expense to be unclear," however SKM met with the CEO and "[he] was able to provide clarification of the expense."

Based on the results of our procedures, we found the following:

- **Solomon's Reimbursement for Personal Contributions –** We noted a reimbursement made to Solomon for a $2,059 personal contribution he made to a hospital on 4/19/2004. We saw a copy of the cancelled check from Solomon to this hospital, along with a handwritten note on his expense report, dated 4/27/2004, that indicated "partial payment for…Volunteer Dinner…as part of responsibilities as corp[orate] chairs." According to a handwritten note, as well as MAS200 data, this expense was charged to the "Entertainment/Meals/Public Relations" expense classification.

  Both Solomon and his wife served as chairs for this particular event. The expense was not classified as a charitable contribution, because it was not a donation to the hospital. Rather, the event was a thank you dinner for volunteers, most of whom were not hospital employees, but who worked on planning a fundraising event for the hospital. We found a copy of a listing of committee chairs and members, which listed both Solomon and his wife as committee members for the event.

  We also discovered a reimbursement to Solomon for a $750 personal contribution he made to an organization dedicated to the development of youth leadership and community. According to this 9/11/2003 expense report, this $750 was also charged to the "Entertainment/Meals/Public Relations" expense classification. There was no explanation on the expense report indicating the justification for the reimbursement.

- **Solomon Reimbursed Twice for Same Expense Report –** We found that Solomon was reimbursed two times for same expense report. He was reimbursed

$1,427 in January 2005, and again three weeks later in February 2005. He eventually reimbursed Beacon for this additional $1,427 in December 2005, 10 months after the issuance of the duplicate expense reimbursement. We were provided a copy of the cancelled personal check from him to Beacon in the amount of $1,427, dated 12/12/2005.

- **Solomon Reimbursement for Usage of Personal Airline Miles –** We read one of Solomon's expense reports, noting an instance where he used his personal airline miles to purchase a flight for business purposes, and then included a $635 charge in his expense report based on the quoted airfare at the time of booking. There was no exchange of cash or credit charge for this flight by Solomon, though he was reimbursed for this $635. He indicated in his expense report that this had been approved by Sollosy.

- **Golf Trip, Miami, Florida –** An expense report submitted by Clark on 4/30/2004 included $2,642 in golf and meals charges in Miami for Solomon, Clark, and several agents. As a result of this finding, we searched for, and identified, other expenses related to this trip in April 2004. Attendees for this trip included Solomon, Clark, five agents, and a political lobbyist who was also owner of Cornerstone Communications Group. We identified $20,096 in total expenses incurred by Beacon related to this golf trip, $2,642 of which was paid via expense reimbursement to Clark, with the remainder of $17,454 being charged to Beacon corporate credit cards. A total of $5,565 of these credit card charges were airfare for these individuals and the rest were charges to the resort and the travel service used to book the trip.

  We found Email correspondence among Solomon, Clark, and the agents regarding this trip, including an Email dated 2/23/2004 from one of the agents to the other trip attendees, in which the agent included "details regarding our trip in April." These details included $11,984 for "both the golf and hotel." The agent subtracted a $6,000 "Beacon Mutual contribution" from the "per person" calculation, resulting in net cost of $5,984, which was to be reimbursed to Beacon by the eight trip attendees at $748 per person.

  We requested supporting documentation for these reimbursements and found a total reimbursement to Beacon of $3,140, including $748 from four of the agents and $148 from the fifth agent. We were not provided with reimbursement details from Solomon, Clark or the political lobbyist. This reimbursement of $3,140, when subtracted from the $10,784 charge to Beacon's corporate credit card, resulted in a net charge to Beacon of $7,644.

  The following is the breakdown of the $20,096 in charges incurred by Beacon related to this trip:

  - $2,642 reimbursed to Clark through an employee expense report,
  - $5,557 in charges to Beacon's American Express corporate credit card,

- $2,605 in charges to the corporate credit card held on site by Solomon's administrative assistant,
- $9,292 in charges (including the net charge of $7,644) to Solomon's personal card.

<u>Allowances to Agents General Ledger Account</u>

During the course of performing our AP disbursement and vendor master file procedures, we discovered that many of the payments we identified as relevant findings were charged to the general ledger expense account called "Allowances to Agents." We performed a query of this account to identify the cash disbursements that were charged against it. Many of these payments have already been discussed in this report. Charges to this account during 2003, 2004, and 2005 were $580,597, $604,506, and $545,674, respectively, totaling $1,730,777. We judgmentally selected 22 payments totaling $445,492 for further procedures. Relevant findings pertaining to these procedures are identified below:

Gillette Stadium Luxury Box – Two of these 22 selections were payments to an insured included in the original whistleblower allegations for football and concert tickets. Payments to this insured during 2003-2005 totaled $339,855. Of this amount, three $85,000 payments totaling $255,000 related to a luxury box at Gillette Stadium for New England Patriots football season tickets that Beacon split with the insured. We also found $71,086 in additional payments for tickets to individual Patriots games and $13,769 related to other events at the stadium, including a Bruce Springsteen concert and tickets to a New England Revolution game.

Solomon's administrative assistant explained that she kept track of the ticket distribution for all Patriots games. She provided us with a listing of the ticket distribution for games between 2002 and 2005. The listing did not identify each individual attendee, but was instead grouped by contact. We scanned the listings and found that members of senior management and certain board members were frequent attendees. In addition, Beacon provided multiple tickets to many of the major agents, often multiple times. For example, Beacon gave 16 tickets to one of its top-producing agents for the 12/7/2003 Patriots game. Some insureds received tickets as well.

According to the administrative assistant, Solomon instructed her to delete these files containing the luxury box ticket distribution information, but she did not. She said it was the only time he had ever asked her to delete a file and could not recall if the order had come before or after DBR's record retention directive. She believed that he told her to delete the files before the Almond Committee inquiry.

<u>Other Procedures</u>

Corporate Credit Card Charges – We requested and read supporting documentation for all 110 Beacon payments made to all three of the corporate card accounts during the three-year period 2003 through 2005, totaling $623,781,[61] including monthly statements and additional support for the individual charges on those statements.

We requested descriptions and the purposes for each of Beacon's corporate credit cards from the finance department who explained:

- An American Express account was used by Beacon's third-party travel agent primarily for employee-related business travel,
- A Bank of America credit card was physically located onsite at Beacon and maintained by Solomon's administrative assistant that was to be used only for necessary and emergency employee purchases,
- A Bank One Visa card held in Solomon's name, for which monthly statements were sent to Beacon and approved by Sollosy.

The following relevant findings are based on the procedures described above:

- **Pinehurst, North Carolina Trip –** We found credit charges related to a golf trip to Pinehurst, North Carolina in April 2005. Supporting documents indicated that Solomon, Clark, five agents, and Beacon's political lobbyist participated in the event.

  We found multiple Emails related to this trip, including correspondence between one of the agent attendees and Solomon, in which the agent asked "what the Beacon Mutual 'contribution' [to the trip] might be." Other Email correspondence among the trip attendees included an Email from this same agent detailing the costs associated with the trip, including "the total cost is approx. $26,264" and that "the net cost per person after the 'contribution' will be $2,283" indicating a contribution of $8,000.[62] The Email also instructed attendees to "send [their] payment to [Beacon's political lobbyist] ASAP" because "[he] will pay the balance directly to Pinehurst." See the "Cornerstone Communications Group" section for more information on Cornerstone, its relationship to Beacon, and allegations made related to Cornerstone.

  Additional Email correspondence included Solomon telling Clark that he was "uncomfortable with Beacon paying our entire bill" and that both of them "should

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[61] The summary of our 390 selections displayed at the beginning at the "Accounts Payable Disbursements." shows 111 corporate credit card payments totaling $624,835. These numbers include one selected disbursement of $1,054 which was subsequently voided. This voided check results in a variance of $1,054 between the total of our corporate credit card payment selections and the number of total payments made related to corporate credit cards per Beacon's MAS200 data.

[62] The $8,000 "contribution" was calculated by taking the estimated total cost of $26,264 divided by the eight participants to arrive at $3,283 per person, which is exactly $1,000 more than the "net cost per person" of $2,283 calculated by the agent.

[put] something in...I think we should pay $800" leaving the remaining costs to be charged to Beacon.

In total, we identified $2,841 in expenses incurred by Beacon related to this golf trip, $2,122 of which was charged to Beacon corporate credit cards with the remainder reimbursed to Solomon via his employee expense dated 5/13/2005, including golf and meals charges for agents during the trip. See the "Cornerstone Communications Group" section for more information on this trip.

- **Kohler, Wisconsin Trip** – We found credit card charges related to a trip to Kohler, Wisconsin in September 2005. According to Beacon corporate credit card charges and related supporting documentation, attendees of this trip included Solomon and five agents. We identified $1,624 in expenses incurred by Beacon related to this golf trip. These expenses were incurred via two disbursements, which were made as payment of Beacon corporate credit cards.

Benford's Law Analysis – We applied Benford's Law to Beacon's AP disbursement data for 2003 through 2005. The formula calculates the expected natural distribution of different digit combinations of numbers in a given population. When we applied this formula against the disbursement data, we found that there was an unexpectedly high frequency of payments made that began with the digit combination "50." We created a summary of payment amounts beginning with "50" and found many payments for exactly $5,000. We isolated these payments and summarized the data by vendor and by payment description. We judgmentally selected 88 payments, totaling $440,000 and requested and read the supporting information. Based on these procedures, we noted the following relevant findings:

- **Charitable Contributions** – Of the 88 payments we selected from this procedure, 23 of them were charitable contributions, totaling $115,000, paid to a total of 19 different vendors. See the "Charitable Contributions" section for more information on this area.
- **Golf Outing Sponsorships** – We selected 16 payments of $5,000 each to 12 different vendors for sponsorship of and/or participation in fundraising golf outings. These vendors included a hospital mentioned previously and a college alumni organization whose committee chair was also an agent, a Beacon insured and IIARI.
- **Agency Recognition Dinner** – One disbursement of $5,000 was paid to a contract agent. An invoice from the agency, provided as support and dated 5/21/2003, indicated that this payment was for a recognition dinner for two individuals. The invoice was approved for payment by Solomon.

PowerComp Cash Disbursements

Overview

During the course of our Examination, Beacon finance personnel indicated that certain cash disbursements are generated from the PowerComp system. These disbursements include payments of claims, return of premium payments to insureds, and payments of base commissions to agents. We performed queries on the PowerComp data to identify these types of transactions, and also to identify and understand other potential types of disbursement transactions generated via the PowerComp system.

All transactions recorded within PowerComp are also recorded in the MAS200 system and the general ledger. However, the details of these transactions are not posted to MAS200; the PowerComp transactions are summarized each month and posted to the appropriate general ledger accounts in batches as described in the "Data Capture and Reconciliation" section of this report.

Procedures

We performed the following procedures on PowerComp cash disbursements:

- Summarized all 2004 and 2005 PowerComp activity by general ledger account to identify the accounts to which PowerComp transactions were posted,
    - Identified the four general ledger cash accounts affected by PowerComp activity,
- Isolated all PowerComp transactions posted to the four general ledger cash accounts during the two-year period and identified all of the transaction descriptions assigned to each transaction,
- Prepared a summary of all PowerComp activity posted to these four general ledger accounts by transaction description and
- Obtained an understanding of the credit transactions (cash disbursements), posted to those accounts to identify cash payments made via PowerComp.

We noted approximately $272 million in credit transactions to these four general ledger accounts, in total, for the two-year period. This activity was broken down by account as follows:

Account Number	Account Name	Credit Activity
106207	FLEET - SPECIAL	$ (59,799,278)
106210	FLEET BANK - MASTER	$ (55,441,506)
220100	O/S CHECKS - CLAIMS	$ (126,112,602)
220200	O/S CHECKS - COMM/RET PREM/DIV	$ (30,441,000)
TOTAL		**$ (271,794,386)**

The $60 million in credit activity to account 106207 represented payments on claims administered by BCBSRI. These payments are initially made by BCBSRI who is subsequently reimbursed by Beacon. Account 220100 also records payment of claims. The credit activity to this account represented payment of all claims that were not administered by BCBSRI. Analysis of claims payments was not a focus of this Examination.

Account 106210 records Beacon cash receipts (debit activity). The $55 million in credit activity related to the account represented reversals of cash receipts. Based on discussions with finance personnel, cash receipts may be reversed for several reasons, most commonly due to the application of previously unapplied or misapplied cash receipts to the appropriate accounts.[63]

Lastly, account 220200 records payment of refunds to insureds and base commissions paid to agents. Approximately $19 million of the credit activity to this account during the two-year period related to base commissions payments. See the "Financial Controls and Cash Disbursements – Agent Commissions" section of this report for more information on these payments. The remaining $11 million in credit activity within this account represented refund payments made to insureds. We isolated this activity and performed the following procedures:

- Summarized the 2004 and 2005 refunds paid by insured,
- Judgmentally selected 10 insureds from each year for which to request additional supporting information and
- Requested the related supporting documentation for the refund payments made to those insureds in the respective year.

To better understand the reason for the refund on certain selections, we also used PowerComp data and performed the following additional procedures:

- Generated a report including an Account Summary and other relevant policy and premium information from PowerComp,
- Read Audit Alerts and results from the AuditLynx system and
- Read Notepad entries for policy comments from PowerComp.

[63] Per discussion with finance personnel, in order to re-apply cash to another policy within the PowerComp system, Beacon must first reverse the initial cash receipt, and re-record the cash receipt, at which point the cash is applied to the correct policy. The system does not allow cash to be applied directly from one policy to another.

Relevant Findings

Refunds Due to Audit Adjustments and Overpayments

Seventeen of the 22 payments we selected related to insureds that received refunds following a premium audit adjustment. One of the selected payments represented a refund because an insured had mistakenly overpaid its premium. Our findings from the remaining[64] payments are explained below.

Transfer of Balances – Fairfield to Argonaut

Two of the payments we selected were refunds resulting from issues encountered during Beacon's switch from Fairfield to Argonaut as the fronting company for its out-of-state policies (see the "Out-of-State Policies" section for more information). When Beacon switched companies, Beacon made the decision to track Argonaut policies outside of the PowerComp system due to a problem setting up an interface with Argonaut. See the "Data Capture and Reconciliation" section for more information. To facilitate the transfer of policies from Fairfield to Argonaut, Beacon effectively cancelled the existing policies and rewrote them under Argonaut. Some policies had credit balances at the time of this cancellation. These credit balances would have remained in the PowerComp system indefinitely. As an accounting workaround, Beacon generated "refund" payments for these accounts, but listed the payee as Beacon Mutual Insurance Company. Beacon cashed these checks and applied the credit to the offline Argonaut policies.

PowerComp Software Error

The last payment we selected represented a refund which was generated due to a technical problem encountered with the PowerComp system unrelated to the switch from Fairfield to Argonaut. This insured's account reflected an incorrect credit balance within PowerComp. According to finance personnel, this credit balance resulted from a "defect" after Beacon's conversion from the legacy WINS system to the PowerComp system. The finance manager claimed that Beacon issued a payment to itself in order to clear the credit balance on the account. This refund payment, for $138,324.15, related to the out-of-state policy for the account. According to the accounts receivable summary for this account, however, the cash payment appeared to be applied back to the same account, effectively nullifying the correction.

Refund Check Issuance Process

When we looked at the cancelled refund checks for these 22 payments, we noted that the payee on the refund check was not the insured in seven instances. For two of these

[64] Two of our 20 selected insureds received two separate refund payments in the same year. As a result, the 20 insureds we selected yielded 22 payments.

insureds, the check payee was a financing company. Emails from underwriting to finance and Notepad entries instructed that the checks be made out to this company for these insureds.

According to finance personnel, refund payments are occasionally made to financing companies as part of the insureds' agreements with the financing companies regarding assignment of rights to refunds. In these cases, the financing companies are entered into the PowerComp system by underwriting personnel. When finance personnel issue payment to these insureds, their respective financing companies are in the system as alternate payees.

In one of these instances, the payee on the check was the parent company of the insured. Notepad entries indicated that the check payee was the parent of the insured we selected.

For one of the insureds, the check payee was the insured's agent. We read Email correspondence indicating the payment was to be made to the agent, because the agent had fronted this amount for the insured.

In the remaining three payments where the check was not made out to the insured, the checks were made out to Beacon, as discussed above.

We discussed the check generation process with finance and underwriting personnel. Based on our understanding, anyone with access to the PowerComp system can add an entity name attributed to an insured's account also called a "participant." This is most often done to add a financing company as a participant on an account, or a receiver entity in bankruptcy cases. However, we were told that subsidiary organizations or even agents have been added to accounts as participants. Once added, underwriting personnel can direct any refund payments related to insureds' accounts to any entity listed. It is also our understanding that the finance department does not review the check requests for reasonableness and does not verify that the payee entity is related to the insured. Payments are issued by finance as long as the payee on the check request submitted by underwriting is listed as an approved alternate payee in PowerComp.

This process represents a significant controls risk where an underwriter could generate payments to clear credit balances within PowerComp to any address they add to the system. Furthermore, this risk is exacerbated in combination by the fact that underwriters have the ability to retroactively adjust account balances as described in the "Retroactive Credit Adjustments" section and *create* credit balances.

Agent Commissions

Overview

One of the whistleblower allegations in the SKM report was that "the caller heard that data to calculate contingency commissions was altered to provide commission to agents that did not necessarily earn it." The caller alleged that Beacon paid an additional $1 million in commissions that it was not obligated to pay. The Almond Report reviewed this allegation and found that "[Beacon] paid agents amounts significantly greater than that which was required under the terms of the agents' contracts, including the grouping of unaffiliated agencies for the purposes of supporting higher payments. An analysis of Beacon's own internal documentation indicated that these amounts aggregated approximately $2.5 million for the commissions earned in the years 2001 through 2004."

Procedures

We performed the following procedures related to agent commissions:

- Read the Almond Report findings and related GSS workpapers,
- Held informational discussions with Beacon personnel to obtain an understanding of the types of commissions paid and the substance of agent contracts,
- Read selected agents' contracts,
- Interviewed relevant Beacon personnel,
- Requested documentation related to commissions and performed subsequent searches of Email and other electronic documents, and
- Requested all documents shared with the board of directors related to 2001-2005 agent commissions and read the board minutes for the meetings where commissions were discussed.

Our procedures did not constitute a complete recalculation of the contingent commission formulas for any years. We read the GSS workpapers and found that they recalculated the contingent commissions. To prevent duplicate efforts, we did not perform a complete recalculation of continent commissions.

Commission Structure

Agent commissions consist of both base commissions and contingent commissions. All agents are eligible for base commissions, while only contract agents are eligible for contingent commissions. The base commission is 6% of net written premium.[65] Contingent commissions have multiple components, including the following:[66]

- Contingent (Loss Ratio) Commission
    - Commission percentage based on loss ratio

[65] Net written premium is defined in the agent agreements as "total written premium less any overdue premium owed to [Beacon] by an account brought to [Beacon] by the Agent, including any premium which is more than 90 days past due on December of the year being considered or which was absorbed by [Beacon] as a bad debt during the period being considered."
[66] Producer's Incentive and New Business "Book of Business" Incentive Commissions were discontinued beginning in 2005.

- Producer's Incentive Commission
  - Additional 2% of premium based on mid-year retention of premium in force
- New Business Individual Account Incentive Commission
  - Additional 2% of premium based on new business
- New Business "Book of Business" Incentive Commission
  - Additional 2% of premium for aggregate new business totaling $500,000 or more

The contingent commission is an additional commission, ranging from 3% to 6% of combined net written premium, where the percentage rate is determined by aggregate loss ratio.[67] If an agent meets all of these criteria, that agent can potentially receive all of these commissions, resulting in effective commission percentages of 14% on recurring business and 18% on new business.

Base Commissions

During the course of the Examination, we found at least one instance where Beacon altered the base commission rates paid to its agent. Clark authorized a special commission rate for an agency on a particular insured's account. See Relevant Finding 7 in the "Selected Individual Insureds" section for more information. In this instance, Beacon manually input a commission rate of 8% on the renewal in accordance with a five-year deal. As a result of this finding, we performed procedures to identify agents that received base commissions in excess of the rates set forth in the agent agreements.

All agents receive a base commission of 6% of net written premium on all policies. Contract agents also receive an additional 2% "new business" incentive commission for all new policies, resulting in a rate of 8% in effect for the first year of new policies. These commission amounts are automatically calculated within the PowerComp system based on policy premiums and these prescribed commission rates of 6% or 8%.

The PowerComp data included all premium, claims, and base commission information. We identified the following information in the PowerComp data related to the calculation and payment of base commissions for each policy and year:

- Written premium,
- Earned premium,

[67] This was effective beginning in 2005. For 2003-2004, commission percentage ranged from 0.5%-6.5% and was determined by a combination of loss ratio and "retention percentage," which was defined in the agent agreements as the written premium for the current period compared to written period for the prior period.

- Total premium derived paid amount[68] and
- Commission amount.

We recalculated the commission percentage by dividing the amount of commission paid by earned premium. We compared our recalculated commission rates to the 8% and 6% thresholds for first year and non-first year commission rates, respectively. We ran queries to isolate potential overpayments of commission for each of these categories and summarized the results below.

Our queries were limited to Rhode Island policies with effective dates of 1/1/2003 and later and where the total in-force number of policy days at the time of our PowerComp data capture (3/15/2006) was 330 days or more.

First Year Commissions

Our queries showed 61 policies in their first year with Beacon where the recalculated commission rate was 8.1% or higher.[69] The recalculated commission rates on these individual policies ranged from 8.12% to 24.91%.

We also calculated the total dollar amount of overpayment on these policies by multiplying earned premium by 8.0% and comparing the product to the actual commission according to PowerComp. The largest overpayment related to these 61 policies was less than $630 and the aggregate overpayment on all of these policies was $2,545. We did not perform additional procedures related to these findings.

Non-First Year Policies

Our queries showed 1,223 policies that were not in their first year of coverage with Beacon where our recalculated commission rate was 6.1% or higher. The recalculated commission rates on these individual policies ranged from 6.1% to 931.2%.[70]

We also calculated the total dollar amount of overpayment on these policies by multiplying earned premium by 6.0% and comparing the product to the actual commission according to PowerComp. The largest overpayment identified was a $9,152 commission for the 8% commission exception noted above. The remaining 1,222

[68] This factor appeared to be the base for the base commission calculation. We did not find a systematic correlation between this amount and written or earned premium. Many of the exceptions in this analysis related to differences between this factor, and the earned premium value we utilized for our recalculation.
[69] We encountered some exceptions that were due to rounding errors (8.01%, 8.02%, etc.) We used a threshold of 8.1% and 6.1% for first-year and non-first year policies, respectively, in order to avoid false positives in our results due to rounding errors.
[70] We noted two policies where the recalculated commission rate was greater than 41.2%. One of these policies had a rate of 931.2% resulting in an overpayment of $2,831. The other policy had a rate of 104.3% resulting in overpayment of $247. Both of these variances resulted from discrepancies between the "Total Premium Derived Paid" and "Earned Premium" amounts within PowerComp.

recalculated overpayments averaged only approximately $63 and ranged between $0.18 and $2,831. The aggregate overpayment on these 1,223 policies, including the $9,152 payment, was $86,553. We did not perform additional procedures related to these findings.

Almond Committee Findings – Contingent Commissions

The Almond Report indicated that some agents did receive contingent commission payments that were not consistent with their agreements, given their loss ratios. The committee's findings included the following:

- No procedure in place to ensure final contingent commission payments are reviewed by Finance.
- Inadequate level of documentation provided to support contingent commissions calculations. The individual responsible for calculating the contingent commissions received data from IT but has no way of knowing it's complete and accurate.
- Variances in both the source data used in the contingent commission calculations and the specific commission percentages that were applied to that source data to determine the final contingent commission amount.
- Exceptions made for 2003 and 2004 contingent commission amounts for certain agents, where justification for such instances included being "close" to the required conditions.
- Instances where Beacon grouped unrelated agencies' premium and loss information for the purpose of qualifying for contingent commission payments.

Calculation and Payment of Contingent Commissions

Regulatory relations personnel explained there was no formal written policy governing the calculation, approval and payment of these commissions. The Almond Report also noted that Beacon does not have a formal written procedure regarding the calculation and payment of contingent commissions.

Based on our own informal discussions with Beacon personnel, we found that contingent commissions were calculated at the end of each fiscal year. The initial calculations were performed by the regulatory relations department using premium and loss data received from the information systems department. The regulatory relations department calculated contingent commissions by agent and provided the results to Clark and Solomon, who reviewed and made changes as they deemed necessary. See the "Statutory Violations" section for DBR's position related to senior management's contingent commissions adjustments.

One employee knowledgeable about the process indicated that Solomon and Clark would identify certain agents that "were close" to meeting the thresholds for payments and they wanted to give them "an extra thank you." This employee recalled that "close" generally meant a few percentage points, but not as much as a 10% variance. Management felt that these 40-plus agents contributed approximately 80% of Beacon's business and making these concessions was warranted. The employee realized, "it was not the best thing to do," but that it was a business decision made by Clark and Solomon.

A regulatory relations employee recalled one instance where one of Beacon's largest agencies was given a flat $100,000 commission despite missing the metrics one year. Beacon's largest agency might also have benefited from a similar concession. We found a schedule that indicated this $100,000 flat commission was paid to the agency mentioned by the regulatory relations employee in 2002 (see the following section for more information).

Underwriting personnel indicated that due to the extremely unprofitable insured mentioned in the original whistleblower allegations (see Allegation 5 in the "Original Whistleblower Allegations" section), the agency producing this account continuously showed poor loss ratios, but that for a number of years they were still granted contingent commissions.

After Solomon and Clark made the adjustments to the contingent commission calculations, requests for payment were sent directly to the finance department, and checks were issued without any finance review.

A Beacon vice president said that the board of directors was responsible for approving the total dollars of contingent commissions, but did not know if the board reviewed the calculations or contracts. When we asked what would happen when the calculations indicated that Beacon was under budget on commissions, the vice president replied, "there's not going to be any remaining money from here," implying that Clark and Solomon would make adjustments to make sure they met the approved budget amount. The vice president believed that Solomon and Clark would review the commission calculations and thought they would look at the agents that just missed the cut. If a couple of agents missed the threshold by a few percentage points, the vice president thought that Beacon would recalculate commission on the whole population applying the exception to every contract agent and see where the calculation came out. The vice president was not aware of any special exceptions to this practice and believed that the board of directors was presented with a listing of commissions by agent that showed the exceptions as footnoted to the schedule.

We found documents that supported the assertion that contingent commission schedules were adjusted in order to pay agents higher commissions than they earned. We found contingent commission schedules that were shared between finance personnel and Clark via Email that showed the calculation of contingent commission amounts, by contract agent. These schedules contained all calculation components, including written premiums, loss ratios, and retention percentages. These schedules also included footnotes indicating the commission amounts for some agents had been altered.

Certain footnotes in these schedules indicated agents were paid based on loss ratio percentages that were not accurate. One footnote said "Agent paid contingent commission based on 65% loss ratio; actual ratio was 67.9%." Agents with loss ratios above 65% did not earn a contingent commission according to the agent contracts in force at the time. Other footnotes were similar, stating that the agents were "paid contingent commission based on 65% loss ratio" when the actual loss ratios were over 65%, which would have disqualified them from contingent commissions.

We found that 10 agencies received contingent commissions that resulted from loss ratio adjustments, which totaled $2,084,443 for the years 1999 through 2002. Each of these agencies had loss ratios between 66% and 112% in the years for which they received loss ratio adjustments. These schedules also showed that there were other agents with similar unadjusted loss ratios that Beacon did not adjust. We found agents with loss ratios between 67% and 135% that were not adjusted and therefore did not receive any contingent commissions as a result. This was contradictory to the vice president's understanding of the adjustment process where adjustments were applied consistently to the whole contract agent population.

We also discovered footnotes indicating that some agents received a "New Business" commission when they did not meet the necessary requirements. At the time, Beacon provided an additional 2% bonus to contract agents that brought in new business of $500,000 or more. These schedules included footnotes that indicated "Agent paid New Business Bonus on…New Business total less than $500,000." We identified four agencies for which exceptions were made. Each agency received between $8,000 to almost $10,000 in "New Business" commission in either 2000 or 2001, for a total of $35,590.

Key Email Correspondence

We found an Email dated 10/15/2004 from Clark to certain employees of one of Beacon's top agencies. It appeared that one of the employees inadvertently copied Clark on an Email complaining about the New York Attorney General's investigations into contingent commission practices in the insurance business. Clark took the opportunity to respond to the entire distribution and made the statement, among others, that, "We [Beacon] have paid contingency commissions to agents that have not met the annual objectives."

In an Email between Clark and an agent dated 10/31/2004, the two discussed the investigations and the agent wrote, "…[I] hope [Solomon] doesn't overreact and cut [contingent commissions] out." Clark responded, "If we cut [contingent commissions] out we WILL REPLACE with straight commission….Don't worry, I have already talked to [the CFO] and she agrees that we can't take away [without] putting back someplace." The agent followed up with "I'm even more worried about the PR side for both you and us. The [Providence Journal] would/could have a field day with this and it would piss the heck out of our clients if they read [my agency] is getting…in some side deal from Beacon. Could really hurt all of us. Enough problems, don't need that."

Board of Directors' Oversight of Contingent Commissions

In the "Statutory Violations" section, we explained that Beacon's enabling act provides, "The board shall by rule also establish a schedule of commissions for voluntary risk and residual risk coverage that the fund will pay for the services of an insurance producer" (2003 P.L. ch. 410 § 16).

We asked a regulatory relations employee whether the board had visibility to the manual adjustments that Solomon and Clark made to the contingent commission schedules. The employee believed that the board only saw the adjusted schedules, which reflected statistics and metrics that had been altered in order to qualify the agents for payment.

We read the minutes to the board of directors meeting dated 4/19/2006. During this meeting, the board asked Clark about contingent commissions and the minutes reflect that he explained, "that management made recommendation to pay contingent commissions to agents who were not technically eligible to receive contingent commissions because of experience but that handling of contingent commissions had been fair and if the matter was within budget, there was some leeway as to payments." Clark reportedly explained that, like the rest of the industry, commissions calculations were not all "black and white."

We requested all documents related to contingent commission payments that were provided to the board for the years 2001 through 2005. The schedules Beacon provided in response to this request did not include the footnotes we saw in the schedules shared between Clark and the finance department regarding the adjustment of loss ratios and payment of "New Business" commissions on net written premiums below the required threshold. The absence of these footnotes from the schedules presented to the board of directors indicates the board was not made aware of these exceptions that were made for certain agents. One of the schedules provided by Beacon included footnotes indicating certain agents' premium and loss information was grouped together, indicating unrelated agents were grouped for the purpose of qualifying for contingent commissions, which was one of the Almond Committee's specific findings.

Conflicts of Interest

Overview

On an annual basis, in accordance with Beacon's Conflicts of Interest Policy,[71] all officers and directors are required to disclose "…any business affiliation or relationships that could give rise to an appearance of impropriety" on the Annual Conflicts of Interest Questionnaire ("Questionnaire"). Furthermore, the Almond Report indicated that the Conflicts of Interest Policy stated, "any contract or transaction between Beacon and an entity in which a Beacon director or officer is either a director or officer or has a financial interest must be disclosed and approved by an affirmative vote of a majority of the disinterested Directors of the Board."

The Questionnaire included the following:

- *Have you or a Close Relative[72] received compensation or other benefits from [Beacon], its affiliates and subsidiaries during the prior calendar year other than in the capacity as officer or director of [Beacon]?*
- *Are you or a Close Relative an officer, employee or director of, or hold any financial interest in (other than a de minimus stock holding in an entity in which [Beacon] may invest in the ordinary course of business), any entity which engaged in contracts or business transactions with [Beacon], and it subsidiaries during the prior calendar year?*
- *The board recognizes that the relationship between [Beacon] and a charitable organization on which a director or officer serves as a director or trustee could be a material relationship. For purposes of this disclosure, such a charitable relationship does not have to be disclosed if [Beacon's] discretionary charitable contributions to any such organization in each of the past two fiscal years are less than 2% of that organizations gross revenues. A list of [Beacon's] charitable contributions is available.*

Finally, the Almond Report noted that "the current Beacon Employee Handbook state[d] that it is Beacon's 'policy to prohibit employees from engaging in any activity that conflicts with the interests of [Beacon] or its policyholders…Conflicts of interest normally arise when employees engage in activities for personal gain that compromise their ability to represent [Beacon's] best interests…You should never extend preferential treatment to a customer or a potential customer or any person for personal gain.'"

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[71] Beacon's Principles of Corporate Governance states "Every director has a duty to avoid business, financial or other direct or indirect interests or relationships which conflict with the interests of the Company. Each director consistent with the Board's Conflict of Interest Policy must deal at arm's length with the Company and should disclose to the Board of Directors (acting through the Chairman and the Governance Committee), prior to taking any action, any conflict or appearance of a conflict of interest."

[72] According to the Questionnaire, a "Close Relative" was defined as "a spouse, children, siblings and their children, parents and their siblings, siblings of a spouse, parents of a spouse, sons and daughters-in-law, and any other blood relative, whether or not residing in your household."

In order to determine if there were any undisclosed conflicts of interest among the directors of the board, we performed the following procedures.

Procedures

We obtained a listing of the members of the board of directors from Beacon's 2001, 2002 and 2003 Annual Reports, located on Beacon's website, as well as a listing of the board of directors as of 3/8/2006, which Beacon provided. We also included Beacon's Corporate Counsel.

We generated a keyword listing based on these names and performed a search for those terms on the 2003, 2004 and 2005 MAS200 vendor data, and the payroll information.

Relevant Findings

<u>Payroll Records</u>

We searched the payroll data for calendar years 2003, 2004 and 2005, which resulted in nine potential matches. Of these, four employees were found not to be related to a board member, two were identified as employees that also served on the board (Beacon's CEOs) and three were employees related to board members.

We asked the human resources department about these relationships and compared their responses to the respective board member's Questionnaires.

<u>Board Member and Beacon Employee</u>

As the CEO's of Beacon, Vass, Solomon and Parent all have been Beacon employees while also serving on the board as ex-officio members. Vass retired from Beacon before the timeframe of our procedures and, as such, he was not included in the payroll data. Solomon was CEO after taking over for Vass until April 2006, at which point Parent was appointed acting CEO. Parent served as acting CEO until January 2007.

Upon reading the Questionnaires, it came to our attention that Solomon did not disclose on his 2005 Questionnaire that his brother was part owner of an insured. In accordance with the Conflicts of Interest policy, he should have disclosed his brother's company. This company has been an insured of Beacon's since 5/15/1998 and its total written premiums were less than $6,000 a year during those years. We performed additional procedures related to this account and did not find preferential treatment extended to this account.

Employees Related to Board Members

Our procedures revealed three Beacon employees during 2003, 2004 and 2005 that were related to current or past board members.

One employee is currently a regulatory relations specialist, who has been with Beacon since 11/28/2000. He is also the son of Vass.

Another employee was hired by Beacon's underwriting department on 1/2/2001. She is the daughter of a former board member who was on Beacon's board during the time of her employment. This relationship was properly disclosed on the former board member's Questionnaire.

The third employee was hired as an employee in Beacon's legal department on 6/20/2005. She is the daughter of a former board member, who served on the board from November 1990 until 4/22/2004. Since her employment did not overlap with the former board member, there were no disclosures required. We found an Email dated 5/25/2005 from the human resources director to Clark that read:

> *"…[the former board member] called and his daughter just graduated…and she needs a job for a year, and then she's going to law school so we have to find a home for her too…I just don't know where we can put her. Maybe she can work in [Legal] or Claims, since she's interested in legal? Oh well, I'm sure we'll come up with something for some of these folks."*[73]

We discussed this employee's hiring with the human resources director who indicated that:

- the employee was qualified for the position that they were hired for,
- there was a need to fill that position at Beacon at the time she was hired,
- her compensation was commensurate with her job level and
- there was no pressure from the board member or Solomon to hire her.

Other

During the examination of the electronic asset listing at Beacon, we noted the name of an employee in the claims department with the same name as one of Beacon's most influential agents. The employee was the son of the agent, who was also a member of Beacon's Agent Advisory Council. We performed a query to compare the claims handled by this employee against the accounts produced by his father and we did not find a conflict.

According to the human resources director, this employee was referred to Beacon by his father, and "at Joe's [Solomon] request we hired him." The human resources director

[73] See the "Political Activities" section for other employment placements related to this Email.

told us that the employee resigned in 2006, but that his resignation "had absolutely nothing to do with his father or potential conflicts of interest."

Vendor Data

We searched the MAS200 data for vendors that matched our keywords, which resulted in 77 potential matches. Of these, 35 were "false positives" and 18 were identified as board members, former board members or employees. The remaining 24 results were then compared with the MAS200 general ledger and cash disbursement detail.

Of the 24 results, the human resources director explained that 16 vendors either had no relationship to the board members or she was not able to verify if there was a relationship. We searched MAS200 for all payments made to these vendors for the years 2003, 2004 and 2005, and our query resulted in payments that were primarily related to items such as shared earnings payments.

PREMIUM PRICING

Introduction

One of the primary focuses of this Examination was to understand whether Beacon's premium pricing philosophy and practices were consistent with the statutory requirements under which it is regulated. In accordance with these statutes, Beacon could not engage in pricing practices that resulted in premiums that were excessive, inadequate or unfairly discriminatory. To assure compliance with this rating standard, the statutes governing Beacon and all other licensed workers' compensation insurers in Rhode Island prohibit the insurer from entering into agreements on pricing, or offer programs, that deviate from filed and approved plans.

We designed our procedures to address the potential statutory violations listed above. We performed the following procedures to obtain an understanding of Beacon's pricing practices and to assess whether additional procedures were necessary:

- Read the SKM report and the Almond Report and the accompanying workpapers,
- Held informational discussions and interviewed underwriting, premium audit, finance, claims, loss prevention and information systems personnel,
- Researched publicly available records and Internet resources for information about Beacon,
- Read Beacon filings and correspondence with DBR,
- Read corporate charters, board and committee minutes and relevant legislation,
- Read Emails and other electronic documents,
- Participated in discussions with third parties having knowledge of the workers' compensation industry,
- Gained an understanding and documented Beacon's policies and practices related to the following areas or programs:
    - CompAlliance and Loss Free Programs
    - Safety Groups
    - Out-of-state coverage.

Based on the information obtained from the general procedures described above, we performed queries utilizing data that we obtained from Beacon's information systems: PowerComp, Beacon's insurance software and AuditLynx, Beacon's premium audit software.

As mentioned in the "PowerComp Data Reconciliation" section, Beacon converted its insurance software systems to PowerComp in October 2003. We found that errors were created when the legacy system data was loaded by Beacon into PowerComp. As a result of these errors some of the queries that we performed (as discussed below) were limited to the 2003 through 2005 timeframe. Other queries and comparisons were applied to longer periods of time, including some data that may have been less reliable than post-conversion information.

The procedures and queries we performed are briefly described below. Our queries were limited to Rhode Island policy data only, unless otherwise specified in section below. As mentioned, some out-of-state data was maintained offline from PowerComp. See the individual sections of this report for a complete listing of procedures and findings.

- **Original Whistleblower Allegations –** We read the SKM report and the Almond Report, as well as read workpapers related to each of the six insureds mentioned during the original phone calls. We performed additional procedures on these six insureds and compared our findings to these reports.
- **Overall Pricing Patterns** – We performed queries and comparisons on data pertaining to Beacon's policies from 2003 through 2005 in order to identify patterns and trends of Beacon's pricing.
- **Agents Analysis** – We categorized Beacon's policies by the producing agent and performed several queries to identify patterns in pricing.
- **Credits and Debits** – We identified certain policies and groups of policies that received high credits and high debits according to Beacon policy data and performed additional procedures on those policies.
- **Classification Codes** – We compared the classification code data received from NCCI to the actual classification codes utilized by Beacon in PowerComp and obtained explanations from Beacon for the variances.
- **Notepad** – We performed a keyword search of Beacon's Notepad and read keyword-responsive entries and performed additional procedures on certain policies.
- **Standard Industry Classification** – We compared the premium data and performance of five insureds named in the whistleblower allegations and two additional policies to their respective industries and performed additional procedures.
- **Selected Individual Insureds** – During the course of the Examination, we identified certain accounts outside of the results of the above queries and performed additional procedures on these policies.
- **VIP Listing** – We identified Emails that included a listing of VIP accounts and performed additional procedures on selected policies included on these listings.
- **Accounts Receivable Write-Offs and Late Adjustments** – We performed queries to identify transactions which caused reductions in insureds' accounts receivable balances, including write-offs and late adjustments and requested support for these reductions and the disposition of the resulting refund generated, if applicable.

Original Whistleblower Allegations

Overview

At the beginning of this Examination, we did not know whether we would have full access to the Almond Report or the underlying workpapers of the GSS team that conducted the inquiry. Therefore, we began the Examination by focusing on the policies mentioned in the original whistleblower allegations in addition to the broader premium pricing and cash disbursement analyses.

According the SKM investigative report dated 1/9/2006, a whistleblower made three calls to SKM's subscription hotline service on 11/15/2005, 11/23/2005 and 12/1/2005. The caller, who wished to remain anonymous, made several allegations with respect to inappropriate pricing of certain Beacon insureds.

The caller mentioned six accounts and alleged misclassifications of payroll at two of the insureds; excessive credits for two others; fabricated EMods for one of the insureds; and inadequate premium for the sixth insured.

On 11/22/2005, Beacon's audit committee chairman authorized SKM to investigate the allegations. SKM concluded, based on their investigation, "no evidence was found of any wrongdoing by [Beacon] or its employees, with respect to the allegations made by the caller."

Beacon's board of directors subsequently established the Ad Hoc Review Committee, which was led by former Rhode Island Governor Lincoln Almond, Lieutenant General Reginald Centracchio – National Guard (Ret.), and Edward Mazze, Dean of the College of Business Administration at the University of Rhode Island. The Ad Hoc Review Committee retained GSS to perform a more substantive review.

During the course of the Examination, we learned that Beacon intended to allow us access to the Almond Report and the related workpapers. In order to avoid duplication of efforts on the original whistleblower allegations, we switched the focus of the Examination to the broader premium pricing and cash disbursement issues mentioned above. We read the Almond Report and accompanying workpapers and reported on new developments or any findings contradictory to the Almond Report.

Procedures

For each of the six accounts, we performed the following procedures:

- Read the hardcopy policy file that was provided by Beacon, that included premium audit reports, Notepad entries and policy renewal and premium calculations documentation,
- Generated a report with an Account Summary and other relevant policy and premium information from PowerComp including written premium, earned

premium, premium as a percentage of payroll, claims incurred and paid, loss ratios, credit structure, program involvement, and other information,

- Read documents in the underwriting and premium audit sections of OnBase,
- Searched Emails for correspondence related to these policies,
- Discussed the policies with underwriting and premium audit personnel involved in the accounts and
- Read the GSS and SKM workpapers.

Relevant Findings

We read the Almond Report and the accompanying GSS workpapers, including their investigative summaries for each of the policies mentioned in the original allegations. We also read specific workpapers supporting the report and these summaries. Based on the procedures we performed, nothing came to our attention that contradicted the findings of the Almond Report.

We have briefly summarized the findings of the Almond Report below and provided additional information for certain policies, based on new developments or findings arising from the Examination.

<u>Allegation 1</u>

The whistleblower alleged that the company's owner, Sollosy, only submitted payroll information in summary form by Class Code rather than detailed by individual employee. It is our understanding, from speaking with premium audit personnel, that this level of information was not sufficient to perform a proper audit. The caller also alleged that the company had misclassifications of payroll.

The Almond Report stated that, "Beacon's files confirm this lack of access." The Almond Report cited Notepad entries that indicated that misclassifications were present at the company, which were uncovered when employees filed claims and the employees' job descriptions did not match their classifications.

The Almond Report and GSS workpapers also indicated that Beacon senior management was aware of the uncooperative nature of the owner, but did not take steps that corrected the actions.

Our procedures did not result in findings that contradicted the Almond Report, nor did we uncover any additional information not already included in the GSS workpapers.

Allegation 2

Based on our reading of the SKM and Almond Reports, the whistleblower alleged that this insured had personnel that were misclassified from construction to clerical, and that Clark and underwriting managers may have been aware of the misclassifications. The caller expanded on the allegation to SKM and indicated that bridge construction workers were not being classified properly. Per the Almond Report, as well as our own procedures, the insured denied that its own workers performed bridge construction work. Loss prevention personnel first noticed the bridge construction work, and premium audit personnel met with the insured in an attempt to get the insured to admit that it was performing bridge construction work.

The Almond Report also noted the following:

> *Insurance documents showing…policy history from 1990 – 1996 indicated that bridge work (class code 5222) was used in each policy with payroll assigned to that code. This information was available to Beacon during the 1997 due diligence review of [the insured] but appears to have been ignored as we note that the bridge classification was omitted in writing the Beacon policy in 1997.*

Our procedures did not uncover any information contradictory to the Almond Report or the GSS workpapers. However, one underwriter felt that the Almond Report did not tell the whole story and that it was very "one-sided." This underwriter claimed that the Almond Report noted that Beacon "knowingly" did not change the Class Code, but in fact, the question was asked directly to the insured and the response always was that subcontractors did the bridge work.

We discussed the underwriter's concern with a premium auditor who stated that he and a loss prevention employee visited one of the insured's job sites during the 2004 policy year and noted that bridge construction workers were wearing company shirts; they also spoke directly to these workers and learned that they were employees of the insured. The premium auditor also recalled that he and the premium audit manager met with the CFO of the insured and they attempted to persuade him that employees had been performing the bridge work. Despite their findings, this meeting did not result in adding Class Code 5222 to the 2004 policy; however it was added on an "if any" basis beginning with the 2005 policy.

We read the 2005 and 2006 renewal information in PowerComp, and noted that Class Code *5222 Concrete Construction in Connection with Bridges or Culverts* was applied to the exposure, as seen in PowerComp. This Class Code had not been previously applied to the payroll.[74] PowerComp lists all Class Codes used in determining manual premium. We noted that 5222 was applied at a rate of $43.44. The 5222 Class Code represented less than 1% and 2% of total payroll for 2005 and 2006, respectively.

[74] Refer to the "Late Adjustments to Accounts Receivable" section for information on a subcontractor of this insured that also had misclassifications of payroll related to Class Code 5222.

During our procedures related to AP disbursements, we located a cash payment of $26,478 made by Beacon to this insured related to work performed at the Beacon headquarters in December 2005. According to an invoice dated 11/29/2005, this payment was for the repair of Beacon's parking lot following damage that was caused by a water main break. The supporting documentation included an initial quotation and final invoice from the insured, as well as two quotations from another construction company for the same repair work. We read the quotes submitted by the two companies and noted the two quotes from the other construction company were $44,680 and $42,073 on 10/28/2005 and 11/15/2005, respectively, while the quote from the insured was roughly half that at $21,500.

<u>Allegation 3</u>

The Almond Report indicated that the whistleblower alleged that this insured "received unwarranted and excessive credits on its policy, possibly in lieu of work performed at the CEO's home."

The Almond Report noted that although there was no evidence of a *quid quo pro* arrangement, the support that was provided for the work performed on Solomon's house did not contain the level of detail GSS was expecting. Solomon explained in a memo sent to the board of directors on 4/13/2006, that the Almond Report did not mention how he provided GSS "access to all contract plans, modifications, etc…from the home I build [sic] in 2003." Also, the insured informed GSS that the payment that was made by Solomon was "slightly less than the costs incurred."

We read GSS' "Report of Interview" with Solomon dated 3/15/2006 where he described the work performed at his house. He reportedly told GSS that his wife primarily dealt with the company in terms of the construction. The memo indicated that Solomon claimed he had to "chase" the insured to send him a bill for the stonework, and following a lunch with the insured's owner, he finally received an invoice for $10,000 three or four months after moving into his new home.

The Almond Report also highlighted that despite high loss ratios (322% and 168% in 2001 and 2004, respectively), the insured received credits ranging from 52% to 58% and "the file does not contain any documentation that explains why this level of credits is appropriate."

The Emails we identified during the Examination revealed new information not mentioned in the Almond Report, as well as information to further support the initial allegation gathered from our reading of supporting documentation and interviews. We explain information obtained from these Emails, and further procedures we performed based on these Emails, below:

Preferential Treatment – An Email chain dated 6/20/2005 between two underwriters alluded to preferential treatment given to the insured. The exchange was in response to a previous Email received from Clark's administrative assistant, which asked the underwriting department to provide a list of accounts where "…Beacon has done something favorable for and who would have something positive to say." One underwriter mentioned this insured, and then wrote, "…or is that TOO obvious!!!" and the other underwriter responded, "He's #1 along with the contractor that got a 20% credit for fixing up [a vice president's] house."[75] The response to the assistant's request stated that the insured received a 58% credit.

We read GSS' "Report of Interview" with Solomon dated 3/15/2006. In his interview, Solomon reportedly explained that in 1995, the insured had an audit dispute with Beacon which led to a severance in the insurance relationship. The write-up of the interview stated that the insured's agent "arranged a surprise meeting" between Solomon and the insured's management and "after several hours they agreed to resume their business relationship." The memo indicated that "[Solomon] gave his personal commitment to [the insured's owner] to be involved in servicing this account in the future."

"VIP" Status – The insured was included on the VIP list (see the "VIP Accounts" section for more information) and we located correspondence and interviewed underwriting personnel who explained that this insured was considered important to Beacon executives. An Email dated 2/12/2002 from Clark to an underwriter said "Please mark this file to show that no notice of cancellation should ever go out without my sign-off. This should be treated as a VIP account." An Email dated 4/3/2003 sent between two underwriters further discussed the special treatment given:

> *First of all if this was any other account it [the renewal] would just be put through with the increase [in premium] and that would be that. If it was any other account we would not be spending almost a full week putting policies together from the audit.....it [the referral] was rejected because of who they are and for no other reason. I know and realize who these people are and who they know and it looks like I will pay the price for this. This is just all politics and I'm stuck in the middle of it all.*

Underwriting personnel explained to us that they were not aware of Solomon's direct involvement in premium pricing decisions with the exception of this account. They noted that the account was always six months behind in payments, but that Beacon could not cancel them. One time, an underwriter made a "mistake" and cancelled the policy for nonpayment and recalled that an underwriting supervisor told him that his job "was hanging by a thread" as a result.

[75] See Relevant Finding 11 in the "Selected Individual Insureds" section for our procedures and findings related to the contractor mentioned in this Email.

Coverage of Out-of-State Exposure – Emails also indicated that Beacon was covering the insured's Connecticut exposure by grouping it into the Fairfield coverage of Massachusetts workers. An Email chain beginning 8/12/2004 and ending 8/25/2004 between underwriting and premium audit personnel discussed the Connecticut exposure. An Email about the insured's policy stated, "I conducted an audit on the above-named Fairfield policy yesterday. During the audit it was discovered that the insured had payroll exposure in CT. The insured stated that his policy has a 'clause' that CT can be added on an 'as needed' basis." An underwriter responded, "This policy covers Mass only at this time. Before you do or say anything to the [agent] or insured please talk to me as this is a VIP account and a close friend of [Solomon]." The premium auditor responded a few days later, "I spoke to [the premium audit supervisor] and she advised me to sumbit [sic] the audit with the CT exposure charged as if it were MA exposure."

We did not locate any documentation regarding the agreement that the insured claimed to have made regarding the Connecticut exposure. In addition, we also noticed based on reading the Account Summary that the out-of-state premiums for this account have been greater than the Rhode Island policy's premiums. For the years 2001 through 2005, the Rhode Island premiums totaled $233,185, compared to $612,320 in premium for the out-of-state polices; Rhode Island premium was approximately 28% of total premium. Some Beacon underwriters interviewed indicated that it was Beacon's interal policy that out-of-state premiums had to be lower than the in-state premiums for Beacon to allow coverage. This, however, was not a written policy and underwriters that we interviewed explained that certain exceptions were made based on management's discretion. This insured and a bank and financial institution were two such exceptions (see Relevant Finding 10 in the "Selected Individual Insureds" section for more on this bank and financial institution).

The credits applied on the Rhode Island policy were used to offset the higher-priced out-of-state policy. See the "Statutory Violations" section for more information on this practice.

Use of Incorrect EMod – The Almond Report indicated that this insured's policy was priced to reflect an EMod of 0.99, but the EMod promulgated by NCCI was higher. We were told that the EMod was maintained below 1.00 specifically because the insured wanted to remain qualified for certain government contracts. Underwriting personnel said that their supervisors knew about this expectation.

We read GSS' "Report of Interview" with Solomon dated 3/15/2006, which confirmed this:

> *[Solomon] acknowledged that [Beacon] has adjusted E-MODS below 1.0 for [the insured], as well as for other construction companies, to allow them to bid on certain contracts. Although he is not involved directly on decisions to adjust E-MODS he defended the practice because of an ongoing disagreement with NCCI over the accuracy and efficacy of their EMODS.*

We read the minutes from the 4/19/2006 board of directors meeting where Clark and Solomon were questioned about several of the Almond Report findings. Clark reportedly stated "that there were three accounts at Beacon with incorrect 'mods'…. He indicated that he was told to keep the mod by [Solomon] and specifically, with respect to [this insured], to keep it under 1.0." Clark also reportedly explained that the practice of keeping EMods below 1.00 to qualify certain insureds for "state contracts" may have been discussed with agents.

According to the board minutes of the same meeting, Solomon appeared to contradict his statement to GSS. The minutes indicated that Solomon claimed that "he had no knowledge of how experience mods were set for [this account] and that any underwriter could do it."

We performed a revised premium calculation by applying the NCCI-promulgated EMods to the 2003, 2004, and 2005 Rhode Island premiums as reported.[76] As there were multiple EMod rates issued by NCCI during these years, we calculated the average NCCI EMod factor and applied these in our calculation. The average EMods for the 2003, 2004 and 2005 policies were 1.27, 1.07 and 1.08, respectively.

Based on our revised premium calculation, we found that Rhode Island premiums would have been approximately $27,000 higher over the three-year period 2003 through 2005 using the EMods developed from NCCI data. The results of our calculation are shown in the following table:

Year	EMod Used by Beacon	Average EMod per NCCI	Original Premium	Recalculated Premium	Undercharge of Premium
2003	0.99	1.27	$ 66,324	$ 84,780	$ 18,456
2004	0.99	1.07	$ 41,445	$ 44,504	$ 3,059
2005	0.99	1.08	$ 66,322	$ 72,254	$ 5,932
TOTAL			**$ 174,091**	**$ 201,538**	**$ 27,447**

We checked PowerComp for the 5/13/2006 renewal information, and found that the policy was renewed with an EMod consistent with the NCCI-issued EMod.

Allegation 4

The whistleblower alleged that this insured received unearned credits on its policy and that the CFO of the insured was a Beacon board member. This board member, who was also the chairman of the board at the time, indicated to GSS that he was not aware of the pricing of the policy. The Almond Report also mentioned that there was an allegation that the insured "may have misclassified job codes."

Aside from the allegations, the Almond Report indicated that the insurance agency through which the policy was written to be owned by the insured's owner. We located a

[76] There was a break in service from 1996 to 2001 and we focused our calculation on these three years, as there was consistent coverage.

letter dated 11/23/2004 from the insured's CFO to Clark that stated that the insurance agency was to be recognized as the broker of record effective on the renewal date of 12/31/2004. The letter also stated that, "Commission checks are to be sent to my attention at the Company." We performed a search of public records and found that the owner of the insured was the president of the insurance agency. We identified an Email dated 1/6/2005 sent among underwriters where one underwriter wrote, "This is a VIP account according to Dave [Clark], as the CFO is on Beacon's board…have new/correct policies mailed out and confirm for me [that the insurance agency] is receiving the commission on both RI and Fairfield as of the 1/1 renewal."

The Almond Report indicated that the insured received credits between 40% and 61% despite high loss ratios. The Almond Report also noted that Beacon and the insured "entered into a three year pricing arrangement in 1997. This agreement included an understanding that the credits to the Rhode Island policy would remain at a level of 60.8% for this period."

Class Code Comparison Calculation – The Almond Report noted that Solomon overrode the classification for certain employees at this local and long distance residential and commercial moving company, and allowed the use of Class Code *7228 Trucking-local hauling only-all employees & drivers* as opposed to *8293 Storage warehouse-furniture & drivers*. The "misclassification," as it was termed in the Almond Report, was first noted in a 1998 premium audit alert, the first year of the policy: "The class codes on policy are trucking codes. Insured is a residential and commercial moving company. Class code 8293 should be the class code that applies. Please review account. The class code 8293 is a much higher rate." We identified a subsequent premium audit alert which appeared on the 2001 through 2004 policies that stated, "The class code used for this account is incorrect. The proper class code is 8293 for a moving company. Per information in note pad, [Solomon] has agreed to use code 7228."

We performed a revised premium calculation for this account and assumed that all employees in Class Code 7228 should have been classified as 8293 for each of the nine years that the insured was covered by Beacon, 1998 through 2006. The difference in Class Code rates between 7228 and 8293 for the 1998 policy year (based on the NCCI Class Code rates adopted in 1996) was $14.18 versus $18.12, respectively. The difference in Class Code rates between 7228 and 8293 for the subsequent policy years 1999 through 2006 (based on the NCCI Class Code rates adopted in November 1998) was $13.47 versus $18.12, respectively.

We calculated the difference in premium as if Beacon had used the higher class code on the policy, and noted that the premiums over the nine-year period would have been approximately $431,000 higher. The results of our recalculation are displayed in the following table:

Year	Premium Based on Class Code 7228	Premium Based on Class Code 8293	Undercharge of Premium
1998	$ 114,189	$ 137,873	$ 23,684
1999	$ 107,799	$ 140,965	$ 33,166
2000	$ 108,739	$ 141,753	$ 33,014
2001	$ 113,996	$ 149,226	$ 35,230
2002	$ 142,362	$ 186,198	$ 43,836
2003	$ 182,761	$ 283,144	$ 100,383
2004	$ 189,362	$ 246,033	$ 56,671
2005	$ 188,135	$ 244,973	$ 56,838
2006	$ 160,969	$ 209,584	$ 48,615
TOTAL	**$ 1,308,313**	**$ 1,739,749**	**$ 431,437**

Document Backdating Issue – We found Emails that indicated that underwriting managers instructed the creation and backdating of a referral form for the policy. We found Emails dated October 2005, approximately 10 months after the effective date of the policy that indicated that the referral form was not in the OnBase system at that time. An underwriting manager sent an Email to underwriting personnel on 10/17/2005, and explained that the "Internal Referral for this $188,000 renewal was NOT in imaging. I need the internal referral form (and loss rating form also) for 1/1/05 – 1/1/06 for the Market Conduct Exam." An underwriter responded on 10/18/2005 and wrote, "This [policy] had been quoted to [the agent] a month before the [broker of record form] came in…I had done a loss rating form in Feb, attached." Another underwriting manager responded and asked, "…considering that this is time sensitive, can you please work up the referral." The first underwriting manager separately responded and asked why the loss rating form was not in imaging to which the underwriter replied, "I don't know, it was created by me on 2/4 when [an underwriting manager] came looking for loss rating sheets for the month…I'm going to look for the Fairfield 05 folder and see if I can find [the underwriter's] referral in there. If not, [the underwriting manager] asked me to recreate. Not sure who wants to sign it…?"

Representatives from DBR were onsite at Beacon between September and November 2005, performing a Market Conduct Examination.

The referral form, created in October 2005, showed a date of 11/2/2004 and was signed by Clark and an underwriting manager who dated their signatures as of 11/2/2004. Beacon provided this form to DBR two times during its Examination.[77]

We found the backdated document in DBR workpapers, signed off by a DBR representative as of 11/8/2005. We shared these facts with the underwriting manger that signed the document, who explained that the facts in the documents, "appear[ed] to be accurate…and as far as other situations, I am unaware of any backdating of documentation."

[77] Beacon also provided this document to GSS during their inquiry.

We discussed this situation with another underwriting manager and they recalled that as a result of a "leak" of the SKM investigation sometime in January 2006, Clark instructed underwriting to "proactively" pull all the files for board member accounts in order to prepare for anticipated questions. This underwriting manager believed that this document was found to be missing during this process and was created in January 2006 and provided to DBR and that this was the only document that was created during this process. The underwriting manager also indicated that some documents were added late to the OnBase imaging system. This recollection of the timing of the document creation was not consistent with the other facts that indicated the document was created in October 2005.

See the "Statutory Violations" section for more information on this issue.

<u>Allegation 5</u>

The whistleblower alleged that this insured's EMod was "made up" to obtain a lower premium rate, rather than using the one provided by NCCI. The Almond Report noted that it was broadly alleged that the insured "received 'massive' credits that were undeserved and that Beacon provided incorrect support to NCCI for the experience mod used to generate the premium pricing…resulting in an unjustified reduction to the premium."

The Almond Report determined that:

- *…the payroll and the historical claims information Beacon used to calculate the experience mod was significantly understated.*
- *…Beacon did not corroborate the reported payrolls and classifications ([the insured] was previously self-insured), and Beacon's due diligence efforts appear to be insufficient.*
- *Beacon agreed to a three year rolling pricing commitment, with the only changes in premium being generated by payroll; thus the experience mod would not change on subsequent renewals. An independent insurance expert consulted during the investigation, has characterized the three year guaranteed rate included in this policy as "highly unusual and not customary".*

The Examination did not contradict the findings of the Almond Report. In addition to the Almond Report, however, we found:

- Beacon made several contributions to hospitals related to the insured, including one unauthorized payment of $25,000. See the "Accounts Payable Disbursements" section for more information.
- Solomon's wife was named to the board of trustees of a hospital that was a member of the insured's hospital group. See the "Accounts Payable Disbursements" section for more information.

- Beacon continued to write coverage for a Massachusetts-based hospital after it disaffiliated from the insured (see below).

Both the in-state and out-of-state policies were unprofitable in terms of absolute dollars over the years. Combined, the actual losses incurred on the account greatly exceeded the premium collected as summarized in the following table:

Policy	Total Premiums	Total Incurred Losses	Difference
Rhode Island	$ 10,809,217	$ 21,278,314	$ (10,469,097)
Out-Of-State	$ 3,499,808	$ 2,539,056	$ 960,752
TOTAL	**$ 14,309,025**	**$ 23,817,370**	**$ (9,508,345)**

Based on Beacon's target[78] loss ratios of 65% for in-state business and 47% for out-of-state business, writing the account has cost Beacon and its mutual policyholders approximately $15.1 million, as highlighted in the table below. (The data below was based on a February 2006 Account Summary, and considered completed policy periods only.)

Policy Location	Number of Completed Policies	Total Earned Premium	Total Claims Incurred	Actual Loss Ratio	Target Loss Ratio	Target Losses	Excess Losses
Rhode Island	5	$ 10,809,217	$ 21,278,314	197%	65%	$ 7,025,991	$ 14,252,323
Out-Of-State	3	$ 3,499,808	$ 2,539,056	73%	47%	$ 1,644,910	$ 894,146
TOTAL		**$ 14,309,025**	**$ 23,817,370**	**166%**		**$ 8,670,901**	**$ 15,146,469**

An Affiliated Massachusetts Hospital – Based on information gathered from interviews, we selected this insured because we understood that this was a Massachusetts hospital and its affiliation to a Rhode Island employer was unclear. Based on the results of our procedures, we found that the insured disaffiliated itself from the Rhode Island-based group of hospitals in December 2002. After this disaffiliation, the hospital was no longer eligible to receive coverage from Beacon because it was not a Rhode Island employer. The Account Summary that we obtained and read showed that Beacon continued to provide coverage to the hospital for one more policy year through its Fairfield fronting arrangement (see the "Out-of-State" section). Emails we read and interview responses indicated that Beacon underwriters were aware that the hospital was no longer linked to the Rhode Island group of hospitals.

An underwriting manager explained that Beacon was only supposed to provide out-of-state coverage through fronting arrangements for exposure of Rhode Island employers. There were some exceptions to this practice and this hospital was the most notable. The

[78] Beacon's "target" loss ratio for in-state and out-of-state policies is explained in the "Overall Pricing Patterns – Loss Ratio" section.

underwriting manager recalled that the policy was written because Clark and Solomon "liked their premium."

The policy effective 12/1/2002 to 12/1/2003 had the second-highest premium in all of Beacon, at approximately $2.1 million. In the "Out-of-State" section, we explained that Beacon's target loss ratio for out-of-state policies was 18 percentage points below the 65% loss ratio on Rhode Island policies due to incremental costs. Based on the reduced target loss ratio of 47%, writing this policy for one year, cost Beacon and its mutual policyholders over $1 million.

<u>Allegation 6</u>

The whistleblower claimed that the premium charged to this insured was lower than the cost of facultative reinsurance Beacon needed to acquire to write the account. The Almond Report found that "the essential facts cited…are accurate," but further noted that Beacon charged the insured schedule debits in an attempt to recoup the cost. Furthermore, the Almond Report concluded "full cost of supplemental coverage" would be charged for the 2006 renewal.

We did not have findings that contradicted the Almond Report. We found the finalized renewal,whose 2006 policy was effective 7/22/2006. We noted that the policy declaration in PowerComp showed that the policy was debited 25% in 2006 (and had been since the 2003 policy). The increase in premium related to the 25% debit did not cause the premium to exceed the cost of reinsurance. Beacon wrote the 2006 policy with a premium of $15,488; however, the cost of facultative reinsurance was $32,250.

CompAlliance and Loss Free Credits

Overview

CompAlliance is a managed care and employee wellness program for insureds started by Beacon and BCBSRI. Beacon filed this program with DBR on 2/15/1996, and DBR approved it on 2/18/1996. The agreement between Beacon and BCBSRI, dated 11/21/1995 that was submitted with the filing explained the program as combining traditional health care coverage and workers' compensation coverage into a single product to "promote economies through cooperative administration." The agreement indicated that the savings of the program result mainly from BCBSRI's handling of Beacon's claims and insureds' access to the discounted BCBSRI health care provider network. The savings realized related to this partnership should be passed onto participating insureds through credits on premium according to the filed program.

According to the filed and approved program, insureds can earn up to a 10% credit on premium. This credit is determined by calculating the percentage of an insured's payroll that is eligible to sign up for BCBSRI coverage. If 100% of employees are covered by the provider BCBSRI, the maximum credit of 10% could be issued by Beacon.

Beacon filed this program as a modification to the Schedule Rating Plan. As a result, the maximum schedule credit an insured could receive increased from 25% to 35%. Per Beacon personnel, however, insureds that did not qualify for experience or schedule rating due to the premium threshold could still qualify for the CompAlliance credit. DBR concluded that Beacon filed the CompAlliance credit as a modification to schedule rating, and as such does not consider CompAlliance to be a separate program.

Beacon also offers insureds credits through its Loss Free Credit Program. This program, filed with DBR in June 1994, awards credits to insureds with two or more years of no losses. The maximum credit, earned for six or more consecutive years of loss free experience, is 15%. According to Beacon's Underwriting Manual, the CompAlliance and the Loss Free Credit programs are mutually exclusive; credits are only provided based on the higher of the two programs. The "Memorandum of Understanding between The Beacon Mutual Insurance Co. and Blue Cross Blue Shield of Rhode Island" also stated, "An insured who never has a claim gets loss free credits but does not reduce expenses since there is no system utilization. Therefore, CompAlliance credit should be small or non-existent." Based on this statement, it appeared from the beginning of the program that Beacon did not intend to give insureds both credits. DBR received this Memorandum from Beacon in November 1995 for informational purposes prior to the official filing of the CompAlliance program.

This same Memorandum also indicated that Beacon had meant to place a time limit on the CompAlliance credit. The Memorandum stated:

> *The rating and experience modification system will over time adjust the rates and modification factors to reflect the lower expenses [of receiving coverage from both Beacon and BCBS]. That process will take three to five years. We want to pass the savings on to the insured before that time through the selective use of this credit. After five years, the rating system will have been modified by the lower expenses and the credit may not be warranted.*

It does not appear that Beacon provided DBR with calculations or justification that lower expenses would result in three to five years, nor did we see such an analysis during the course of the Examination. Beacon has not modified the application of the CompAlliance credit since it came into use in 1995. We identified an Email between Clark and another vice president, dated 10/17/2005, during DBR's Market Conduct Examination that suggested that Beacon management felt that the CompAlliance credits were at risk. Clark wrote, "they [DBR] are really digging into CompAlliance credit. We will lose that one."

The table below, based on data retrieved from PowerComp, shows the total number of insureds and policies[79] that have participated in CompAlliance and Loss Free since Beacon's implementation of the two programs, and the total written premium generated by these polices, as well as the dollar amount of credit received:

[79]"Policy" signifies a single year of coverage for a given insured.

Program	Number of Insureds	Number of Policies	Total Written Premium	Total Credit
CompAlliance	3,383	14,549	$ 477,577,091	$ (53,622,633)
Loss Free	15,876	65,531	$ 180,044,030	$ (17,190,320)

While the number of insureds receiving a Loss Free credit is greater than those receiving a CompAlliance credit, the premium and credits generated by the CompAlliance insureds is higher, implying that smaller insureds tend to receive a Loss Free credit.

This table, based on queries we performed on Beacon's PowerComp data, shows CompAlliance and Loss Free statistics for 2005 only:

Program	2005 Number of Policies	2005 Written Premium	2005 Credit
CompAlliance	2,054	$ 73,137,909	$ (8,252,900)
Loss Free	7,813	$ 19,198,288	$ (1,967,582)

Our queries showed that Beacon wrote 15,723 Rhode Island policies in policy year 2005; approximately 13% of Beacon insureds were part of the CompAlliance program in 2005, and approximately 50% received a Loss Free credit in this year.

Procedures

We read both the CompAlliance and Loss Free filings and searched for relevant Emails.

We also queried PowerComp data as follows and performed the procedures listed below to see if the credits for the two programs were applied within the limits of the filed programs:

- Queried PowerComp data[80] for all policies receiving a CompAlliance and/or Loss Free Credits, including written and earned premium, credits, and loss ratio in our data results,
- Applied a filter to include only those policies with written premium over $10,000, and then:
    - Isolated policies that received both a CompAlliance and Loss Free Credit,
    - Identified policies that received greater than the maximum 10% credit according to the CompAlliance program according to our computation,
    - Statistically selected 59 records to send to BCBSRI to confirm that the insureds were indeed members of BCBSRI, and obtained explanations for the 13 exceptions that were returned by BCBSRI.

[80] We were given access to all PowerComp data, including the information converted from the WINS legacy system prior to the conversion to PowerComp on 10/1/2003. The data covered the period 1/1/1992 through the beginning of March 2006.

Relevant Data Findings

As seen in the tables above, our PowerComp query returned 3,383 individual insureds and 14,549[81] individual policies that received a CompAlliance credit from the inception of Beacon's operations to the beginning of March 2006. Over this same time period, 15,876 individual insureds and 65,531 policies received a Loss Free credit.

We applied a threshold of $10,000 of written premium in order to conduct further procedures on the CompAlliance and Loss Free programs. Once the $10,000 written premium threshold was applied, 2,048 individual insureds and 9,157 individual policies with written premium over $10,000 received a CompAlliance credit from the inception of Beacon operations to the beginning of March 2006. Over this same period, 1,578 individual insureds and 3,000 individual policies with written premium over $10,000 received a Loss Free credit.

Application of both CompAlliance and Loss Free Credits

Of the total population, we noted 115 policies that received both a CompAlliance credit and a Loss Free credit in the same policy year. Per the filing approved by DBR, Beacon insureds were eligible to receive one or the other credit, but not both. We noted that all 115 records were for policy years before the implementation of PowerComp.

We provided the list of records to the underwriting department for explanation. The underwriting department confirmed that all 115 policies improperly received both credits. Underwriting provided no further explanation as to why both credits were given or how the credits passed approval, but did indicate that the legacy WINS system did not have controls in place to prevent the issuance of both credits. The PowerComp system implemented a control that does not allow both Loss Free and CompAlliance credits to be given to the same policy.

We calculated the excess dollar amount of credits given over all policies related to this error. We calculated the sum of the lower of the two credits for each of the 115 policies as $156,973 using the PowerComp data. Since the lower of the two credits should not have been provided to the insured according to documents filed with DBR, this amount represented excess credit. The total written premium on these 115 policies was approximately $1.9 million based on the results of our PowerComp queries.

CompAlliance Credits Greater than 10%

We identified 82 instances where the CompAlliance credit listed in PowerComp was greater than the maximum 10% allowed; the date of each of these instances occurred prior to the PowerComp conversion. Beacon personnel reviewed these exceptions in the

[81] The CompAlliance program was filed on 2/15/1996 and approved by DBR on 2/18/1996; however, our data showed 32 policies with effective dates prior to 2/15/1996 (the earliest being 10/2/1995) that received a CompAlliance credit.

WINS legacy system and confirmed that our data results were correct. In PowerComp, there is an additional control that was not present in WINS that prevented an underwriter from awarding an insured with a CompAlliance credit greater than 10%. Underwriting personnel showed us that PowerComp has the CompAlliance credit percentage hard-coded in a drop down menu, and the maximum allowed is 10%. In WINS however, an underwriter manually typed in the credit percentage. Therefore, for our exceptions, underwriting personnel indicated that the incorrect percentage was entered into the system by Beacon personnel.

We made six judgmental selections from the 82 records and requested Beacon to provide further explanation by pulling the policy declaration pages to determine if the insureds actually received the credit stated in our data. We also requested underwriting personnel to search Notepad for explanatory entries for the six selections to attempt to find a reason for the excess credit. For each of the selections, the information provided by underwriting personnel showed that the insured received a CompAlliance credit greater than 10%. Screenshots of the premium calculation in PowerComp showed that the percentage of CompAlliance credit for these insureds matched our data and was greater than 10%. The policy declaration pages for these selections did not list the CompAlliance rate, but listed the dollar amount of credit. We recalculated the CompAlliance rate from the policy declaration information only, and noted that for all six selections, the dollar amount on the declaration was consistent with the calculations in our queries and with the PowerComp premium calculation screenshot. Although we received support that our data reflected the credit given to the insureds, underwriting personnel were not able to provide an explanation as to why an excess credit was awarded.

For all 82 exceptions, we calculated that the amount of credits provided in excess of the maximum 10% CompAlliance credit totaled $219,946 on written premiums of approximately $2.6 million based on our queries of PowerComp data.

<u>BCBSRI Confirmation</u>

We statistically selected 59 records and sent a listing to BCBSRI to confirm that the insureds were covered by BCBSRI's managed care program in the year that the selection specified.

BCBSRI returned the confirmation with 13 exceptions (a 22% exception rate). For four of the records, the insured did not appear in BCBSRI's system for any period; for the other nine records, the insured received health insurance from BCBSRI, but not in the year that we specified.

We provided the results of the confirmation to the underwriting department for further explanation. For three of the four exceptions that did not appear in BCBSRI's system, underwriting personnel provided us Beacon documents with notes by Beacon personnel stating that the insured was covered by BCBSRI. In some instances, the notes indicated that the agent informed Beacon of participation; in other cases, it was not mentioned how

Beacon knew that the insured was eligible for a credit. An underwriting manager admitted that an underwriter might take the agent's word or the insured's word when applying the CompAlliance credit, and did not typically conduct an independent confirmation of BCBSRI coverage. For one of the exceptions, the insured was listed under a different name in PowerComp. An Email from the insured to an underwriter provided a BCBSRI policy number. The insured might not have appeared in BCBSRI's system because Beacon had it under a different name than BCBSRI.

For the other nine exceptions, underwriting personnel provided us documents and PowerComp screenshots of the premium calculation showing that underwriting continued to apply the CompAlliance credit after the insured stopped its coverage from BCBSRI. Beacon did not receive a certification that the insured was a part of BCBSRI each annual renewal.

In his interview, a vice president explained that BCBSRI used to send Beacon a report of each of its insureds that had BCBSRI coverage and the percentage of employees covered. Before Clark took over as the vice president of underwriting, this report was posted on a bulletin board in the department to be used as a reference for the CompAlliance program. The vice president interviewed said that this practice "atrophied" when Clark took over the position. Based on discussions with underwriting personnel there is no procedure for independent verification of an insured's BCBSRI coverage. One underwriting manager referred to the CompAlliance program as "a mystery."

As evidenced by the exceptions that resulted from the confirmation sent to BCBSRI, Beacon does not have a process to ensure that insureds that have been provided with the CompAlliance credit are indeed a part of the program. Since the approval program requires participation by the insured in the managed care and employee wellness programs offered by BCBSRI, the allowance of these credits without confirmation of such participation is not in accordance with a filed and approved program and is, therefore, a violation of R.I.G.L. § 27-7.1-5.1.

Safety Groups

Overview

Beacon has established safety groups, generally affiliated with trade organizations, to place insureds with similar business operations into groups in order to reduce injuries and related costs through shared loss control programs and best practices. Since participation in safety groups theoretically would reduce claims costs to Beacon, the programs have been designed to pass some of these savings onto members through credits and shared earnings plans.

As discussed under the "Statutory Violations" section, Beacon has not filed the rating programs for ten of the safety groups with DBR. Per R.I.G.L. § 27-7.1-5.1(a), rates utilized by Beacon are subject to approval by DBR. Beacon filed only two programs (RIBA and RICC). However, the rating structure for the two filed plans has changed since their approval and Beacon did not make an amended filing. Therefore, every policy issued on any safety group program during the period covered by this Examination was a violation of R.I.G.L. § 27-7.1-5.1(a).

We performed the following procedures in order to obtain a general understanding of the history and pricing practices for these groups.

Procedures

To gather more information on safety groups, we performed the following procedures:

- Interviewed underwriting managers and senior underwriters for general information on safety group history and agreements,
- Requested and read all agreements between each safety group and Beacon, and
- Conducted data queries to compare the maximum credit allowed for each safety group against the credits received by insured in those safety groups for the period 2003 through 2005.

Relevant Findings

Based on the procedures performed around safety groups, we have found the following:

- Approximately 17% of Beacon's Rhode Island policies were part of a safety group in 2005.
- Written premium generated from safety group insureds accounted for approximately 18% of Beacon's 2005 Rhode Island premiums.
- At least four safety groups may have been provided multiple-year deals guaranteeing stable pricing at some point over the history of the group.
- Six of the 12 safety groups have had cumulative loss ratios through 2005 above the Beacon target loss ratio of 65%.
- The safety groups with the three highest cumulative loss ratios were also those that received the three highest average credits.
- Agents from Beacon's top agencies acted as paid and unpaid consultants to some of the safety groups.
    - For the MCGRI safety group, Beacon made an agreement with the president of one of the insureds to pay an additional amount to this individual for assisting in bringing the group over to Beacon.[82]

[82] Although we located an agreement and confirmed with Beacon personnel that such an agreement had been made, we did not locate payments to this individual.

- From 2003-2005, there were 54 policies out of 8,187 safety group-affiliated policies that appeared to receive a credit greater than the maximum for that safety group.
    - While most of the exceptions occurred because of mistaken application of credits, for one of these instances, an exception was made to retain the business of this insured.
- Beacon developed three new shared earnings plans specifically for certain safety groups, but did not file these plans with DBR.

<u>General Information</u>

Our queries showed that as of 12/31/2005, approximately 17% of Beacon policies had a safety group affiliation noted in PowerComp. The table below shows the number of policies by safety group affiliation for policy year 2005, as well as the total written premium for each group for policy year 2005:

Safety Group Name	Total Written Premium	Policy Count	% of Total Count
No safety group affiliation	$ 121,720,276	12,981	82.6%
Automobile Risk Management Association ("ARMA")	$ 1,973,396	74	0.5%
Business & Industry Safety Group ("BISG")	$ 691,186	31	0.2%
Community Provider Network ("CPN")	$ 1,400,372	21	0.1%
Jewelry Industry Safety Group ("JISG")	$ 1,660,463	115	0.7%
Manufacturers Comp Group of Rhode Island ("MCGRI")	$ 1,178,921	34	0.2%
Rhode Island Builders Association ("RIBA")	$ 2,245,471	158	1.0%
Rhode Island Builders Association Universal Safety Program ("RIBAUSP")	$ 4,133,510	345	2.2%
Rhode Island Chamber of Commerce ("RICC")	$ 8,174,961	1,832	11.6%
Rhode Island Health Care Association ("RIHCA")	$ 3,126,193	31	0.2%
Rhode Island Marine Trade Association ("RIMTA")	$ 1,190,685	65	0.4%
Rhode Island Partnership Home Care ("RIPHC")	$ 459,107	12	0.1%
Self-Insureds Manufacturers Association ("SIMA")	$ 1,365,736	24	0.2%
Total Safety Groups[83]	**$27,600,001**	**2,742**	**17. 4%**
Total Beacon	**$149,320,277**	**15,723**	**100.0%**

Total written premium generated from safety group members accounted for approximately 18% of Beacon's Rhode Island premiums in 2005.

Safety Group Pricing

Each safety group has its own pricing and shared earnings program, reevaluated every year. Most groups have a general group discount, and members in some groups have additional credit opportunities based on loss ratio performance. The table below lists the maximum credit an insured could potentially have received in 2005.

[83] An underwriting manager provided us with Account Summaries for each safety group. The written premium numbers we obtained from PowerComp, which we calculated by taking the sum of written premium of each insured in each safety group, did not tie exactly to the Account Summaries. Due to known issues with Beacon's Data Warehousing, which generates Accounts Summaries, we have used PowerComp data in this table and in most instances in this section.

Safety Group	Potential Maximum (Credit)/Debit
ARMA	(46%)
MCGRI	(55%)
SIMA	(60%)
JISG	(35%)
CPN	40%[84]
RIBA	(65%)
RIBAUSP	(50%)
RIHCA[85]	(35%)
RIPHC	(25%)
BISG	(30%)
RICC	(15%)
RIMTA	(15%)

Underwriting personnel informed us in their interviews that the Trend and Development approach is used to determine the pricing for each safety group. It was further explained that after the credit structure is determined using Trend and Development, each insured is priced separately using its own EMod and the standard premium algorithm. Another Beacon employee told us they believed the pricing for safety groups was flawed. He explained that although some aspects of the Trend and Development approach were used, the safety group pricing was based on a "quasi-loss rating" methodology. Beacon does not have an approved Trend and Development program filed in Rhode Island. See the "Statutory Violations" section for more information on the violation that this lack of filing represents.

An underwriting manager also informed us that many of the safety groups were recruited out of self-insurance by Solomon and offered attractive pricing for the first couple of years of service in order to win the business. An underwriter explained that, originally, Solomon was the primary contact for all groups except the RICC group, which was handled by a vice president.

During the course of the Examination, we found that at least two safety groups were provided multiple-year deals, and interviewees stated that two others were on multiple-year deals as well:

- An underwriter stated that ARMA was a previously self-insured group of approximately 90[86] members and recalled Solomon entered into a three-year deal

[84] Refer to the "Credits and Debits" section for more information on the CPN safety group and the debit it received in 2005.
[85] Per underwriting personnel, the insureds of RIHCA and RIPHC are individually priced, so this maximum credit is only a guideline and an insured may receive a higher credit.
[86] Our data showed that ARMA had 74 members in 2005.

and afforded a significant discount over this period. The underwriter indicated that they were surprised about Solomon's treatment of this account because they were previously self-insured and their claims history might not have been calculated or recorded consistent with Beacon's tracking of such information. The ARMA schedule provided by underwriting personnel showed that all members of this group received a 65% discount in 2000 and 2001. From 2002 onwards, however, the discount was based on loss ratio, with a credit amount for insureds with a three-year rolling loss ratio less than 70%, and a different credit amount for those with a loss ratio greater than 70%. Tables that follow show the ARMA performance for the first three years of service and cumulatively, showing that the loss ratio for the group was 113% and 103% for these two time periods, respectively.

- MCGRI was also provided a three-year deal designed to guarantee a stable premium for the group beginning 1997. A letter dated 10/27/1997 from an underwriting manager to one of Beacon's largest agents, written with the same language as we have seen other three-year deal letters, committed Beacon to a stable pricing approach. This agent acts as the management consultant to MCGRI, and Beacon paid his agency directly for these services as discussed below. Emails also showed that the agent was heavily involved in the formation of this group and initial price negotiations. As seen in the table below of this section, the pricing for this insured was inadequate for the first three years, as the group as a whole experienced a loss ratio of 108%, above the Beacon target loss ratio of 65%. Performance has improved, however, and its cumulative loss ratio since inception through 2005 was 68%.
- SIMA received a 70% credit for the first three years with Beacon. An underwriter informed us that SIMA was on a three-year deal, and commented that the pricing for this group was a "disaster." The table below shows that SIMA had a 130% loss ratio for its first three years as a group.
- An underwriter indicated that one safety group, RIBA, had been granted a three-year deal as well. We noted that all members of RIBA received a 35% credit from 1999 until 2001.

<u>Performance Agreement with a Board Member of an Association</u>

We identified an Email from an underwriting manger to members of senior management and other underwriting managers dated 6/21/2005. It was sent in response to an Email sent out by an association that asked their members to oppose the Beacon legislation. Solomon forwarded the association's Email first to a vice president, who responded with, "is there anyone [sic] at [this association] that can…announce that it is not an endorsed position?"[87] Solomon forwarded the Email to the underwriting managers and one of them wrote back, "We believe that [a board member of the association] was instrumental in setting up the MCGRI group and that in doing so, we (Beacon) paid him a 'commission/override' in partnering with us."

We asked another underwriting manager about this arrangement and they provided us the 10/27/1997 agreement mentioned above. The letter indicated that Beacon would make payments to this association's board member, who at the time was also the president of an MCGRI insured and was instrumental in bringing the group out of self-insurance and over to Beacon. The letter stated, "As you know our pricing includes one percentage point to [this individual]. There is a provision for an additional 1/2 point to him at year end based upon the performance of the group." Underwriting managers stated that the individual was paid 1 to 1½ percent of the MCGRI premium. We did not, however, locate any payments in our data to this individual under this agreement.

Special Shared Earnings Plans

We learned from an underwriting manager that Beacon had developed three shared earnings plans specifically for certain safety groups that were different from the four shared earnings plans mentioned in the "Statutory Violations" section. The first plan, SE-SG, was created for ARMA as a compromise; ARMA had expected a higher credit on the 2004 renewal, but Beacon was hesitant to give them a higher credit due to their performance the prior year. In 2003, the ARMA loss ratio had been 101%. As a compromise, Beacon developed the SE-SG plan to return money to group members at year end, if available. According to the underwriting manager, SE-SG has not resulted in return payments to the group.

SG-1 was first implemented in 2004 as well, for RIBA. Subsequently, SIMA, BISG, JISG, RIPHC, RIHCA and RIMTA were all enrolled into this plan. SG-2 was created for MCGRI in 2005.

None of these special shared earnings plans were filed with DBR. See the "Statutory Violations" section for a discussion on the violations that these shared earnings plans represent.

Safety Group Performance Summary

To develop a more comprehensive understanding of the performance of safety groups and to compare whether the credits awarded to the safety groups appeared to correspond to

[87] A similar incident where Beacon did not receive full support from one of the heads of its safety groups occurred in mid-2006. Per a Providence Journal article dated June 4, 2006, the then-president of the Greater Providence Chamber of Commerce (which is a part of the RICC safety group) would not give the Chamber's support for the Beacon legislation back in June 2005. The president claimed that Solomon threatened him after he did not endorse the legislation.

the actual performance, we compared the loss ratios and credits of each of the groups since inception and for the first three years of coverage. Our interviews and corroborating documentation provided by interviewees showed that multiple-year deals appeared to have been provided to four of the safety groups.

The table below shows each safety group's cumulative performance from inception of the group through 2005:

Safety Group	Earned Premium	Average (Credit)/ Debit %	Loss Ratio
ARMA	$ 10,508,821	(56%)	103%
BISG	$ 3,014,481	(25%)	46%
CPN	$ 7,325,151	3%	90%
JISG	$ 8,813,277	(57%)	97%
MCGRI	$ 6,676,904	(46%)	68%
RIBA	$ 15,355,792	(35%)	45%
RIBA-USP	$ 10,326,908	(28%)	28%
RICC	$ 41,301,922	(15%)	43%
RIHCA	$ 15,162,755	(31%)	71%
RIMTA	$ 97,837	(15%)	63%
RIPHC	$ 2,690,120	(20%)	45%
SIMA	$ 818,964	(57%)	76%

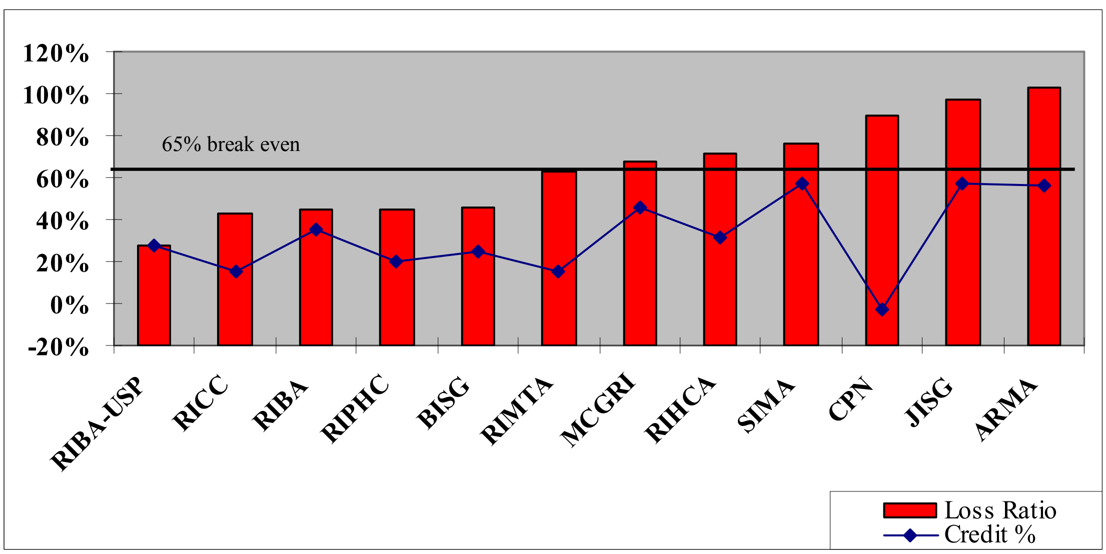
Based on the results of our queries, the cumulative loss ratios for these groups have ranged from 28% to 103%. Six of the twelve groups, ARMA, CPN, JISG, MCGRI, RIHCA and SIMA, have had cumulative loss ratios greater than Beacon's target loss ratio of 65%. Five of these six groups received average credits greater than 30%.

We also queried the performance of each safety group for the first three years of the groups' coverage, as three of the four safety groups that appeared to have multiple-year deals received these deals in the first three years of coverage:

Safety Group	Total Premium for Three Years	Average (Credit)%	Three-Year Loss Ratio
ARMA	$ 3,412,953	(65%)	113%
RICC	$ 5,041,856	(15%)	49%
BISG	$ 2,347,025	(24%)	37%
CPN	$ 2,366,514	(7%)	64%
JISG	$ 2,942,311	(70%)	168%
MCGRI	$ 1,844,554	(49%)	108%
RIBA	$ 2,810,098	(0%)	30%
RIBA-USP	$ 2,163,867	(19%)	35%
RIHCA	$ 2,685,359	(43%)	80%
RIMTA[88]	$ 1,416,419	(17%)	54%
RIPHC	$ 661,888	(26%)	26%
SIMA	$ 1,654,012	(70%)	130%

Three of the groups had constant credit structures for the first three years of coverage: ARMA, JISG, and SIMA. This is an indication that JISG might also have been provided an initial three-year deal. The group's initial agreement did not indicate a written stable pricing plan.

We graphed each safety group's cumulative loss ratio against each of its average credit structure from inception through 2005:



The chart above shows that with the exception of CPN, the safety groups with the three highest cumulative loss ratios were also those that received the three highest average credits.

[88] The RIMTA information in this table only includes two years, as the group began in 2004.

Administrative and Consulting Fees

Beacon pays each of the safety groups approximately 1-2% of the premium to help fund the cost of training programs and materials as well as marketing expenses, including brochures and flyers to promote the safety group. An underwriter mentioned that the JISG uses the administrative fee to host an annual dinner where each attendee (including Beacon representatives) receives a "2½-pound stuffed lobster." Beacon does not track the spending related to the fees it pays to the groups. Furthermore, based on our discussions with underwriting personnel, it did not appear that Beacon measures the effectiveness in terms of cost savings related to the administrative and consulting fees paid to these groups.

Our interviews revealed specific arrangements between Beacon and two of the groups regarding these fees, as well as information about the involvement of certain agents with some of the safety groups.

During interviewing, an underwriter explained that an agent from one of Beacon's top-producing agencies acted as the management consultant for the MCGRI group and his agency received an annual $25,000 consulting fee paid directly by Beacon for these services. This payment is paid in lieu of a payment made to the group. We noted that the premium for this group for 2005 was approximately $1.2 million, thus, the $25,000 payment represents approximately 2.1% of the premium, similar to the fee paid to other groups. This underwriter said that despite the agent's involvement, the group is not closed-off to other agencies. Our data showed that for 2005, 12 of the 34 insureds in MCGRI were produced by this agent's agency. Underwriting personnel claimed that Beacon does not take the $25,000 fee into consideration for pricing decisions for MCGRI.

We also learned of a payment made to IIARI as part of the RIBA safety group agreement. During our cash disbursements procedures, we discovered payments of $85,756 made to IIARI during the period 2003 through 2005. We asked Beacon personnel about this payment, and an underwriting manager informed us that $60,132 (70%)[89] of the payments were for annual fees that Beacon pays to IIARI related to the two RIBA safety groups. They explained that the RIBA program was originally envisioned to be exclusively for one agency's clients, but that a decision was made to make it open to all that qualified. The underwriting manager also told us that two agents acted as unpaid consultants to the RIBA group. In lieu of a consulting fee paid directly to these agents or their agencies (such as the fee paid to the agency that managed MCGRI), Beacon paid 1% of total RIBA premium directly to the IIARI annually. This was *in addition to* the 2% fee paid to RIBA. We located cash disbursements payments to IIARI and selected one payment during procedures performed in this area (see the "Financial Controls and Cash Disbursements" section). The supporting documentation showed calculations that confirmed the

[89] Of the remaining payments to IIARI, $17,000 (20%) of the payments related to Beacon sponsorships of IIARI events or outings. The remaining 10% of payments were comprised of payments under $1,000 and appear to be primarily related to course registration and license renewals.

payments to IIARI equaled 1% of premium for the 2002/2003 policy year. Beacon pays RIBA 1% soon after the policy year ends, but then sends them an adjustment, if necessary, after all audits take place and earned premium is finalized. The $60,132 paid to IIARI for RIBA from 2003 to 2005 appeared to be for policy years 2002 through 2004. An underwriting manager claimed that Beacon does not know what the IIARI does with these funds or whether either of these agents receive compensation from IIARI or RIBA for their services. The underwriting manager also explained that one of the consulting agents had contacted Beacon after the issuance of the Almond Report and requested to be disaffiliated with the RIBA program.

Agent Involvement

We found that five of the safety groups (MCGRI, RIBA, CPN, RIMTA, and RIHCA) have agents serving as consultants to or are main contacts of these safety groups, either on a paid or unpaid basis. We asked underwriting personnel why it appears that certain agents direct more business to the safety groups than others. An underwriter explained that any agent can place its business into any group, but there are a lot of smaller agents that are "too lazy" to review Beacon's programs to determine qualification for these groups. In some cases, larger agents use this as a selling point to draw business away from the smaller agents. The underwriter also speculated that some smaller agents might not "push" the groups because the extra credits would reduce their commissions.

Data Results

We performed a query to check whether insureds in safety groups received credits greater than the maximum allowed per the group agreement for policy years effective between 2003 and 2005.

Our data showed 8,187 instances where a policy was a member of one of the twelve safety groups between 2003 and 2005. Of this amount, there were 53 (0.6%) policies where it appeared that the credit or debit given to an insured was greater than the maximum allowed per Beacon's agreement with the safety group. We sent the list of exceptions, including insured name, policy number, the pricing structure, and what we believed to be the maximum credit[90] to an underwriting manager, who provided an explanation for each of the exceptions. We summarized our results by safety group below:

- **ARMA** – One insured received a 65% credit in 2004, but the maximum credit allowed was 46%. According to underwriting, this insured qualified for a 65% credit in 2003. Per the spreadsheet information provided, ARMA members with loss ratios

[90] We requested underwriting personnel to provide the credit program and shared earnings plan for each safety group for each year of the groups' existence and used this document to obtain our credit maximums for this test.

less than 70% in two of the three years preceding and including the current policy year received a 65% credit. This changed to 46% in 2004. According to underwriting personnel, the credit was not reduced properly and remained at 65% upon renewal.

- **CPN** – One insured received a 14% debit in 2004, compared to the other members of the group that received 3% debits. Underwriting personnel explained that the members of this safety group are individually priced; however, we noticed that all of the other members received the same debit in 2004. In 2005, the entire group received the same debit of 40%. Underwriting personnel did not explain the reason for the higher debit for this insured.
- **JISG** – In 2004, 20 members of JISG received credits of 50%, and 14 received a credit of 50% in 2005. The maximum credit for both of those years was 35%. For 2004 and 2005, the group had 103 and 115 members, respectively. An underwriting manager claimed that members of JISG receive a 50% credit if they have a five-year, loss-free history. This was not stated on the spreadsheet created by Beacon, nor was this contained in the JISG agreement provided.
- **RIBAUSP** – Five insureds in this group received greater than the maximum credit:
    - Four of the insureds were reportedly coded incorrectly by accident as RIBA and received the maximum credit of 60% for this group.
    - One of the insureds mistakenly received the wrong credit in years prior. When Beacon noticed the mistake, the insured was provided additional credit to afford them the dollar value of the error.
- **RIMTA** – Four insureds appeared to have received greater than the maximum RIMTA credit. An underwriting manager explained that this group was individually priced until 7/1/2006; because the group formed so recently, few insureds were members, and the group was not "official" until 7/1/2006.
- **RICC** – Two RICC members received greater than the maximum credit in 2004; however, an underwriting manager explained that they did not join the group until 12/1/2004, at which time their policies were rewritten to correspond to the effective dates of others in the group. Both of these insureds had two 2004 policies: the first policies were short-termed and reissued on 12/1/2004 to match the effective dates of the remainder of the group. The PowerComp data shows the insureds as having joined the safety groups during their 2004 policies, but because the safety group policy year had already begun, they were not priced according to the group schedule until the next year.
    - A third RICC policy received a higher credit in 2005. Beacon provided this insured a credit of 25%, but the maximum credit for the RICC group that year was 15%. According to underwriting personnel, this was an exception made to retain the business of this insured.

Out-of-State Policies

Overview

There are two distinct issues related to Beacon's legal ability to provide coverage directly or through fronting arrangements for out-of-state ("OOS") exposure. The Examination has revealed that these two issues have been combined and confused by Beacon over the years. Additionally, the Examination has determined that Beacon has not even followed its internal procedures in this regard.

2003 P.L. ch. 410 § 3 provides, in relevant part:

> *The purpose of the fund is to ensure that all employers in the state of Rhode Island have the opportunity to obtain workers' compensation insurance at the lowest possible price. It is also the policy and purpose of this act to establish and maintain that the fund shall be the workers' compensation insurance carrier of last resort.*

These two sentences address two distinct issues:

- Voluntary Business Limited to Rhode Island Employers – The first sentence means that Beacon is statutorily limited in its voluntary business to providing coverage to "Rhode Island employers." Beacon may, therefore, only write out-of-state risks if it is incidental to the in-state risk of a Rhode Island employer.[91]
- Beacon's Obligation as Carrier of Last Resort – The second sentence requires that Beacon cover *all* in-state risks in its capacity as the insurer of last resort. In this regard, it is irrelevant whether the employer is based in Rhode Island. Beacon's obligation is to provide insurance for the in-state risk only, not the out-of-state risk of the employer.

We discuss both of these issues separately in the following sections.

Voluntary Business Limited to Rhode Island Employers

Coverage for the out-of-state risks of Rhode Island employers has been provided through the use of fronting arrangements. This was required because Beacon is not licensed to write insurance in any state other than Rhode Island and is therefore prohibited from writing insurance on Beacon paper by the laws of the other states.[92] Under the fronting

[91] It is our understanding that Beacon was required to cover a Rhode Island employee traveling and working out of the state on a temporary basis, as long as the employee resides in Rhode Island and the majority of his work takes place in the state. As such, coverage for this type of employee is not addressed in this section.

[92] Beacon has a "limited license" in Massachusetts, however, this license only allows them to defend claims made in the courts of Massachusetts and does not allow them to issues policies in their own name in Massachusetts. This "limited license" was necessary because of the numerous incidences of Rhode Island employers doing work in Massachusetts and claims brought in that state as a result.

arrangements, the fronting carrier issues the policy to the employer. The fronting carrier then cedes substantially all of the risk to Beacon but retains a portion of the premium, known as a "fronting fee," as income. Fronted policies must be written on the approved rates and forms of the insurer in the state in which the coverage is issued.

Throughout the Examination, we found that Beacon did not have clear policies and procedures related to its writing of voluntary business with incidental out-of-state risks. Furthermore, the Examination found several instances where Beacon had provided questionable OOS coverage.

<u>History of Beacon's Fronting Arrangements and Castle Hill Insurance Company</u>

Beacon has been providing coverage for OOS payroll exposure through a number of different fronting arrangements since the mid-1990s. The original fronting arrangement was with Travelers Insurance. In 1997, Beacon switched its fronting partner from Travelers to Fairfield Insurance Company ("Fairfield") and Genesis Insurance Company, both subsidiaries of Gen Re. On July 24, 1997, based on the terms of the fronting arrangement with Gen Re, Beacon formed BMIC Service Corporation, a wholly-owned subsidiary and a Rhode Island licensed insurance agency, to facilitate the relationship.

Beacon continued to offer OOS coverage to selected Rhode Island employers through the Gen Re subsidiaries until 2001. Following the September 11, 2001 terrorist attacks, Gen Re stopped accepting new OOS business from Beacon, but continued to renew policies it had already written.

As a response to Gen Re's decision, Beacon formed Castle Hill Insurance Company ("Castle Hill") as a "wholly-owned Rhode Island domestic stock insurance company subsidiary" on 10/15/2003. During the Castle Hill licensing process, Beacon and DBR entered into an agreement called an "Undertakings Agreement" that established the parameters under which Castle Hill was allowed to operate. The document, dated 10/15/2003, indicated that Beacon "shall limit Castle Hill to writing such Coverage only for Rhode Island employers for their out-of-state employees and Residual Market Programs directly related to such business."

Castle Hill has never written any policies. Despite the intentions of the Undertakings Agreement, Castle Hill has not yet been licensed in any other state and, therefore, is prohibited from writing insurance in any other state. Unless and until Castle Hill is licensed in other states, the only manner in which Beacon can write the voluntary incidental OOS exposures of Rhode Island employers is through a fronting arrangement with a carrier licensed in the other state.

Beacon did not provide new OOS coverage from November 2001 through May 2005 when another third-party insurance carrier, Argonaut, signed on as Beacon's fronting partner. The amount of new OOS business that Beacon has provided has decreased significantly since 2001 mainly due to pressure from its reinsurance provider, Gen Re, to reduce its exposure and divest of unprofitable OOS policies. Also, since 2002, underwriting manager approval is required to write any new OOS business.

Characteristics of Beacon's Fronting Arrangements

Per a document entitled "BMIC Service Corporation," Beacon handled the majority of administrative responsibilities associated with providing insurance such as "underwriting, quoting, billing, collecting," and claims settlement. Beacon also retained the risk of the OOS exposure through a series of reinsurance agreements.

Beacon incurred certain incremental costs to provide OOS insurance in addition to its standard in-state policy cost. Additional reinsurance costs, overrides and commissions contributed to a higher cost basis for each OOS policy written. The incremental cost of an OOS policy contributes to a target loss ratio that is 18 percentage points lower than Beacon's in-state rate. See the "Overall Pricing Patterns" section of the report for an explanation of Beacon's target loss ratios.

Beacon was also less flexible in pricing its OOS business. Fronting companies are obligated to adhere to the premium pricing and rating guidelines approved in the state of coverage. As discussed numerous times in this report, Beacon was also required to adhere to premium pricing and rating guidelines under Rhode Island law. We did not review the pricing of out-of-state policies for compliance with statutory requirements in states other than Rhode Island. No information came to our attention during the Examination to suggest that any fronting carrier violated these statutory requirements.

Under the Fairfield/Genesis arrangement, Beacon's OOS policies were not allowed to receive credits in most states. As a result of the pricing inflexibility on OOS policies, we found multiple instances where Beacon heavily discounted the Rhode Island policy of an insured specifically for the purpose of providing an overall price for the combined package. See the "Statutory Violations" section for further information on combining policies, and the "Premium Pricing – Selected Individual Insureds" section for examples where the pricing of the in-state and the OOS policies might have been considered together.

Beacon's Practice Related to OOS Policies

Although there appeared to be discussions over the years around establishing procedures for providing OOS coverage in the underwriting department, formalized guidelines were never approved. Based on discussions we had with senior underwriters, many believed that Beacon could only cover OOS business of a Rhode Island employer if the Rhode Island segment was larger than the OOS portion.[93] Although this was never presented to

[93] Some underwriters maintained that OOS exposure had to be less than Rhode Island exposure for Beacon to write the policy through the fronting agency; other underwriters thought that the OOS premium had to be lower that the Rhode Island premium.

DBR, consistent application of this standard would likely satisfy the restriction on voluntary business to "Rhode Island employers." However, underwriters cited two specific accounts that did not meet this criterion (see Allegation 3 in the "Original Whistleblower Allegations" section and Relevant Finding 10 in the "Selected Individual Insureds" section for more information on these two accounts). One underwriter also stated that Clark would make certain exceptions to this OOS understanding from time-to-time.

We also found that there was wide diversity in practice and understanding about the requirements relating to the determination that covered risks were, in fact, Rhode Island employers. Statements received from various underwriters included the following:

- One underwriter referred to several IRS rules that determined whether the employees were Rhode Island insureds depending on certain factors such as the location of hire, the location of payroll disbursements and whether taxes were withheld.
- Another underwriter believed that an OOS policy did not have to qualify as a Rhode Island employer, but must have shared common ownership with a Rhode Island employer.
- An underwriting manager explained that there had to be a Rhode Island "business relation" to write OOS business. The underwriting manager recalled that when she began working at Beacon, she believed that the Rhode Island portion needed to be larger than the OOS portion, but it was always unclear if this was based on payroll or premium dollars.
- Another underwriting manager confirmed that there were no guidelines regarding the handling of OOS exposures.

We read the Underwriting Manual, which included one and a half pages of information related to OOS policies, none of which covered the criteria in the above-mentioned memo. The Underwriting Guidelines only addressed systems issues and document locations.

During the course of the Examination, we found instances at Beacon where OOS policies were provided, but there was not sufficient common ownership established with a Rhode Island employer. A Massachusetts hospital and one other insured from North Carolina are examples detailed in this report.

For 2005, OOS written premium accounted for less than 4% of Beacon's total written premium.

Beacon's Obligation as Carrier of Last Resort – In-State Exposure of OOS Employers

As discussed above, Beacon is the statutory market of last resort.[94] This means that Beacon must provide coverage for all in-state exposures, regardless of where the employer is based. Beacon's enabling act and the statutes governing workers' compensation would allow different pricing for any residual market exposure that Beacon could show as an abnormally high risk. However, Beacon has not made any such filing and does not segregate its residual market business.[95]

The Examination found a number of documents and Emails where Beacon employees and Beacon's counsel discussed the appropriate handling of residual market risks. These documents showed that Beacon confused the limitation on its voluntary writings to Rhode Island employers with its obligation as the residual market. First, we found an internal Beacon memo dated 11/17/2004 with no author specified that memorialized a discussion amongst the underwriting managers and Clark related to the definition of Rhode Island employer. The intention of the memo was to propose guidelines where Rhode Island payroll exposure might be covered for OOS employers. As noted above, the "Rhode Island employer" language in the statute does not allow Beacon to refuse to issue residual market policies, limited to the in-state risk, to out-of-state employers. None of the "conditions" discussed internally at Beacon were shared with DBR at the time they were being implemented. The initial four conditions in the 11/17/2004 memo were listed as:

1. *Applicant has a RI unemployment tax ID number,*
2. *Pays RI payroll taxes or withholds income taxes for RI,*
3. *Employees for whom coverage is sought are listed on an Employer's Tax and Wage report filed with the RI Department of Employment and Training (Form DET-TX-17), and*
4. *RI is the geographic location of a substantial portion of employment for the employees for whom coverage is sought.*

If all four of the above conditions were not met, the memo stated that the insured had to meet at least one of the above four conditions, and all three of the conditions below. These exceptions were subject to the approval of the vice president of underwriting:

5. *Applicant has regular piece of business in RI,*
6. *Employee was hired in RI, and*
7. *Applicant qualifies and is in good standing with Secretary of State to do business in RI.*

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[94] "Market of last resort" and "residual market" are synonymous terms which generally mean insureds who "…are in good faith entitled to but who are unable to procure insurance through ordinary methods." Rhode Island, like virtually every other state, has a residual market for all insurance that is mandated by statutes. In Rhode Island workers compensation insurance is required for all employers who employ workers in the state regardless of the principal location of the employer. Therefore, employers that do not qualify for insurance with voluntary writers would be prohibited from doing business in the state if a residual market did not exist.

[95] As the result of a change in its enabling act Beacon is not required to segregate residual market business, however, there is nothing in the statute that would prevent segregation.

According to one underwriting manager, this memo was not shared with the underwriters so as not to encourage underwriters to write OOS employers without supervisor approval. In regard to this issue, one underwriter said that Beacon's philosophy was to only write on risks with "desired Rhode Island exposures."

We also located a memo from Beacon's counsel to Solomon, dated 5/19/2004, entitled "Providing Insurance to of [sic] Out-of-state Employers and Agent Responsibilities." The purpose of this memo was to address several questions:

- *What is a Rhode Island employer for purposes of the charter of The Beacon Mutual Insurance Company ("Beacon") pursuant to which Beacon is required to provide workers' compensation coverage?*
- *What information should Beacon and its agents require to verify that an employer has sufficient ties to Rhode Island to qualify as a Rhode Island employer?*
- *Does a Rhode Island insurance agent have a duty to procure workers' compensation insurance through Beacon for an out-of-state applicant?*

Beacon's counsel wrote that because the enabling act does not define "employers in the state of Rhode Island," the act left it up to Beacon to form its own definition. This memo went on to state that Beacon considered Rhode Island employers to be as described in Part Three of its standard workers' compensation insurance policy: "A 'Rhode Island Employee' is an employee whose principal place of employment <u>and</u> place of hire are within the State of Rhode Island <u>and</u> who performed the most substantial portion of employment within the State of Rhode Island."

The memo further inferred that the language above limits coverage to Rhode Island employers only. It also stated that Beacon had consistently denied coverage to employers that it believed did not qualify as a Rhode Island employer, and it "appears that DBR has accepted Beacon's position on this issue."[96]

The memo went on to conclude that:

> *Although Beacon is an 'insurer of last resort' for Rhode Island employers, Beacon is not an insurer of last resort for out-of-state employers, and in fact, cannot insure such employers. Therefore, there can be no expectation by out-of-state employers that coverage will be provided by Beacon. . .[and] an agent is not at risk when Beacon denies coverage to an out-of-state employer because of the language of Beacon's Charter and the unambiguous language of Beacon's policy.*

As expressed above, DBR strongly disagrees with this conclusion. The memo essentially reads "Rhode Island employer" into the second sentence of 2003 P.L. ch. 410 § 3, which explicitly states "[i]t is *also* the policy and purpose of this act to establish and maintain

[96] Beacon's position that the DBR "seemed to accept this position" appears to be derived from DBR's processing of complaints. Beacon's position "evolved" through the years and only in 2006 was DBR made fully aware of Beacon's position on this issue, which this Examination established was inconsistently applied.

that the fund shall be the workers' compensation insurance carrier of last resort" (emphasis added). The legislature's use of the word "also" indicates that the requirement that Beacon be the carrier of last resort is completely separate and apart from the limitation that its voluntary business is limited to Rhode Island employers. To interpret these sentences as advocated by Beacon's counsel essentially leaves Rhode Island without a residual market since out-of-state employers who have Rhode Island operations could not obtain workers' compensation insurance unless they were able to do so from a competitive carrier. This has become a serious concern, especially for those states whose residual market does not cover out-of state exposures, including Massachusetts and Maine. Although Beacon's counsel indicates that DBR "appears to accept Beacon's position" the position was never presented to DBR as a legal interpretation. Rather, DBR began to receive complaints from employers who were required to obtain insurance for Rhode Island operations by the DLT but who Beacon would reject because they did not have a Rhode Island location. As discussed further, it appears that this position would vary depending upon whether Beacon wanted to write the business. This is the antithesis of a market of last resort.

Overall Pricing Patterns

In order to view Beacon's premium pricing philosophy from an overall perspective, we ran a number of different queries against the PowerComp data. Our queries were limited to data for Rhode Island policies with policy periods beginning in calendar year 2003 through 2005. These limitations excluded data on out-of-state policies and pre-PowerComp conversion data, as we learned both were less reliable.

Relevant Findings

Based on the procedures performed on data subject to the criteria listed above, we have found:

- Approximately 15,700 Rhode Island policies were issued annually from 2003 through 2005.
- The average policy issued over this three-year period had $9,740 of premium.
- Approximately 82% of all policies issued had less than $10,000 of premium but only contributed approximately 19% of total written premium to Beacon.
- Approximately 70% of all policies received no schedule or consent-to-rate credits or debits during the period. In terms of Loss Free and CompAlliance credits, this population was broken down further as follows:
    - Approximately 35% received Loss Free program credits that averaged 9.0%.

  - o Approximately 4% received CompAlliance program credits that averaged 9.7%.
  - o The remaining 31% received no schedule credits, consent-to-rate credits, Loss Free or CompAlliance credits.

- Less than 0.4% of all Beacon insureds were debited during the period, totaling approximately $1,500,000 of surcharges compared to approximately 29% of insureds that received a schedule or consent-to-rate credit totaling approximately $116,800,000 in discounts.
- Of the 29% of insureds that received a schedule or consent-to-rate credit, the average discount was approximately 28% ($8,435 per insured).
- The average written premium of insureds that received schedule or consent-to-rate credits was $21,529. This premium was greater than approximately 91% of Beacon's policies.
- Over 2,000 policies with consent-to-rate pricing were issued during the period. See the "Statutory Violations" section for more discussion on consent-to-rate pricing.
- Larger insureds were provided with more schedule and consent-to-rate credits; however, the loss ratios for larger accounts indicated poorer performance. For example, the table below illustrates the average credit and corresponding average loss ratio based on selected premium size ranges:

Premium Size Range	Average Schedule and Consent-To-Rate Credit	Average Loss Ratio
$0 - $5,000	6%	34%
$5,001 - $10,000	12%	30%
$50,001 - $100,000	19%	48%
$100,001 - $250,000	21%	57%
$250,001 - $500,000	20%	52%

- Agents that produced the most business with Beacon procured substantially more schedule and consent-to-rate credits for their insureds compared to agents with smaller books of business. For example, the average credit on a policy produced by an agent with a book of business between $100,001 and $250,000 was 12%, compared to an average credit of 28% given to insureds produced by agents with books of business of $5,000,000 or more.
- Despite the favorable pricing extended to Beacon's largest agents, the loss ratios for their insureds were higher than the loss ratios for smaller agents' books of business.

We discuss these main findings in more detail below, along with tabular and graphical representation, if applicable.

<u>Overall Population</u>

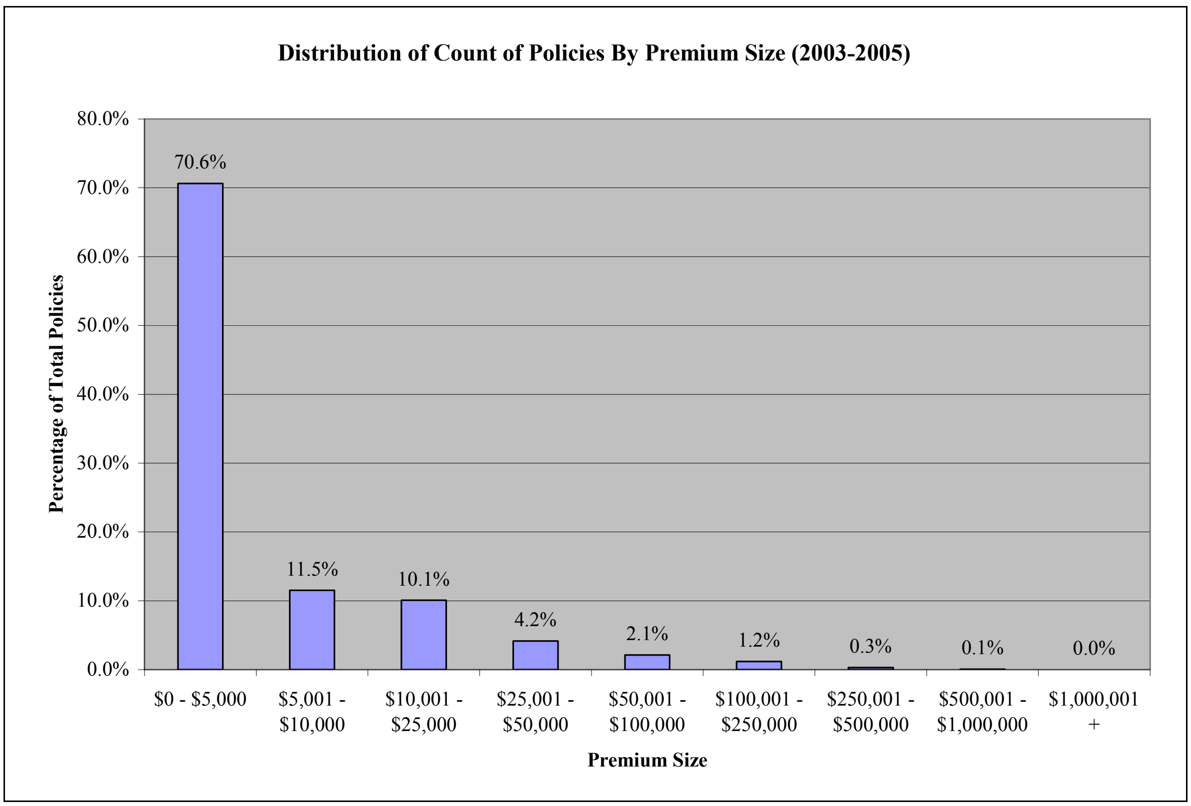
Our queries reflected a total population of 47,091 Rhode Island policies for 2003 through 2005. This averaged to approximately 15,700 different policies for each of the three years. We calculated the average premium for all policies to be approximately $9,740.

Overall, our data showed total written premium for the three policy years of:

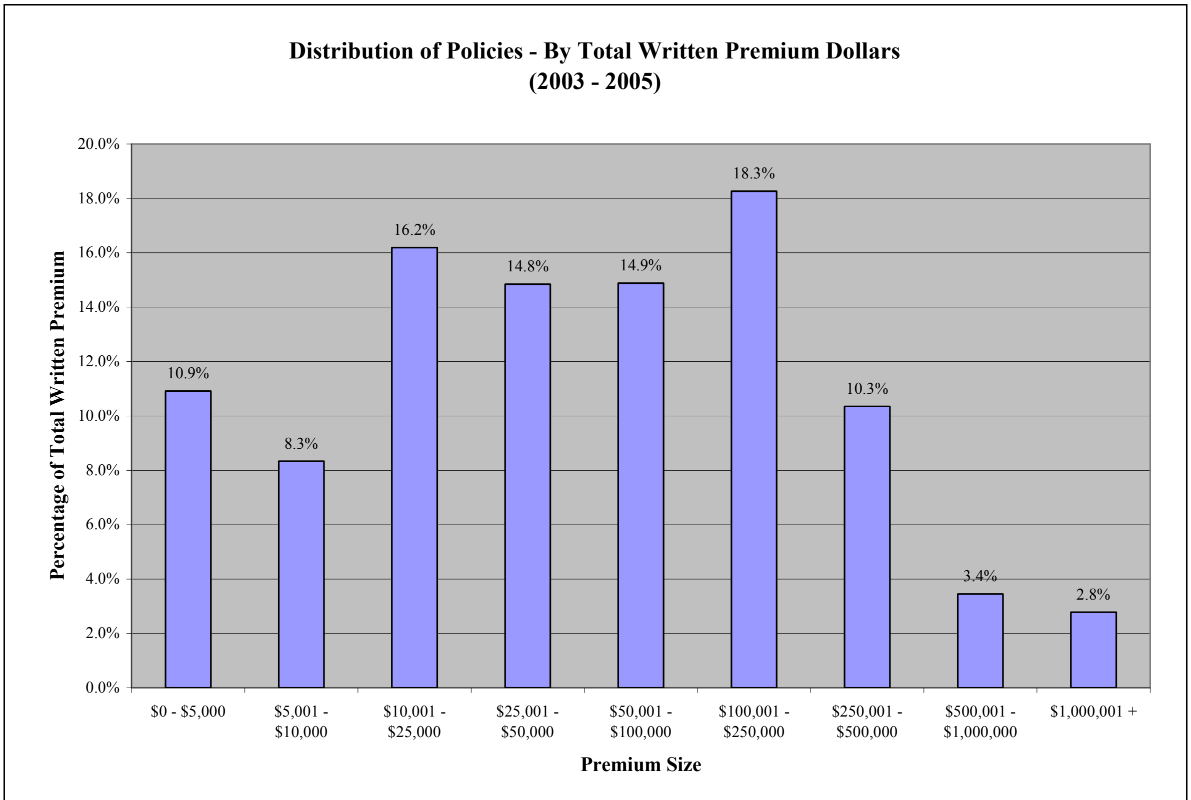
Beginning Policy Effective Year	Total Written Premium
2003	$151,773,326
2004	$157,662,983
2005	$149,320,277

<u>Distribution of Policies</u>

The distribution of policies by premium size was heavily weighted towards small companies. The chart below shows that 70.6% and 11.5% of all Beacon policies had premiums between $0 - $5,000 and $5,001 - $10,000, respectively, accounting for 82.1% of the population of insureds.



Although the distribution of Beacon's policies by policy count showed the substantial majority of policies were below $10,000 of premium, the distribution that showed contribution to total written premium was somewhat inverse to the chart above. The same population of policies that totaled 82.1% of all Beacon policies only accounted for 19.2% of total written premium, as illustrated below:



Schedule and Consent-To-Rate Credits and Debits[97]

Beacon's system did not separately account for schedule credits and consent-to-rate credits; therefore, the credit and debit figures provided in this section represent the total of these two categories.

Of the total population, 70% (33,083) received no schedule or consent-to-rate credits or debits. The following table breaks down the policies in this category according to extra credits that might have been extended for the CompAlliance and Loss Free programs:

[97]For the purpose of this section, credit percentages are in terms of written premium. In the premium algorithm, these credits occur earlier in the calculation, above Premium Discount. Without calculating them individually, it is difficult to explain the "actual" credit percent applied to the policy. For the purpose of this section, credit and debit percent is assumed to be – Total Credit or Debit divided by Written Premium before the application of the Credit or Debit.

	Premium Size			
	$0 - $5,000	$5,001 - $10,000	$10,001+	Total
Number of Policies With No Scheduled / Consent-To-Rate Credits	27,199	2,961	2,923	33,083
Loss Free Credit				
Number of Policies with Loss Free Credit	15,074	1,080	403	16,557
Average Loss Free Credit	$ 128	$ 683	$ 1,490	$ 197
Average Written Premium on Loss Free Accounts	$ 1,252	$ 6,733	$ 16,763	$ 1,987
Average Loss Free Credit Percentage	9.3%	9.2%	8.2%	9.0%
CompAlliance Credit				
Number of Policies with CompAlliance Credit	664	342	924	1,930
Average CompAlliance Credit	$ 219	$ 705	$ 5,025	$ 2,606
Average Written Premium on CompAlliance Accounts	$ 2,290	$ 7,221	$ 46,268	$ 24,218
Average CompAlliance Credit Percentage	8.7%	8.9%	9.8%	9.7%
Policies with No Additional Credits	11,461	1,539	1,596	14,596

Based on the schedule above, 14,596 of the 47,091 policies in our population, or 31.0%, received no supplemental discount in the form of schedule credits, consent-to-rate credits, Loss Free program credits or CompAlliance program credits.

Approximately 68.7% of Beacon insureds over this time period received some form of discount broken down as follows:

- Approximately 39.3% received some discount for one of the two programs outlined above, but did not receive other credits.[98]
    - The Loss Free program afforded 35.2% of insureds with a credit. These insureds had an average premium of $1,987 and received an average Loss Free discount of 9.0%.
    - The CompAlliance program provided the other 4.1% of insureds with an average discount of 9.7%[99] on an average premium of $24,218. See "CompAlliance and Loss Free Programs" section for more information on these two programs.
- Approximately 29.4% of Beacon insureds received schedule and/or consent-to-rate credits.

Over the three-year period, approximately $116,800,000 of schedule and consent-to-rate credits were granted annually to approximately 4,615 policies. Conversely, approximately $1,500,000 of debits were charged annually to approximately 55 insureds over the same period.

Approximately 0.3% of all Beacon insureds were debited during this period. This figure was inflated, however, because Beacon debited an entire safety group (CPN), with 21

[98] The breakdown of CompAlliance and Loss Free credits in this section is limited to those policies that did not receive any schedule or consent-to-rate credits or debits, and may not be indicative of the averages of the overall programs. See the "CompAlliance" section for a broader discussion on these two programs.
[99] This discount is only 0.3% below the maximum credit available under the CompAlliance program.

members, totaling approximately $482,000 in debits in the 2005 policy year. The CPN debit accounted for approximately 13% of the accounts debited and 32% of the total dollar amount debited to Beacon insureds over the period.

The following schedule summarizes the distribution of schedule and consent-to-rate credits provided by Beacon for policy years 2003 through 2005:

Credit Percentage	Percent of Total Beacon Insureds	Average Annual Total Credits	Average Annual Credit Per Policy	Average Written Premium	Average Credit Percentage
0% to 10%	5.3%	$2,331,190	$2,795	$28,013	9.1%
10% to 20%	18.1%	$8,503,205	$2,987	$13,245	18.4%
20% to 30%	1.5%	$4,324,221	$18,118	$46,308	28.1%
30% to 40%	2.0%	$10,044,883	$32,543	$52,756	38.2%
40% to 50%	1.5%	$6,373,622	$26,931	$27,191	49.8%
50% to 60%	0.5%	$2,487,838	$31,625	$22,654	58.3%
60% to 70%	0.5%	$4,859,226	$68,120	$38,239	64.0%
	29.4%	$38,924,185	$8,435	$21,529	28.2%

Beacon's total earned premium for the fiscal year ended December 31, 2004 was $147,580,201, according to its audited financial statements. The average annual total credit of $38,924,185 for policies receiving a schedule or consent-to-rate credit translated to an approximate credit percentage of 20.9% across all policies at Beacon. These credits, however, were only distributed to 29.4% of the policies at Beacon. This subpopulation of insureds had an average annual written premium of $21,529, larger than 90.9% of Beacon policies. These insureds were provided with an average discount of approximately 28.2%.

As we reported earlier, Beacon stopped notifying DBR of consent-to-rate credits in September 2001. The schedule above indicates that Beacon provided some amount of consent-to-rate credits to all policies that received greater than 30% credits (the maximum schedule credit not including CompAlliance, which was tracked separately, was 25%). Based on the data, at least 2,086 policies were issued from 2003 through 2005 with a consent-to-rate credit without notification to DBR.[100]

As we discussed earlier, insureds should have only been eligible for schedule credits if they were eligible for schedule rating. We asked Beacon underwriting managers about this, and an underwriting manager responded by Email, "I would also say that there was a lack of understanding by some regarding the fact that a premium threshold was required to be met and that the [schedule credits were] used at [the underwriters'] discretion."

[100] As reported in the "Statutory Violations" section of this report, Beacon reported that it extended consent-to-rate credits to 2,834 policies during the period 2002 through 2005.

Range Comparison

Loss Ratio – A policy's loss ratio is a mathematical expression that compares the total losses for a particular policy period against the earned premium for the same policy period. Loss ratio is based on policy year, not calendar year, and the ratio is not cumulative. Poor loss experience during one policy year does not affect the loss ratio in subsequent years.

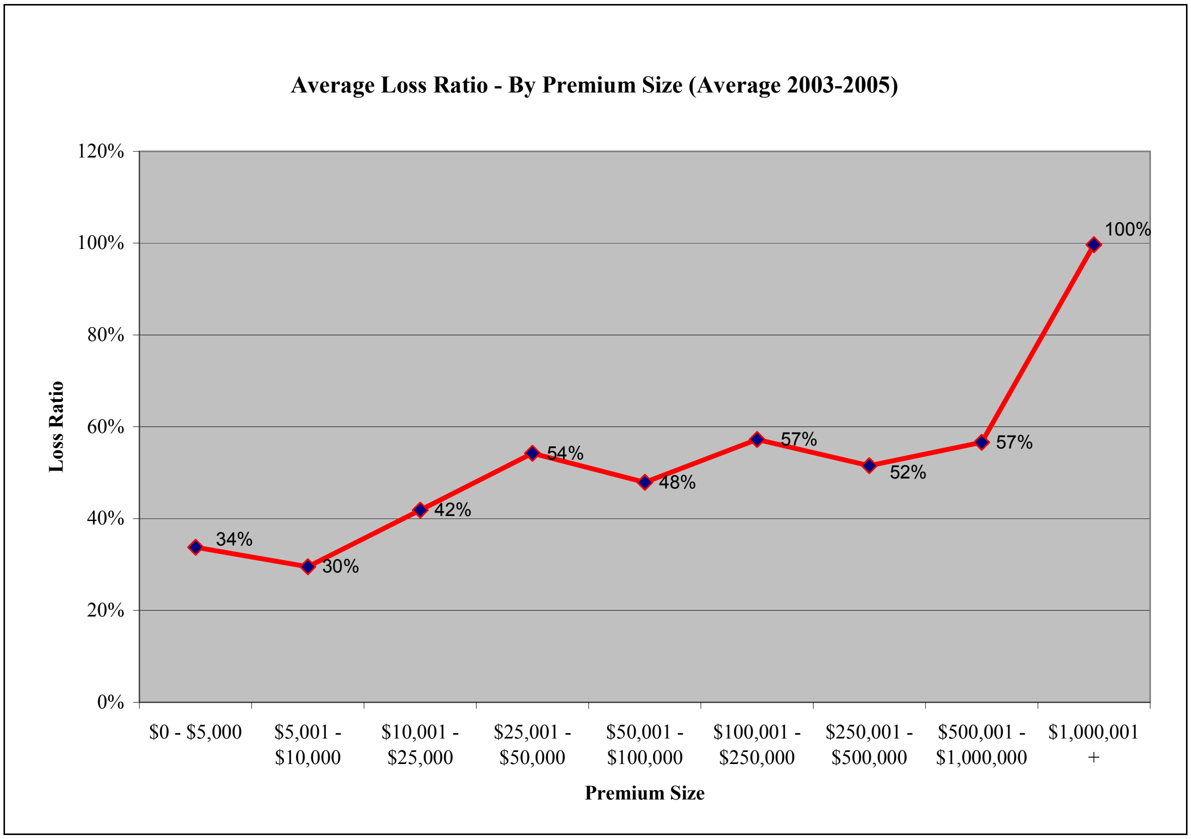
Loss ratio is expressed as a percentage where a 100% loss ratio indicates that all of the cash generated from premium has been or will be used to fund the actual losses due to claims for a policy period. Loss ratio does not consider other costs of writing workers' compensation insurance such as commission, taxes, fees and other general expenses. These factors, along with a percentage for underwriting profit, contingencies and other costs are components of Beacon's LCM filing (see the "Underwriting at Beacon" section for more information).

Beacon's finance director explained that based on Beacon's most recent proposed LCM filing dated 5/30/2006, the permissible loss ratio was 68.5% for Rhode Island policies. The director also explained that Beacon had used benchmark loss ratios of 67% and 65% to analyze their business before this LCM calculation. These factors have been referred to as Beacon's "breakeven" or "target" loss ratios.

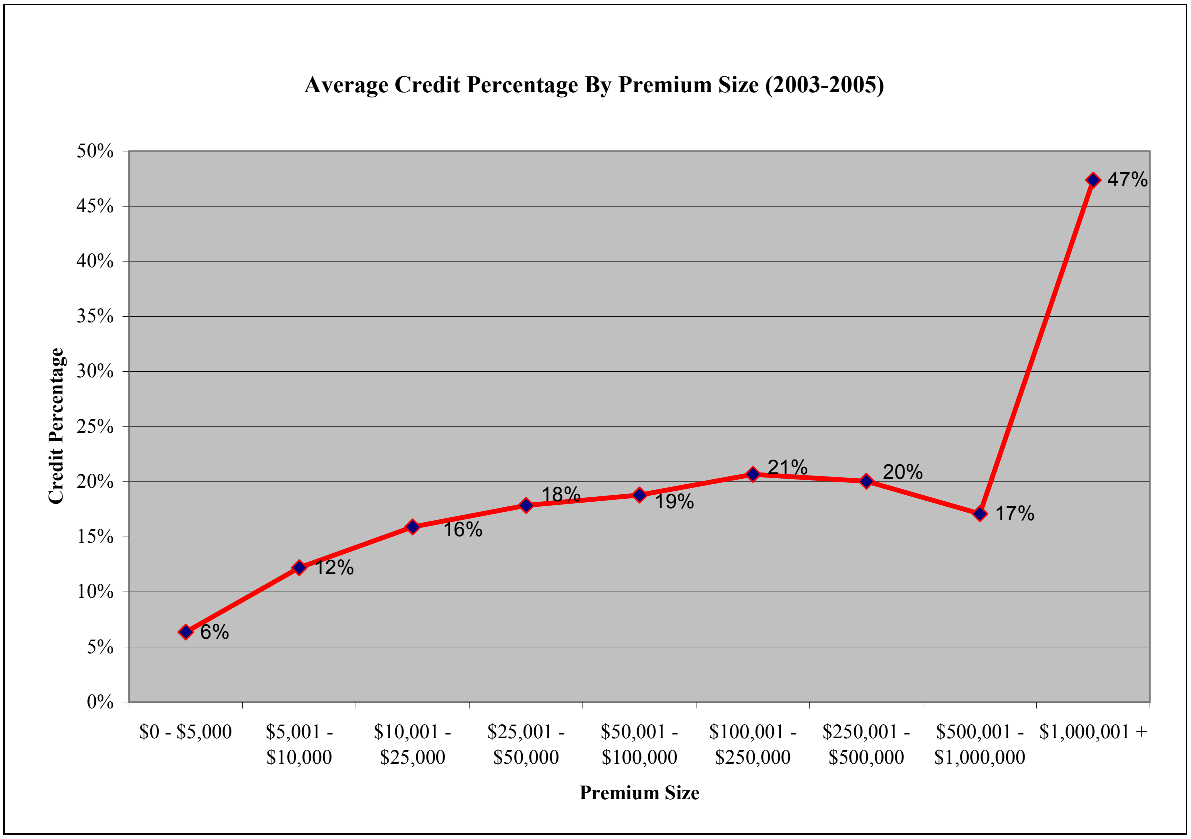
Recalculation and testing of the LCM factors and Beacon's breakeven rates was not within the scope of this Examination. For the purpose of this report, we utilized the assumption that a 65% loss ratio represented Beacon's breakeven or "target" rate for Rhode Island policies.[101]

We compared the loss ratios for all Beacon policies and graphed the results according to one of nine ranges of premium sizes for policy years beginning in 2003 through 2005. According to the graph below, loss ratios increased as premium size increased. The loss ratios for the first two premium size ranges ($0 - $5,000 and $5,001 - $10,000) were 34% and 30%, respectively. The loss ratios for the largest three premium size ranges ($250,001 - $500,000, $500,001 - $1,000,000 and $1,000,001+) increased to 52%, 57% and 100%, respectively. (The largest range in this comparison contained limited data. Only two insureds had Rhode Island premiums greater than $1,000,000 during this period.)

[101] According to the finance director "the out-of-state break-even is about 18% lower than for Rhode Island business. Reinsurance costs average 7% higher, the fronting fee and the override make out-of-state commissions 16% higher, but the taxes and assessments are lower by 5%."



Credits – Loss ratio is a function of incurred losses and earned premium. Two factors that reduce earned premium are schedule and consent-to-rate credits. These credits, explained above, followed a similar pattern to the loss ratio chart above. We graphed the average credits (including debits where applicable) by premium size. This data does not include CompAlliance and Loss Free credits discussed elsewhere.



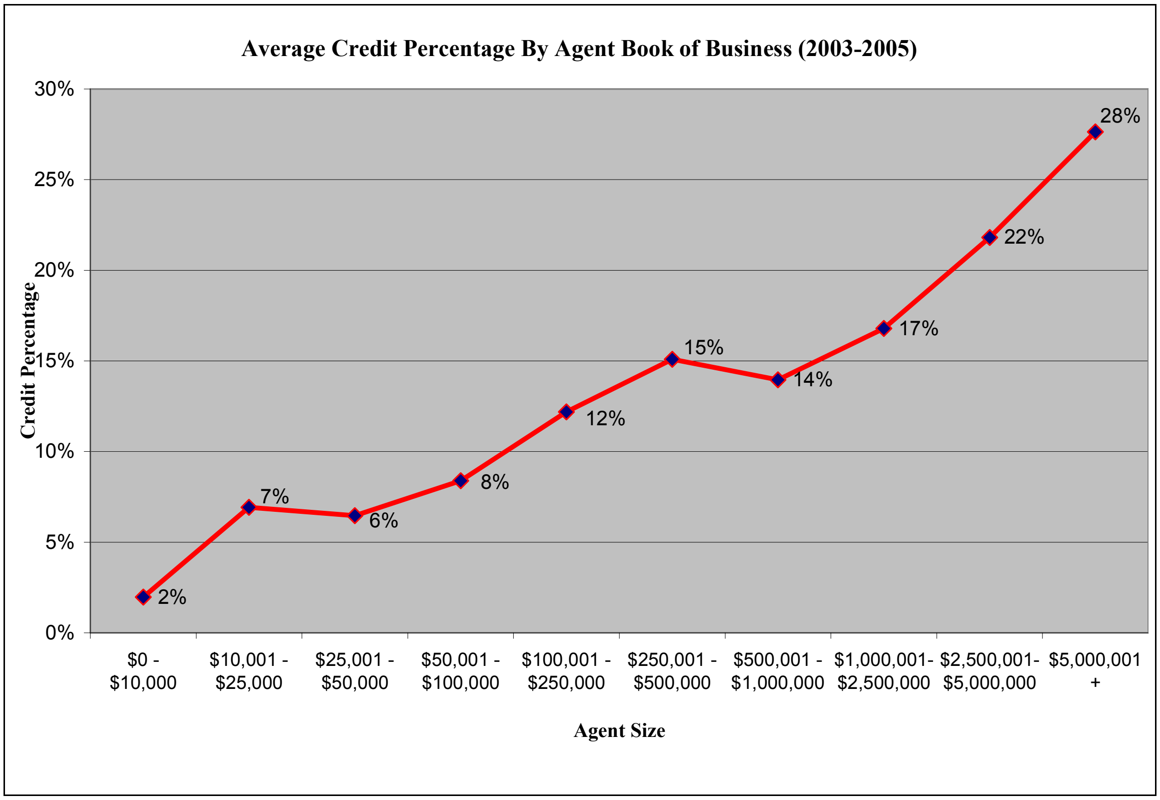
Based on the chart above, the average credit percentage applied to policies increased proportionally to premium. Insureds with premiums between $0–$5,000 and $5,001–$10,000 received, on average, approximately 6% and 12% credits, respectively, compared to average credits of 20%, 17% and 47% in the highest three premium ranges, respectively.

Agent Size – We also summarized the results of the data according to the size of the agent. We separated the data into 10 ranges of agent size from a low range of $0–$10,000 to a high range of over $5,000,000. Agent size is commonly referred to as their "book of business." This comparison was based on the annual book of business for all Rhode Island premiums with effective dates beginning in 2003 through 2005.

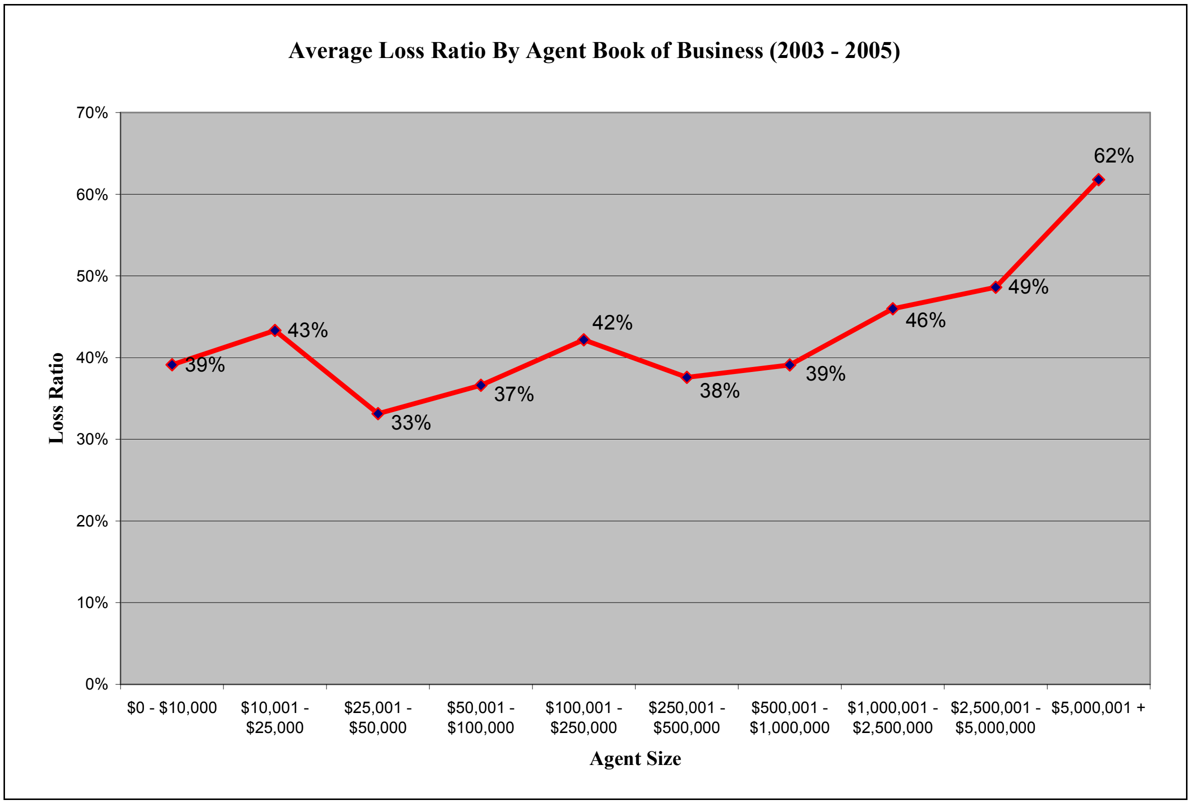
The average premium size of policies produced by agents increased based on the size of the agency. In other words, we found that agents with smaller books of business generally produced lower premium accounts. For example, the average written premium for agents with the following selected book of business ranges increased as follows:

Agent Book of Business Range	Average Written Premium
$0 - $10,000	$ 1,716
$50,000 - $100,000	$ 4,270
$500,000 - $1,000,000	$ 8,220
$5,000,000+	$20,771

We compared the average credits granted and related loss ratio performance against agent size ranges. The chart below shows that the average credit percentage granted to insureds appeared to increase in direct proportion to their agents' book of business. Agents that produced less than $100,000 in annual premiums to Beacon were only able to procure schedule or consent-to-rate credits in the single digits, on average. Larger producers, on the other hand, enjoyed average credits above 20%.



Despite the disparity in the credit percentages granted to larger agents, the policies produced by the largest agents were, on average, the poorest performers in terms of loss ratio. Schedule and consent-to-rate credits should be extended to individual insureds based on the risks specific to their organization and should have nothing to do with which agent produces the account.



The chart above shows that the business produced by agents with annual books of business greater than $1,000,000 was statistically the worst performing over the three-year period.

Agents Analysis

Overview

The Almond Report found that "inappropriate relationships exist between Beacon and a select group of insurance agents that has resulted in the practice of providing these agents, and certain of their clients, preferential treatment to the possible detriment of other policyholders and agents."

We performed interviews with senior management, underwriting and premium audit personnel that supported and emphasized the level of agent influence over Beacon's pricing. Several underwriting employees indicated that the agent, not the insured, was Beacon's primary customer.

Throughout this report, we have highlighted a number of instances that showed the special appreciation that Beacon had for its agents including, among others:

- Underwriting pricing decisions made due to "agent accommodations" or other pricing concessions requested by agents,

- Manipulation of fixed and contingent commission payments,
- Other benefits including golf events and international and national travel and
- Strong personal friendships between senior management of Beacon and certain agents.

We also reported in the "Overall Pricing Patterns" section that we found that the largest producing agents were procuring the largest discounts for their insureds. Based on all of these findings, we conducted queries and calculations to quantify the effect of agents' influence over premium pricing.

Procedures

We performed our procedures in this area in three main phases. The data utilized for our queries included Rhode Island policies where the policy effective date was between 2003 and 2005. We first generated a query to return a listing of the 50 largest agencies by book of business, ranked them from largest to smallest and calculated performance metrics, such as loss ratio, by agent. We then compared the total written premium and the total credits awarded to insureds by agent and grouped this data by agent book of business. Finally, we organized the data in order to see whether insureds' changes to and from top agencies resulted in otherwise unexplained pricing variances. The procedures related to each of these phases are listed below:

- <u>Agent Rank by Book of Business</u>
    - Queried PowerComp for policy pricing information (including written premium and credits issued) for each insured,
    - Organized the resulting data by agent name,
    - Accumulated information from all policies in order to calculate, by agent:
        - Number of policies,
        - Total written and earned premium,
        - Rank of agents by total written premium and
        - Loss ratio for each agent.
- <u>Credits by Agent Rank</u>
    - Queried PowerComp for written premium and schedule and consent-to-rate credits/debits for each insured and

  - Organized the data by agent rank, and stratified the results showing the data for the largest 5, 15, 50, 100 and All Agents as ranked by book of business.[102]

- Change in Credits from Agent Switches
  - Queried PowerComp for all instances when an insured switched to or from one of Beacon's largest 15 agents to a non-top 15 agent,
  - Queried PowerComp for data specific to each qualifying insured,
  - Calculated the change in credit structure and summarized the results according to the direction of the switch (to or from the largest agents) and
  - The data utilized in this query was further limited to exclude switches that involved a break in Beacon coverage and safety group participation.

Relevant Findings

Our data queries and calculations resulted in the following findings for the cumulative period of 2003-2005:

- The largest 50 agents at Beacon, by total written premium, accounted for only 8% of the total number of agents, but produced approximately 75% of Beacon's total written premium.
- The loss ratios by agent were under 100% for each of the largest 50 agents,
  - Three of these agents' loss ratios, however, were above the Beacon target loss ratio of 65%.
- The average credits were greater for the largest agents than for smaller agents.
- A switch to one of the largest 15 agencies resulted in an increase in credits approximately 15% of the time.
- A switch from one of the largest 15 agencies to smaller agency resulted in a decrease in credits approximately 7% of the time.

Based on these findings, which are described in more detail below, we found that a switch to one of the largest 15 agents did not ensure an increase in credits; however, insureds produced by the largest agents received higher credits. The statistics indicated that the large agents were able to secure more favorable pricing for their books of business compared to smaller agents. Throughout the remainder of this report, we have highlighted several examples of agent influence over the pricing decisions of Beacon policies and have found that the largest agents were the most influential.

[102] See the "Overall Pricing Patterns" section for a comparison that shows the average credits awarded to insureds produced by agents of a particular size. The information in the "Overall Pricing Patterns" section differs from the analysis in this section because in that section, the data is graphed by agent book of business ranges, whereas the data in this section is compared by rank.

Agent Rank by Book of Business

There were 666[103] unique agent names listed within PowerComp during 2003 through 2005. The largest 50 agents[104] produced approximately 75% of Beacon's total written premium during this time period. Loss ratios for the largest 50 agents ranged from a low of approximately 24% to a high of approximately 97%. The following table shows the total number of Rhode Island policies produced by the largest five agents by total written premium including average loss ratio and calculated credit rate. [105]

Agent	Total Policy Count	Total Written Premium	Average Loss Ratio	Calculated Credit Rate
Agent 1	2,395	$ 50,223,367	50%	23%
Agent 2	387	$ 35,085,934	76%	33%
Agent 3	1,455	$ 20,846,379	97%	18%
Agent 4	1,460	$ 20,636,341	46%	22%
Agent 5	1,177	$ 14,658,541	57%	21%

Six of the largest 50 agencies experienced loss ratios over the three-year period that exceeded Beacon's target loss ratio factor of 65%:

Agent	Rank	Total Policy Count	Total Written Premium	Average Loss Ratio
Agent 1	2	387	$ 35,085,934	76%
Agent 2	3	1,455	$ 20,846,379	97%
Agent 3	26	105	$ 3,222,354	74%
Agent 4	27	368	$ 3,072,156	66%
Agent 5	28	13	$ 3,011,556	80%
Agent 6	41	292	$ 2,256,101	67%

Credits by Agent Rank

We queried PowerComp data to summarize schedule and consent-to-rate credits according to the size of Beacon's agents. We organized Beacon's insureds by agent size, dividing the agents into five ranges: Largest 5, Largest 15, Largest 50, Largest 100 and All Agents, based on written premium. The table below illustrates the results of this query, which indicated that the average credit provided to an insured was larger based on the relative size of its producing agent.

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[103] The total number of agents in PowerComp is 666, but 29 have similar names, and may represent shared ownership or branch offices. These similar names have not, however, been combined for the purposes of our analysis, and are treated as separate agents.

[104] The largest 5, 15 and 50 agents discussed in this section represent the agents' rank by total written premium.

[105] We calculated an average credit rate for each agent by taking the total dollar value of credits issued to insured of the agent divided by the total modified premium generated by each agent.

Agent Range	Total Written Premium	Modified Premium	Total Credit	Total Policy Count	Calculated Credit Rate	Credit Rate of All Other Agents
Largest 5	$ 141,450,562	$212,613,398	$ (52,402,384)	2,395	25%	15%
Largest 15	$ 237,901,610	$348,732,500	$ (79,362,545)	14,876	23%	13%
Largest 50	$ 343,809,348	$486,346,319	$ (99,346,786)	27,025	20%	11%
Largest 100	$ 404,162,449	$561,906,291	$(108,481,991)	35,452	19%	11%
All Agents	$ 458,756,586	$626,001,054	$(115,285,220)	47,091	18%	-

Change in Credits from Agent Switches

During the Examination, we found several instances where an insured received an increase in credits on their policy that occurred simultaneously with a switch in agent. It appeared, from this sample set of findings, that some of the largest credit increases occurred concurrent with a switch to one of Beacon's largest agents. We found two specific examples of this, discussed under Relevant Finding 5 and 13 in the "Selected Individual Insureds" section. Based on these instances, we calculated the frequency with which a change to one of Beacon's largest 15 agents resulted in an increase in credits and, conversely, the frequency with which a change from one of Beacon's largest 15 agents resulted in a decrease in credits.

Switches to One of Beacon's Largest 15 Agents – Our query showed that there were 374 agent switches, given our criteria stated above, from smaller agents to one of Beacon's largest 15 agents. Of these switches, 75 involved a simultaneous change in credits, of which 56 involved an increase in credits. The credit increases were broken down as follows:

Increase in Credits	Number of Switches
0-5%	7
6-10%	10
11-15%	28
16-20%	3
21-25%	4
26-30%	3
31-35%[106]	1
Total	**56**

Based on the results of our query, approximately 15% of the total number of agent switches to one of Beacon's largest 15 agents resulted in an increase in credits. Of the 56 instances where the change coincided with an increase in credits, approximately 86% of the time, the increase was 20 percentage points or fewer.

Switches from One of Beacon's Largest 15 Agents – Our query showed that there were 314 agent switches from one of Beacon's largest 15 agents to smaller agents. Of these

[106] No switch involved an increase in credits greater than 35 percentage points.

switches, 50 involved a simultaneous change in credits, and 23 involved a decrease in credits. The credit decreases were broken down as follows:

Decrease in Credits	Number of Switches
0-5%	4
6-10%	7
11-15%	7
16-20%	3
21-25%	0
26-30%	1
31-35%	0
36-40%[107]	1
Total	**23**

Based on the results of our query, approximately 7% of switches from one of Beacon's largest 15 agents to a smaller agency resulted in a decrease in credits. Of the 23 instances where the change coincided with a decrease in credits, approximately 91% of the time the decrease was less than 20 percentage points.

Based on the procedures performed, the data did not show that a switch to one of the largest 15 agents guaranteed an increase in credits; at the same time, it did not show that a switch from a one of the largest 15 agents guaranteed a decrease in credits.

Credits and Debits

Overview

We grouped all Rhode Island insureds into ranges by the credits/debits issued to every Beacon policy. For the purpose of the analysis, a credit/debit was (1) inclusive of schedule and consent-to-rate credits/debits,[108] but (2) exclusive of CompAlliance and Loss Free credits. The source data from PowerComp included data imported from the legacy system, WINS, prior to 2003. We have found that PowerComp data prior to 2003 was less reliable. Therefore, we focused our procedures on those policies with effective dates during 2003 through 2005.

We queried PowerComp and organized the resulting data, as described below, to observe any patterns, common distributions and outliers relative to the issuance of credits/debits.

Procedures

We queried the PowerComp system to create a table listing 16 "ranges" of credits/debits. Each range consisted of ten percentage points, from the first range of credits of -80%–90%, to the last range of debits of +60%–70%. The table included dollar figures to

[107] No switch involved a decrease in credits greater than 37 percentage points.
[108] Beacon's data does not distinguish between scheduled credits and consent-to-rate credits.

represent the value of the total credit/debit for each range. See the "Overall Pricing Patterns" section for more information related to the general statistics developed from this analysis.

Relevant Findings

Based on the results of the distribution above, we selected six insureds on which to perform additional procedures due to the high percentage of credits or debits issued. We read AuditLynx and Notepad entries for additional policy information, and obtained Account Summary information from PowerComp. We also read documents from the OnBase system.

The following table illustrates the ranges that we selected for further procedures:

Relevant Finding	Policy Year	(Credit) / Debit Percent Bucket	Total (Credits) / Debits
Relevant Finding 1	1998	(70%) to (80%)	$ (563,129)
Relevant Finding 1 and 3	1999	(70%) to (80%)	$ (730,263)
Relevant Finding 2	2000	60% to 70%	$ 63,942
Relevant Finding 3	2000	(70%) to (80%)	$ (170,613)
CPN Safety Group (21 different policies)	2005	30% to 40%	$ 481,566
Relevant Finding 4	2006	(70%) to (80%)	$ (972,489)
Relevant Finding 5	2006	(60%) to (70%)	$ (112,068)

<u>Relevant Finding 1</u>

Based on the procedures performed, this insured was provided a multiple-year deal guaranteeing a stable pricing approach for three years. This deal resulted in premiums that were inadequate to cover the incurred losses over the period of the deal and subsequent periods. In addition, we found that the EMod used in pricing the account in the second year might have been incorrectly applied. Finally, Beacon priced the account net of agent commission, but did not appropriately file this with DBR.

In 1998 and 1999, the insured was provided credits between 70% and 80%. PowerComp data indicated that the account was priced without an EMod, and provided a 72% credit, amounting to an approximately $563,000 discount in the first year. Incurred losses exceeded premiums for the first four years by approximately $633,000, but the credits remained high (72%, 74%, 68% and 59%, respectively).

We located a ModMaster[109] calculation dated 4/2/1998 that indicated that the appropriate EMod for this account as of 5/1/1998 was 1.06. Also included on the printout from

[109] ModMaster is third-party software that is used for computing, analyzing and presenting the workers' compensation EMod. ModMaster is licensed by NCCI.

ModMaster was a "minimum modification factor," which assumed no losses, of 0.55. The data showed that Beacon used the minimum modification factor of 0.55 in lieu of the calculated EMod beginning with the policy effective date of 5/1/1999. An underwriting manager stated that this must have been a clerical error.[110]

We found a letter dated 4/24/1998 that was sent from an underwriting manager to the CFO of the insured confirming the multiple-year deal. The language in the letter was consistent with the majority of Beacon's multiple-year deals. See the "Statutory Violations" section for more information on multiple-year deals.

A letter from the underwriter to the agency producing the account on 4/20/1999, which attached a renewal quote, noted, "[the agent] stated that he needed a premium of $160,764 to get the renewal." A handwritten note on the letter indicated, "guarantee mod for 2 years."

We read additional correspondence that indicated that the insured requested coverage in the state of Virginia. The underwriting manager wrote to the CFO of the insured on 4/28/1999 and informed him that Beacon would insure both locations at a combined price of $180,000 (see the "Statutory Violations" section for more information on combining policies). This letter was written two days before the beginning of the second policy year and Beacon extended the two additional years of the stable pricing guarantee to the out-of-state policy as well.

A letter from the agency to Beacon on 4/29/1999 instructed Beacon to issue the policies "net of commission." Beacon did not file this variance with DBR. See the "Statutory Violations" section for more information on the practice of pricing net of commission.

<u>Relevant Finding 2</u>

Based on procedures performed, this insured received credits in the 70%-80% bucket in both 1999 and 2000. We located a Beacon "conceptual proposal" dated 12/5/1997 that stated the insured was offered a guaranteed credit structure for three years with the only variables being payrolls, modification, and state rates. The PowerComp data indicated credits increased from 27% in 1998, the insured's first year, to 73% in both 1999 and 2000 (a 170% increase). See the "Statutory Violations" section for more information on multiple-year deals.

The credit percentages were highest during the period of highest loss ratios. Loss ratios were 187%, 248% and 182% in 1999, 2000 and 2001, respectively, corresponding to credits of 73%, 73% and 59% in these same years. A Notepad entry written by an underwriter on 2/15/2000 explained "to avoid giving additional schedule credits to offset the increase inthe [sic] exp. mod [Beacon] will keep expiring mod of .79 (3/1/00 mod is

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[110] For the policy effective 5/1/1999, Beacon's hardcopy Account Summary and our PowerComp data showed that the EMod used for pricing purposes was 0.55. However, when we recalculated the premium using Beacon's premium algorithm, it appeared that a neutral EMod factor of 1.00 was utilized for pricing. Beacon's own Account Summary, in this case, showed incorrect data.

.90…).” Beacon inappropriately used the expired EMod of 0.79 in lieu of the correct EMod. We also noted on the Account Summary that a fixed EMod of 0.76 was used during the 1998 and 1999 policy years. See the “Statutory Violations” section for more information on the use of incorrect EMods.

We performed a revised premium calculation by applying the NCCI-promulgated EMods to the insured’s 1998, 1999 and 2000 premiums as reported.[111] As there were multiple EMod rates issued by NCCI during these years, we calculated the average NCCI EMod factor and applied these in our calculation. The average EMods for the 1998, 1999 and 2000 policies were 0.97, 0.90 and 0.85, respectively.

Based on our revised premium calculation, we found that premiums would have been approximately $18,000 higher over the three-year period 1998 through 2000 using the EMods from NCCI. The results of our calculation are shown in the following table:

Year	EMod Used by Beacon	Average EMod per NCCI	Original Premium	Recalculated Premium	Undercharge / (Overcharge) of Premium
1998	0.79	0.97	$ 58,582	$ 64,708	$ 6,126
1999	0.79	0.90	$ 55,790	$ 63,536	$ 7,746
2000	0.79	0.85	$ 58,432	$ 62,858	$ 4,426
TOTAL			**$ 172,804**	**$ 191,102**	**$ 18,298**

A referral form dated 2/14/2001 stated “insured coming off 3 year deal, has not been profitable...key account to producer...discussed renewal with producer – doesn't want to increase premium all in one year.” The referral also had a note from the underwriter that explained that the “agent asked for: (1) 1 year guaranteed cost at $90k or (2) 2 year guaranteed cost with $110-115k with dividend plan.” The underwriter recommended, “one year at $93,906, 2 years at $116,549.” According to the Account Summary, the 2001 policy written premium was $88,349.

Over time, the credits provided and losses incurred decreased, and the account generated a cumulative loss ratio of approximately 68% through the policy period ending 3/1/2006. This loss ratio was slightly above the 65% loss ratio Beacon considered its target rate.

Relevant Finding 3

This insured was debited 70% in 2000 and 2001. The loss ratio on the account was favorable to Beacon (55%) in 2000 and over the two-year period of coverage 2000 through 2001, Rhode Island premiums exceeded losses by about $243,000. The underwriter indicated that the debits were applied to offset the large losses that Beacon incurred during the first few years of the policy. This insured had two prior policies with

[111] While performing the revised premium calculation based on the MAS200 data provided by Beacon, we noted that the 1998 and 1999 premiums were actually calculated using an EMod of 0.79, not 0.76 as reported on the Account Summary.

Beacon. These prior policies, covering four years, experienced annual loss ratios of 7%, 289%, 511% and 223%, respectively.

The agents for the insured over the first four years were two of Beacon's largest producers. Cumulatively, the loss ratio on these prior policies was 241%.

When this insured switched agents to a smaller agency for the 2000 and 2001 policy years, Beacon began debiting the account 70%.[112] According to PowerComp data for the period 2003 through 2005, this smaller agency was the 190th largest producing agent in terms of total written premium. The premium on the Rhode Island portion of the policy increased from $83,415 in the 1999 policy year to $128,110 in its first year with the smaller agency.

After two years of 70% debits, the cumulative loss ratio on the Rhode Island policies improved to 134%. We found renewal forms and Emails in the OnBase system that further explained that the debits were applied to offset the large losses from the early years. We asked the underwriter to provide the consent-to-rate letter, as Beacon is required by statute to obtain the insureds consent when debiting a policy. He responded that he could not locate the letter, nor could he remember if he had sent one at all. See the "Statutory Violations" section for the statute governing consent-to-rate.

Relevant Finding 4

This was originally a non-producer account, but was produced by one of Beacon's top five producing agents beginning in 1999. The Account Summary showed that from the inception of this policy on 1/1/1998 through 1/1/2006, the loss ratio had been greater than Beacon's target loss ratio of 65% in all but one year (22% loss ratio in 2001). The cumulative loss ratio on this policy through the period ended 1/1/2006 was 101%. Despite the poor performance, this insured continued to receive credits between 41% and 66%.

Based on the procedures performed, the insured was provided a three-year deal guaranteeing stable pricing at inception. We found a Notepad entry dated 1/12/1998 that stated the insured was provided a multiple-year deal for three years that held the EMod at a constant 0.64. According to the Account Summary, the insured had an EMod of 0.64 for 1998 and 1999 and a 0.65 EMod for year 2000.[113] When the initial three-year deal expired, the insured was offered a subsequent deal committing to stable pricing for two more years. See the "Statutory Violations" section for more information on multiple-year deals.

A renewal file review form dated 11/22/2004 further indicated that the insured entered into a third multiple-year deal following the first five years of stable pricing. The third

[112] PowerComp data indicated that Beacon debited the insured in 1994 and 1995 in the amount of 2% and 15%, respectively.

[113] Based on data we received from NCCI, the approved EMods for this account were within 0.01 of the Beacon-utilized EMods during 1998 through 2000.

multiple-year agreement was a variation of the boilerplate agreements that Beacon had previously offered. According to this renewal form, "The agreement allows for pricing adjustment based on loss ratio for both the [Rhode Island] and [Fairfield – out-of-state] policies. The 2006 renewal will allow for adjustment to the pricing." We located an Email between two underwriters dated 3/4/2003 that attached a "Multi Year Pricing Commitment" on Beacon letterhead. According to this document, the pricing structure of the third multiple-year deal was based on the loss ratio performance of the combined Rhode Island and out-of-state policies and that the "price adjustment is exclusive of changes in payroll and changes in the mod. The percent increase in premium is in addition to these other adjustments." Based on the loss ratio performance, the document provided for the following price adjustments:

Loss Ratio	Price Adjustment
0% to 60%	No amendment to credit
61% to 75%	No more than a single digit percent increase in premium (exclusive of changes in payroll or mod)
76% to 90%	At minimum 10% increase and no more than 25% increase in premium (exclusive of changes in payroll or mod)
91% to 100%	At minimum 25% increase and no more than 35% increase in premium (exclusive of changes in payroll or mod)
100% and up	No pricing commitment

This pricing mechanism was not filed with DBR. The methodology employed by this "commitment" also appeared to have no relation at all to schedule rating or Book Method underwriting. An underwriting manager explained that these deals were done on an individual basis and this type of pricing would be "atypical." He said, "if this deal came to me in 2003, I probably would have been less receptive based on these rates." The underwriting manager did not see this deal as a violation of filing criteria because it did not represent a firm commitment by Beacon. See the "Statutory Violations" section for a discussion on combining the pricing of policies.

Additional Findings

<u>Relevant Finding 5</u>

A bank and financial services institution also appeared as an outlier in our work, as it received credits in the 70%-80% bucket in 2006. We discuss this insured in Relevant Finding 10 in the "Selected Individual Insureds" section of this report.

<u>Relevant Finding 6</u>

We noted another outlier in the 2005 PowerComp data. In the entire data set, from inception of Beacon through 2006, our data indicated that 26 policies were debited over 30%. Of these policies, 21 of them were debited in 2005 with a debit in the 30%-40% range. We pulled the PowerComp Account Summary information for 2005 for these 21 policies and noted that they all appeared to be social services organizations (all except one were assigned to SIC code *8322 Individual and Family Social Services)*. All policies had the same effective date, which suggested that they were part of a safety group plan. Per discussion with underwriting personnel, these insureds were members of CPN, and they owned and operated group homes for mentally and physically challenged patients. Underwriting personnel said that this group was debited in 2005 due to historically poor experience and noted that this was discussed with, and agreed upon, by the group. An underwriting manager provided a letter dated 3/22/2006 to DBR from Beacon, which listed the 21 policies with a consent-to-rate debit of 15% (in addition to a schedule debit of 25%). See the "Safety Groups" section for more information.

Classification Code

Overview

As we explained in the "Underwriting at Beacon" section, Beacon has not adopted any changes in its loss cost rates since it implemented the advisory loss costs filed by NCCI effective as of 11/1/1998. We discussed the process by which the 11/1/1998 rates were entered into PowerComp with the information systems department. According to information systems personnel, rates "…were applied to all policies whose Policy Period Effective Date was [later] than 11/1/1998." The purpose of the procedures described below was to identify Class Code rates that were used by Beacon to price policies with effective dates after 11/1/1998 that did not comport to the approved loss cost rates.

Procedures

We performed the following procedures to identify discrepancies between Class Code rates in Beacon data and approved loss cost rates:

- Obtained data[114] from PowerComp, which included a breakdown of payroll exposure by Class Code number, Class Code description and the Class Code rate that was used for each policy period,
- Compared the rate used in PowerComp to the approved 11/1/1998 NCCI loss cost rates, which were obtained from Beacon's *Rate Comparison By Class Guide*
- Identified instances where the rates utilized were not in agreement with the NCCI-approved rates,
- Calculated the effect of the difference on manual premium for that Class Code based on the approved rates, [115]

[114] Our data was limited to Rhode Island policies only with effective dates of 1/1/1999 forward.
[115] Manual premium is the first subtotal in the premium algorithm, and is calculated based on the amount of payroll in each job classification. The amount of payroll in each job classification is multiplied by the class code rate attributed to that classification.

- Selected policies with an absolute dollar value variance of $10,000 or more on manual premium for that Class Code and requested the policy declarations for each and
- Read the policy declaration pages and discussed the variances with Beacon personnel.

Relevant Findings

We identified 18 instances that involved 10 different insureds where the variance from the NCCI rate resulted in an absolute value difference of at least $10,000 to manual premium.

Of the above 18 instances, 13 were due to a Federal designation known as USL&H.[116] In the cases where USL&H codes resulted in the variance, we confirmed that the base Class Code rates were multiplied by the NCCI-approved multiplier of 1.83.

We also noted two instances, both for the same insured, that at first appeared to have Class Code rate variances, but upon further procedures, we learned otherwise. The insured had variances in 1999 and 2000 in which an incorrect Class Code rate appeared to be used for Class Code *8861 Charitable or welfare organization-professional employees & clerical*. We discussed these with an underwriting manager, who explained that this Class Code had been "A" rated. They explained that "A" rates, or advisory rates, are used when NCCI does not have enough data to properly assign a loss cost to that classification. In such situations, Beacon contacts its actuary to develop a rate. NCCI issued a rate effective 5/1/1995 for Class Code 8861. Filing Memorandum: Item B-1323A-A Rate Revised Transition Program outlined a tiered approach that allowed insureds to use a gradual approach to transition to the new rate. The rate for Class Code 8861 could be gradually increased or decreased per the tier stated in the Filing Memorandum for up to five years, until the actual rate was reached. According to an Email from the underwriting manager, the insured "used the proper tiered rates at that time." Although these two instances were deviations from the 1998 NCCI rates, we did not consider them to be exceptions.

The remaining three instances had actual discrepancies, where the 1998 rate was not used for all or some of the payroll classifications of the insured. Based on our selections, approximately $31,000 of manual premium was overcharged to insureds from 1999 onwards as a result of the use of incorrect Class Code rates on a net basis. We discuss below each insured and the reasons for the variances.

[116] See the "Underwriting at Beacon" section for more information on USL&H designation.

Relevant Finding 1

In order to retain its business, Beacon promised this insured that 1996 rates would be used for three years, specifically, the 7/1/1997, 7/1/1998, and 7/1/1999 policy years. An underwriting manager confirmed that, "the effective date of the rates used was 11/96. This account was secured through a[n] open bidding process. We agreed to hold the rates for a three-year period during that bidding process. This [1999] was the third year of that policy." He also stated "…we should have used the rates effective 11/98." We learned during our discussions with Beacon personnel that even if policies were issued after the 1998 rates took effect, Beacon employees are able to go into PowerComp and manually change rates.

We found that the 1996 NCCI rates were applied for each of the class codes for this policy year. The table below shows the difference between the rate used by Beacon and the 1998 NCCI rate for the 1999 policy year, as well as the total dollar value of payroll to which the incorrect rate was applied:

Class Code	Class Code Description	Class Code Exposure	Rate Used	1998 NCCI Rate	Manual Premium Overcharge
8742	Salespersons, collectors or messengers-outside	$ 194,452	0.80	0.74	$ 117
8810	Clerical office employees NOC	$ 2,885,762	0.49	0.48	$ 288
9033	Housing authority & clerical, salespersons, drivers	$ 4,326,624	5.01	4.02	$ 42,834
	Total	**$ 7,406,838**			**$ 43,239**

If Beacon had utilized the 1998 Class Code rates, manual premium for this insured would have been approximately $43,000 lower for the 1999 policy year. See the "Statutory Violations" section for how multiple-year deals constitute a statutory violation.

Relevant Finding 2

The agent for this insured requested an 18-month policy right before the conversion to 1998 rates, and thus the 1996 rates were locked in and carried over for six months. The underwriter confirmed that the 1996 rates were used. According to discussions with the underwriter, in order to write an 18-month policy, these two policies were established in the system two days apart. In July 1998, Beacon created one 12-month policy with an effective date of 7/1/1998, and another six-month policy with an effective date of 7/1/1999. Since the 7/1/1999 policy was entered into the system in July 1998 before the 1998 rates were effective, it was priced using the 1996 rates.

The table below shows the difference in manual premium on the six-month policy if Beacon had utilized the 1998 Class Code rates:

Class Code	Class Code Description	Class Code Exposures	Rate Used	1998 NCCI Rate	Manual Premium Overcharge/ (Undercharge)
5606	Contractor-executive supervisor	$ 74,501	5.35	4.16	$ 887
5191	Office machine or appliance installation inspection adjustment or repair	$ 110,600	3.53	2.51	$ 1,128
8227	Construction or erection permanent yard	$ 81,878	6.92	5.85	$ 876
5506	Street or road construction-paving or repaving & drivers	$ 89,693	13.39	11.34	$ 1,839
8106	Iron or steel merchant & drivers	$ 357,780	15.34	17.37	$ (7,264)
5222	Concrete construction in connection with bridges or culverts	$ 550,709	38.54	43.44	$ (26,985)
8810	Clerical office employees NOC	$ 919,197	0.49	0.48	$ 92
	Total	**$ 2,184,358**			**$ (29,427)**

For the six-month policy, manual premium for this insured would have been approximately $29,000 higher if the correct Class Code had been applied.

<u>Relevant Finding 3</u>

Beacon used the 1992 NCCI Class Code rate for the 11/15/2004 policy year for this insured. An underwriting manager provided this information to us in an Email and stated "…it appears as though (according to our 1998 rate book) we had no 1998 rate for this class, thus the 1992 rate was used." *The Rate Comparison by Class Guide* did not contain this Class Code and its rate, but NCCI data did have a rate for this Class Code, and we used this rate in our comparison displayed below.

The data showed that the 1992 rate was used to price both the 11/15/2004 and 11/15/2005 policies.

The table below shows the total effect on manual premium of the use of the incorrect Class Code rate for the 11/15/2004 policy:

Class Code	Class Code Description	Class Code Exposure	Rate Used	1998 NCCI Rate	Overcharge of Manual Premium
7335	Dredging-all types-Program II-State Act	$ 161,385	21.82	13.92	$ 12,749

The table below shows the total effect on manual premium of the use of the incorrect Class Code rate for the 11/15/2005 policy:

Class Code	Class Code Description	Class Code Exposure	Rate Used	1998 NCCI Rate	Overcharge of Manual Premium
7335	Dredging-all types-Program II-State Act	$ 50,000	21.82	13.92	$ 3,950

Had the correct Class Code rate been applied, the insured's manual premium would have been approximately $17,000 lower than what was actually charged.

While conducting procedures for this insured, we read underwriting documents that indicated that this is a Maine corporation whose employees were performing temporary work in Rhode Island. See the "Out-of-State" section for a discussion on Beacon's coverage of out-of-state employers.

Notepad

Overview

Notepad is an element of PowerComp, Beacon's insurance software. It functions as a running diary that underwriting, claims, loss prevention, and finance personnel use to document certain facts pertaining to policies. We inquired about the ability to overwrite, delete, or modify entries in the Notepad system and we were provided with a document that was prepared by an information systems employee. It read:

> *Once the required information is entered the note can be saved. Once saved, the note CANNOT be modified. It will remain in the database with typographical errors and erroneous text that has been entered. If the note is not saved, it is discarded and not inserted to the database. A note can never be deleted...Any request to change the note text or caption would have to come through a help desk request. This request would require additional paperwork and Sr. management signoff before the change could be made. The only users with access to change this data would be the Database Administrators. To the best of my knowledge, I do not believe that a request has ever been made to have any note text modified or deleted.*

Procedures

We requested and obtained the "Note Text" table extract from the PowerComp system, which contained all Notepad entries dating back to 1992. Data from Beacon's predecessor systems was converted to PowerComp in October 2003. We received the data on 3/27/2006 and the table included approximately 2.9 million Notepad entries.

We developed a listing of 34 keywords and ran them against the Notepad data that resulted in approximately 174,000 records. We segmented these results according to note type. There were three types of notes in the system, those attributed to a specific policy ("Policy Notes"), those attributed to a specific claim ("Claim Notes"), and those notes not attributed to either a specific policy or claim, but only to a legal entity.

Furthermore, we stratified the results by premium size to identify notes related to policies with premiums greater than $10,000 and those greater than $50,000. We primarily focused on Policy Notes with premiums greater than $50,000; however, for select keywords, we expanded our search to include Policy Notes with premiums greater than

$10,000, and for some keywords, we read both Policy Notes and Claim Notes for policies with premiums greater than $10,000.

Based on the results of our keyword search criteria, we read approximately 5,200 notepad entries. We judgmentally selected 13 policies for additional procedures. The nature and specifics of the potential issues for each of the entries varied and we tailored our procedures accordingly to address those issues. Generally, we performed the following procedures:

- Generated a report including an Account Summary and other relevant policy and premium information from PowerComp,
- Read electronic AuditLynx data for audit results and alerts,
- Read documents in selective underwriting and premium audit sections of OnBase,
- Performed focused searches of Emails which matched our forensic keyword listing and
- Discussed the policy with underwriting and premium audit personnel.

Based on the results of our procedures listed above, we identified 11 policies that represented relevant findings detailed below.

Relevant Findings

<u>Relevant Finding 1</u>

We found credits that were retroactively increased from 30% to 50% on the 4/18/2003 and 4/18/2004 policies of an engineering and construction company, based on Solomon's direction, to appease the insured, who appeared to be a friend of Solomon's, according to Emails that we read. An Email from the insured's agent, Beacon's largest agent, stated that the insured wanted the increase in credits in order to offset the additional premium from a premium audit on the 4/18/2003 policy.

A Notepad entry dated 7/28/2004 indicated that the insured had a discussion with Clark and Solomon and that Beacon agreed to increase the credit from 30% to 50% for the 4/18/2003 and 4/18/2004 policy periods. The Account Summary showed that the insured received a credit of 50% since inception of the policy on 4/18/2003.

We found a renewal form dated 3/20/2003 that showed that Beacon originally wrote the 2003 policy with a 30% credit and a "two year rate lock (excluding payroll increase and exp [E]mod change)." The underwriter confirmed to us in an Email that "The two year rate lock was requested by the agent and agreed to by Beacon. The only thing that was locked in was that the credit would not go below 30% for those two years."

We also found a premium quote dated 2/24/2004 that showed that Beacon originally wrote the 2004 policy with a 30% credit. On 7/28/2004, the underwriter endorsed the credit be changed to 50% on the 4/18/2004 policy, based on a request made via the insured's agent. The Email, dated 7/27/2004, stated, "The client incurred an additional premium on the 03-04 audit of roughly $125k. He wanted some relief from that amount…so he called [Solomon] directly. [He] agreed to revise the schedule credit on the 03-04 [and] on the 04-05 to 50%. He also agreed the revised audit debit premium could be paid over 4 monthly installments."

Based on the results of the procedures performed in the "Retroactive Credit Adjustments" section, we found that Beacon retroactively adjusted the insured's credit structure to generate a reduction of premium. Specifically, we found that, on 7/28/2004, Beacon increased the credits on the 4/18/2003 through 4/18/2004 policy from 30% to 50%. This change occurred approximately three months after the expiration of this policy period and generated a premium reduction of $60,137. This figure was built from two components. First a $24,681 reduction in accounts receivable was posted to the account on 7/28/2004 relating to the increase in the credit percentage. Second, an additional premium amount posted to the account on 7/8/2004 in the amount of $125,991 (assuming a 30% credit) was reversed and re-posted with an amount of only $90,535 reflecting the 50% credit, a difference of $35,456. We read premium adjustment reports that indicated that this variance was also related to the increase in credits. Following these entries, a balance of $65,854 remained due from the insured. The accounts receivable summary showed that the insured paid $18,045 towards this balance, and the remainder was converted into a note receivable and was paid off as of 11/9/2004.

We also found that Beacon adjusted the credits on the 4/18/2004 through 4/18/2005 policy after the policy effective date, but before the policy expiration date. This increase, like the year before, was from 30% to 50%. On 2/11/2005, Beacon paid the insured $32,862, which was coded as a refund.

We performed a query on the PowerComp data to show the difference in premium on the policies if Beacon continued to use the 30% credit with which it originally priced the policies. Based on this query, premiums would have been approximately $130,000 higher over the two years if a 30% credit had been used to price the policies. The table below illustrates the results of our queries.

Policy Year	Original Premium with a 50% credit	Recalculated Premium with a 30% credit	Premium Difference
2003	$ 153,312	$ 213,449	$ 60,137
2004	$ 180,416	$ 250,478	$ 70,062
TOTAL	**$ 333,728**	**$ 463,927**	**$ 130,199**

See the "Retroactive Credit Adjustments" section for more information related to instances where Beacon changed the credit structure after policies had been priced.

Relevant Finding 2

We found that Beacon entered into an agreement with a discount department store under which the store's policy was priced based on the combination of Rhode Island and out-of-state policies, and included a multiple-year commitment, as well as a contingent pricing arrangement.

The Notepad entry dated 3/30/2004 indicated that Solomon was contacted by the agent of the insured and asked to "bridge the gap" between Beacon's quote and a competing insurance carrier's quote. According to the Notepad entry, Beacon agreed to a $320,000 premium and a two-year deal "if the combined (Beacon and Fairfield) loss ratio is 35% or better." According to the hardcopy Account Summary, which was as of April 2006, the combined loss ratio for the 4/1/2004 policy was 67%, which was higher than the "35% or better" as indicated in the Notepad entry. The cumulative combined loss ratio on this account was 62% since inception and through the 4/1/2005 policy year.

In an interview, the underwriter stated that this policy was a situation where both the Rhode Island and out-of-state policies were combined in terms of pricing. The underwriter recalled that Beacon offered a two-year deal, which was contingent upon the loss ratio performance following a discussion involving underwriting personnel, Solomon and the insured's agent, one of Beacon's top five producing agents. The competing insurance carrier, which had substantially increased the premium at the last minute on the renewal quote, previously insured this insured. Beacon first quoted the insurance below the other carrier's renewal figure. When the other carrier found out, they tried to undercut Beacon again, but Beacon won the business with the deal described above.

See the "Statutory Violations" section for more information on multiple-year deals, contingent pricing, and combining policies.

Relevant Finding 3

We found that Beacon reduced its original quote in half in order to undercut the competition and wrote the return business, even though it had written off amounts on the prior policy that were not collected prior to quoting the business.

An underwriter wrote a Notepad entry, dated 10/7/1998, that stated that the prior policy with this insured resulted in a bad debt write-off and Beacon originally quoted the return business with no credits as "we can not [sic] justify crediting the account." A competitor priced the account for half of Beacon's quote. When he heard this, Solomon reportedly approved a 25% credit and the premium was written at $12,019,[117] slightly below the competing quote of $12,364. Per PowerComp, a 25% credit was given in the first year after returning to Beacon (policy effective date 10/17/1998). The underwriter did not recall why Solomon might have been involved on this matter, but indicated that he overrode the initial pricing approach.

[117] This represents a 46% decrease from the original quote of $22,775

After re-signing the insured, Beacon wrote the policy from 10/17/1998 through 10/17/2002. Beacon gradually reduced the credits provided to the insured in the second, third and fourth years upon renewal, eventually to zero. The loss ratio over this four-year period was approximately 71%, slightly above Beacon's target loss ratio for Rhode Island policies of 65%.

Under 2003 P.L. ch. 410 § 11(b)(12), Beacon is allowed the opportunity to deny coverage to an insured that has debts outstanding with Beacon, and our discussions with underwriters led us to believe that Beacon has an understanding that past debts must be collected before writing a new policy. See the "Political Activities" section for another example of an insured whose past debts were forgiven before reinstating the policy. Complaints to DBR have indicated that Beacon does enforce 2003 P.L. ch. 410 § 11(b)(12) with regards to some insureds (even when the debt is owed by a predecessor corporation – as allowed by the statute). No documentation was found to explain the inconsistent application of this statute.

<u>Relevant Finding 4</u>

We found that this insured received an increase in credits as an agency accommodation.

The Notepad entry dated 12/1/2004 stated that the agent requested a "30% credit on renewal" and that Beacon had "agreed to do this as an agency accommodation." The Account Summary confirmed that in the renewal period subsequent to this Notepad entry, the credit increased from 20% to 30%, in line with the agent request. We did not find any other support for this credit increase other than compliance with the agent's request.

<u>Relevant Finding 5</u>

We found that this insured received an increase in credits when it switched from a smaller insurance agency to one of Beacon's top five producing agents. Further, based on the procedures listed in the "VIP Accounts" section of this report, the president of this insured was also the chairman and CEO of another insured, which was included as a VIP account.

On 9/20/1996, the underwriter authored a Notepad entry that stated that Solomon directed underwriting to provide a 20% credit. The Account Summary showed that this credit was extended to the insured concurrent with its switch from a smaller agency to a larger insurance agency. The credit equated to a $29,730 discount for the 10/1/1996 policy year. The larger agency produced this account for five years, over which period credits ranged between 20% through 45%. The loss ratio over the four years of coverage before switching to the larger agency was 19% compared with the loss ratio over the five years after the switch of 72%. This insured switched agents again beginning 10/1/2001 to a different smaller agency but the credit structure remained in the 25% to 40% range. The loss ratio for this account deteriorated further to 119% under this new agent through the performance of the last completed policy year. In summary, over the coverage period 10/1/1996 through 10/1/2005, this policy was extended credits between 25% and 45% despite its loss ratio during the same period was 96%.

<u>Relevant Finding 6</u>

We found that Beacon provided this insured a multiple-year deal as well as an increase in credits as an agency accommodation.

On 12/15/1997, an underwriter wrote a Notepad entry that stated that he talked with the agent, who was with Beacon's largest agency, about the 1/1/1998 renewal. The underwriter had proposed reducing the credit from 52% to "around 25%" because of "terrible loss history." The agent told the underwriter that when the policy was written, an underwriting manager provided a "three-year price guarantee" and the agent produced a letter that we located in OnBase. Based on the letter, the underwriter revised his proposal and noted that the credits would remain at 52%. This was a multiple-year deal that underwriting management made with the insured without the underwriter's knowledge. In the underwriter's opinion, the deal was made, "just to get the business."

We located and read the letter mentioned above, dated 1/3/1996, from Beacon to the agent that contained language common to deals around this time period (see the "Statutory Violations" section for more on multiple-year deals). The Account Summary showed that the loss ratio over the three-year deal was approximately 174%. Based on Beacon's target loss ratio of 65%, this loss experience translated into a financial loss to Beacon policyholders of approximately $740,000 over this period. The cumulative loss ratio for this insured from the inception of coverage through 1/1/2006 was 74%. The insured's policy premiums have increased over 174% from the original price effective 1/1/1997, while its payroll has only increased approximately 65% over the same period.

We identified several documents through our procedures that provided additional information regarding the influence of the agency in pricing decisions:

- A document entitled Large Accounts File Review dated 11/5/2001 included a note from the underwriting manager that stated, "Per discussion w/ Dave Clark we will call agent to determine price he can sell." In his interview, he said that this language was not "atypical" but often reflected an agent's suggestion, not that Beacon would necessarily give them the accommodation. The underwriting manager admitted that these accommodations were not consistently provided to all agencies.
- Another Large Accounts File Review dated 11/26/2002 indicated that "[The agency] did not want to take the entire credit away so we are adding a level 10% shared earnings plan to the renewal which will most likely never affect the insured with their prior loss history."

- An Email dated 12/17/2003 stated, "Dave [Clark] met with [an agent at the insured's agency] to discuss this account. [The agent] asked [Clark] if we would consider repricing this account to include a 20% credit on the renewal. Apparently [the agent] is experiencing competition…[and] asked if [Beacon] would like to consider this an agency accommodation…." A follow-up Email dated 1/13/2004 stated, "Policy was renewed with Beacon at a 20% credit." Based on the Account Summary that we read, a 20% credit was added to the account for each renewal following this exchange.

<u>Relevant Finding 7</u>

We found that an underwriter intended to reduce this insured's credit to 23% because of its poor loss history, but an underwriting manager allowed credits to remain at 43% as an agency accommodation.

A Notepad entry dated 10/18/2004 stated the renewal credit was preliminarily decreased "…from 43% to 23% due to poor loss history and a 197% loss ratio in the current term. [An underwriting manager] advised [the agent] that we would restore the 43% schedule credit on the renewal as an agency accommodation."

We located an Email, dated 6/20/2005, from an underwriter to Clark's administrative assistant that indicated, "many accommodations [were] made for insured."

The underwriting manager claimed that he did not recall why the agent was provided the accommodation, but explained that the insured was a "center of influence" for the agent and an important client of Beacon's largest agency.

We read the Account Summary, which confirmed that Beacon applied a 43% credit on the account's 2003, 2004, and 2005 policies. Beacon began providing credits on this account in 1994 and they have ranged from 15% to 54% in over ten years of coverage. Over the period that the insured received the highest credits (1997 through 2004), its loss ratio was over 100%.

<u>Relevant Finding 8</u>

This insured had significant out-of-state exposure, yet the decision was made to write the policy and include an 11% credit.

On 7/9/2002, an underwriter authored a Notepad entry that stated that an investigation of a claim occurring in Massachusetts had revealed that only 5% of this insured's work was located in Rhode Island. Despite the out-of-state exposure, Beacon wrote the policy for one year and provided the insured an 11% credit.

The agent for this insured worked for one of Beacon's larger producing agencies, and was also a member of the Agent Advisory Council. He was present during the investigation of the Massachusetts claim.

An underwriting manager sent an Email dated 4/24/2003 to Clark with a copy to the underwriter and explained that the policy had another Massachusetts claim and asked the agent whether the renewal would be placed with another carrier. The underwriting manager wrote that the agent was not "hopeful" that he would be able to place the business elsewhere. Despite the knowledge that most of the payroll was out-of-state, Beacon quoted the insured on the renewal, removing the 11% credit from the quote. Clark asked the underwriting manager via Email on 4/29/2003 what Beacon's understanding was at the time Beacon originally wrote the policy. The manager explained, "The understanding was that [the agent] was going to do what he could to get it replaced for [the renewal period] as he realized that we did him a favor remaining on it thru 2002-2003. And, we further told him that if he could not replace it, then all credits would be removed at 5/3/03."

The underwriter described this account as "a weird one" during his interview. He said that he found out by reading a Loss Control report that most of the insured's business was outside of Rhode Island. He said that the account could have been cancelled immediately upon finding this out, but that Beacon decided to wait until renewal. Eventually, the account was placed with another carrier after the first year.

The underwriting manager recalled that the agent originally represented that this company hired all of its employees in the state of Rhode Island, but they discovered in a new business audit two to three months after inception that most of the exposure was outside of Rhode Island. There were some "philosophical differences" over this issue that delayed the determination for a number of months that the policy should not have been written. The underwriting manager said that Beacon did not cancel the policy immediately because that would have left the company without coverage and explained that Beacon asked the agent to voluntarily place the business with another carrier on renewal. We asked the underwriting manager why Beacon, knowing the issues on the account, would have offered a quote on the renewal and they replied "we were helping the agent." The underwriter and the underwriting manager both did not recommend quoting the business on renewal, but that Clark overruled their decision.

Relevant Finding 9

This insured's agency was indirectly involved in the pricing of the 2006 policy as they informed Beacon that they had competition for this policy. The underwriter initially wanted to reduce the credits by 10 points, but because there was a threat of losing the account, credits were only reduced two points. We also found that the insured has not been part of the CompAlliance program since 1997, but has still been receiving a CompAlliance credit through its current policy.

A Notepad entry, dated 12/8/2005, indicated that the underwriter wanted to remove 10% of credits on the renewal and "…quote at 30% [credits]; however, [the agent] indicates we will lose acct if we do this as [a competing carrier] is also quoting. We need to keep [premium] flat in order to renew. Per Dave Clark ok to renew as is…we can keep [premium] flat at $77k if we quote 38% credit, down 2 points...issuing [policy] as we now have agency agreement on pricing." The Account Summary showed that Beacon reduced the credits issued on the 2006 policy from 40% to 38%.

One of Beacon's largest producing agencies produced this account since Beacon began covering it effective as of 12/31/1996. Credits on the account ranged between 35% and 53% every year despite periods of poor loss performance. For example, there was a stretch of time between 1999 and 2002 where loss ratios were 95%, 155%, 263%, and 281% in consecutive years. Cumulatively, through 1/1/2006, the loss ratio on this account was approximately 101%.

We questioned the underwriting manager on the renewal, who believed there "was a lot of dialog" with the agency on this account. They explained that this was an account where Beacon had to "service the s___ out of" in order to control losses because of the low premium.

Coincidentally, the 1/1/2000 policy for this insured was one of the 59 selections that we sent to BCBSRI for confirmation under our CompAlliance procedures (see the "CompAlliance and Loss Free Credits" section). BCBSRI informed us in the return of our confirmation that this insured has not had coverage with BCBSRI since 4/1/1997. This disqualified the insured from the CompAlliance program. Per PowerComp data, however, the insured began receiving a CompAlliance credit on the 12/31/1998 policy, over a year after it no longer had BCBSRI coverage. Because this was an exception to the confirmation, we requested support from Beacon to show why it had provided the insured with the CompAlliance credit. We received a renewal checklist for the 1/1/1999 policy that included a field for "CompAlliance" and "10%" was written in the space. This is the only support we received for the insured's admission into the CompAlliance program. From the 1998 policy through the latest 2006 policy, the insured had received $55,967 in CompAlliance credits on total written premium of $466,439 over this same time period.

We also located a 1/2/2006 Email from the agent to Solomon inquiring as to whether Beacon could give this insured, a printing company, a printing job, as the president of the company had been loyal to the agency and to Beacon. The agent also explained that the company's president had been "running some interference with the RI Mfg Assoc,[118] he's on their board I believe…definitely a guy we want to keep on our side." The agent also indicated that the insured had just renewed with Beacon, despite a lower quote from another insurance company. Solomon was not able to give the company a printing job, indicating that Beacon had no large print needs because it did not print annual reports, but suggested the president's name for a possible board seat. The agent replied that this individual would not be a bad choice, but the two also discussed other individuals for the position.

[118] See the "Safety Groups" section for more information on the Rhode Island Manufacturing Association's opposition of the Beacon legislation.

Relevant Finding 10

We found that Beacon wrote the 3/26/1999 policy with an incorrect EMod and simultaneously increased the insured's credits after the insured changed from one of Beacon's top producing agencies to Beacon's largest agency.

On 5/28/1999, an underwriting manager wrote a Notepad entry that stated that the "[agent] asked that we offset increase caused by rising mod. Our quote used one mod and the actual mod is something else." The underwriter wrote that there was already a 40% credit on the policy and that increases in premium were due to EMod increases. The underwriting manager also wrote that the insured was a "longstanding agency client very visible in community. I agreed to stay with the modification originally quoted for this policy year only."

Underwriting personnel wrote these Notepad entries when the insured returned to Beacon after a break in service from 3/26/1996 to 3/26/1999. Upon its return, the insured was provided a 40% credit (previously 0%), and it changed its agent from one of Beacon's top producing agencies to Beacon's largest agency. The EMod on the return was 0.84. According to NCCI, the promulgated EMod for this effective date was either 1.11 or 1.03 and these EMods were issued on 4/13/1999 and 11/1/1999, respectively; however, neither of these EMods was used. The underwriter stated that they believed this to be an instance where Beacon incorrectly quoted a lower EMod than it should have and needed to stick by the original quote. The underwriter also recalled that the competitiveness of the market in 1999 might have led to the increase in credits.

Relevant Finding 11

We found that Beacon quoted both the Rhode Island and out-of-state policies together as an agency accommodation and also wrote the policy net of commission without an approved filing.

On 4/18/2000, an underwriter authored a Notepad entry that stated that the agent asked Beacon to quote both the in-state and out-of-state policies together at $210,000 "as opposed to $285,000 as I quoted combining the $120,000 RI quote and the two Fairfield quotes...spoke to Dave Clark because [the agent is one of Beacon's largest]…we will make the accommodation - write the program for $210,000...the $210,000 is NET!! of commission."

The Account Summary showed that the insured had an out-of-state policy beginning on 5/1/2000 and the premium on this policy was $83,583 for 5/1/2000, for a combined written premium of $205,838. The cumulative loss ratios on the Rhode Island and out-of-state policies were 75% and 13%, respectively, since inception through the end of the 5/1/2004 policy year, which resulted in a combined loss ratio of 62%. The underwriter explained that this account had many issues back in 1996 and left Beacon because of disagreements with the prior underwriter. Beacon tried to win the account back in 2000, and Notepad entries represented the negotiations. Beacon had given the agent a quote that priced the Rhode Island and Connecticut policies together at $285,000. The underwriter recalled that the agent mistakenly quoted the policy to the insured based on the in-state policy price of $190,000 for the whole program. In order to "save the agent's face" Beacon agreed to a $210,000 price for the whole program. Beacon also eliminated the agent's commission on the account.

Standard Industrial Classification ("SIC") Code

Overview

For five insureds named in the whistleblower allegations and two additional insureds that were brought to our attention, we compared each against other insureds in its SIC group.[119] SIC codes were developed by the U.S. government to categorize a company's operations. Although there are set descriptions for each SIC code, Beacon's underwriters must judgmentally assign the code for new business applications and enter this code manually into PowerComp. Therefore, the PowerComp data was limited by the possibility of inaccurate or incomplete information entered into PowerComp; there might have been insureds included in a particular data set that did not have similar business operations to the other insureds in the data set, or insureds that should have been included in the data set were not due to miscoding by underwriting personnel.

The purpose of this comparison was to see whether insureds with comparable business operations and risks were being priced consistently. We also isolated the three most predominant Class Codes for each insured to identify any insured for which the Class Code distribution did not appear reasonable given its industry. Additionally, we calculated the Weighted Average Class Code factor for each insured by weighting each Class Code for a particular insured against the payroll to which it applied and calculated the average. We calculated this metric to identify any insured whose Weighted Average Class Code was significantly greater or less than its peers.

Procedures

For each of the seven SIC codes, we performed the following procedures:

- Queried PowerComp to find the SIC code for each of the seven insureds,
- Queried premium pricing information for all policy years of all insureds labeled with the same SIC code,
- Calculated the Weighted Average Class Code for each insured in each data set and
    - Created pivot tables using the PowerComp data and the calculated premium pricing data to compare information of insureds in each data set.

[119] We did not conduct a SIC comparison for Allegation 6 because there were no other Beacon insureds with its SIC code according to PowerComp data.

The results of our procedures showed pricing factors inconsistent with the seven insureds as compared to their industries. Based on the procedures we performed for the SIC code comparison, the five insureds discussed in the "Original Whistleblower Allegations" section all appeared to receive some level of preferential treatment, mainly through higher credits than their peers. We discuss the sixth insured's performance in more detail under Relevant Finding 2 in the "VIP Accounts" section, and we discuss the seventh insured, a financial services institution under Relevant Finding 5 in the "Credits and Debits" section, as well as, in Relevant Finding 10 in the "Selected Individual Insureds" section.

Our work also revealed other insureds with pricing factors inconsistent with the averages of their representative industries. Upon identifying these insureds, we performed the following steps to understand how their policies were priced:

- Read the hard copy Account Summary from Beacon and compared it to PowerComp data,
- Read Audit Alerts and results pulled from AuditLynx data,
- Read Notepad entries for policy comments from PowerComp,
- Read select documents in underwriting and premium audit sections of OnBase
- Requested and read policy declaration pages and
- Interviewed certain underwriting and premium audit personnel involved with the account.

Our procedures resulted in information that explained and supported Beacon's pricing for many of the insureds whose pricing appeared unusual at first. For a number of insureds, however, we found pricing issues and inconsistencies. We summarize the relevant findings for these insureds below.

Relevant Findings

<u>Relevant Finding 1 – SIC Code 8062 General and Surgical Hospitals</u>

A 2005 renewal form indicated that a local hospital was granted a three-year deal guaranteeing stable pricing.

This hospital has been insured with Beacon since March 1999. It is the third largest hospital in its SIC code, with an average payroll of over $24 million, as compared to the insured discussed as Allegation 5 in the "Original Whistleblower Allegations" section of this report, the largest insured in the industry with over $421 million in average payroll, and to the second largest insured in this SIC code (see Relevant Finding 2), with over $69 million.

We selected this insured because its average cost per $100 of payroll ("C100") was the lowest in this SIC code, at $0.56. The average C100 for this industry was $0.87. Credits on this policy have ranged from 35% to 65% over the seven-year coverage period.

The 2005 renewal, dated 1/13/2005, stated, "Insured was on a 3 year deal with Beacon from 1999 to 2001. Since then the pricing has been stairstepped towards right pricing." The section further stated, "The mod is going down 4 pts (89 to 85) and the schedule credit is being adjusted to 32% (from 35%) to keep a flat renewal with the only increase being due to payrolls." We asked underwriting personnel about the term "stairstepping" and they explained that Beacon would gradually take credits away from insureds to avoid "sticker shock." Beacon would do this so as not to alarm the agent that Beacon was "changing its philosophy" by taking the credits down in one year.

We noted that the language regarding the payroll being the only factor changing premium was consistent with language on other multiple-year deals where Beacon would offset the change in premium factors (EMod and classification changes) by utilizing credits.

Despite the multiple-year deal, the loss ratio for this account during the initial three-year deal was approximately 61%, below Beacon's target loss ratio of 65%.

<u>Relevant Finding 2 – SIC Code 8062 General and Surgical Hospitals</u>

The performance history of this insured showed that this insured was inadequately priced. They were granted a multiple-year deal guaranteeing three years of stable pricing. Beacon also utilized an EMod that was calculated by the agent to price this insured. This EMod was lower than the NCCI-promulgated EMod. Over the first three years of the policy, under the multiple-year deal, the loss ratio was 234%, and from the inception of the policy on 12/1/1999 through 12/1/2005, the insured experienced a loss ratio of 113%.

We selected this insured because this selection had the highest one-year loss ratio of any policy in this SIC code (302% in 1999). Despite the high loss ratio, the insured received credits that ranged from 15% to 55% over its six-year coverage period.

A referral form dated 11/20/2000 noted that the EMod of 0.86 was a "non-NCCI mod. [calculated] by agent." The form indicated the insured was "entering second year of 3 year arrangement." Attached to the referral was the three-year agreement letter, dated 9/30/1999. The letter read, "While we are not able to guarantee the rates for a three year period, we will guarantee the effect of the rates…. The only change in premium will be reflective of the payrolls." Multiple-year deal letters for other insureds that we read contained similar language. See the "Statutory Violations" section for a discussion on multiple-year deals.

The referral form for 2003, dated 7/24/2003, stated, "This insured was on a multi year pricing commitment…Since then we have been stairstepping towards right pricing." Per the underwriter, the original EMod factor was calculated by the agent based on figures from the insured's self-insurance period, and that the EMod and credits were kept constant for three years to maintain the premium price per the agreement. The underwriting manager stated that some agents have software to calculate EMods, but Beacon is only allowed to accept them if they have been accepted by NCCI. Despite his approval on the referral, the underwriting manager said that Beacon should not have accepted the agent's EMod calculation because this insured would not have qualified for an NCCI EMod due to insufficient loss experience.

According to data provided by NCCI, the agency promulgated its first EMod for this insured on 7/25/2001 for the policy period beginning 12/1/2000. The EMods released by NCCI for years two and three of the policy ranged from 1.20 to 1.25; however, Beacon continued to use the 0.86 factor calculated by the agent. If Beacon had utilized the NCCI EMod factor, premiums would have increased substantially, as seen in the table below:

Year	EMod Used by Beacon	Average EMod per NCCI	Original Premium	Recalculated Premium	Undercharge of Premium
2000	0.86	1.21	$ 320,280	$ 447,302	$ 127,022
2001	0.86	1.22	$ 335,496	$ 474,798	$ 139,302
Total			$ 655,776	$ 922,100	$ 266,324

Beginning with the policy effective 12/1/2002, Beacon applied NCCI EMods to the policy.

This insured was included on Beacon's VIP lists because of a close relationship with a Beacon vice president. The vice president explained to us in an Email dated 7/31/2006 that he had represented the insured as an attorney when he was in private practice before coming to Beacon. He said that he was a member of a committee that helped plan an annual golf outing for the benefit of the insured and remained on the committee until 2003. The underwriting manager was not aware of any interference by this vice president with the account on pricing matters.

Relevant Finding 3 – SIC Code 4212 Local Trucking Without Storage

Loss history for this insured, a demolition company, indicated that its policies were inadequately priced. From the inception of the first policy through the most recently completed policy period, the insured experienced a 331% cumulative loss ratio.

We selected this insured for two main reasons. First, the C100 has fluctuated considerably, from $8.72 to $37.55 during the period of coverage. Secondly, the two predominant Class Codes for this insured, *5022 Masonry NOC* and *5057 Iron or Steel Erection NOC*, did not appear to belong within the trucking industry.

The variance in C100 for the most recent policy (increase from $11.97 for the policy effective 3/23/2005 to $34.21 for the policy effective 8/26/2005) resulted from the correction of payroll misclassifications in previous years. The underwriter explained that there was no Class Code for demolition work and that payroll should have been coded based on the type of property that the company demolished, according to NCCI. The underwriter had incorrectly classified payroll to code *7228 Trucking-Local Hauling Only – All Employees & Drivers*. Once corrected in 2005, the majority of the payroll was classified to code *5057 Iron or Steel Erection NOC,* which carried a rate of $37.50, compared to $13.47 for 7228.

The insured appeared to have been a financially troubled company, and its intermittent history resulted from the account being cancelled (and then reinstated) by Beacon multiple times due to non-payment. Beacon employed a collections attorney to collect payment. Beacon documented that the insured was uncooperative during premium audits, and did not provide sufficient information to determine appropriate Class Codes and premium. An underwriting manager commented that poor accounts such as this one are the result of Beacon being the insurer of the last resort.

The underwriter described this account as a "disaster account." The underwriter suggested a 20% debit to this account according to a referral form dated 9/20/2002, but this proposal was rejected and the policy was issued with no debit. Per the underwriting manager, Beacon must show that the insured is worse than its class to warrant a debit. This statement appeared to contradict Beacon's leniency with respect to schedule and consent-to-rate credit application.

During his interview, the underwriting manager remarked that the 20% debit suggested by the underwriter should have been applied given the facts of the case. We asked the underwriting manager about Beacon's ability to surcharge (up to 300%) insureds "who present higher than normal risks within a class" under 2003 P.L. ch. 410 § 11(d)(3). The underwriting manager explained that the surcharge option can only be used if there is an identifiable dangerous condition, and the surcharge can only be utilized up until the condition is corrected.

The underwriting manager also explained that Beacon rarely debited accounts because it was worried about complaints to DBR. He indicated that history has shown that DBR reverses the debits. DBR concludes that these concerns are without merit. Over the past six years, DBR has not initiated departmental action against Beacon with regard to debits under 2003 P.L. ch. 410 § 11(d)(3).

<u>Relevant Finding 4 – SIC Code 7389 Business Services Not Elsewhere Classified</u>

An Email showed that the agent directly influenced the pricing on this account, resulting in an unsupported CompAlliance credit and additional credits.

We noted that the insured has had two policy numbers with Beacon, one for the period 3/1/1993 to 3/1/1996, and another from 4/1/1996 through the date of this report. We selected this account because its average C100 from the first policy to the second decreased approximately 52%, even though its Class Code distribution remained consistent and losses did not decrease significantly. When the insured switched agents to Beacon's largest agency on 4/1/1996, they began receiving a CompAlliance credit and a 15% schedule credit.

The agent wrote to the Beacon underwriter via Email on 3/5/2004 and stated, "we face outside competition on all lines. For work comp we are only working with Beacon Mutual. We'd like help in the following areas." The agent requested a dividend plan for the insured, an increase in the schedule credits to 20%, and an increase in the CompAlliance credit from 5% to 10%.

Documents provided by Beacon dated prior to the agent's Email indicated that the 4/1/2004 renewal was being priced assuming schedule credits of 5% and a CompAlliance credit of 5%. Three days after the Email, the policy was issued and provided schedule credits of 20%, and a 10% CompAlliance credit. PowerComp showed that the insured was entered into SE-9601, the aggressive shared earnings plan, beginning the 2004 policy year.

In his interview, the underwriter indicated that he probably made the agent accommodations himself for this insured and also said that he was "sure I didn't check" to see if the insured qualified for the maximum CompAlliance credit.

Relevant Finding 5 – SIC Code 7389 Business Services, Not Elsewhere Classified

The results of our procedures showed that this insured was granted a multiple-year deal guaranteeing a stable pricing approach for the period 10/1/1999 through 10/1/2002. During this three-year period, the insured's loss ratio was approximately 144%.

This insured has had three policies with Beacon since 5/1/1993. We selected this insured for several reasons including, an average C100 decrease of approximately 57% between the first policy period (5/1/1993 - 7/1/1995) to the third (7/1/1997 - present). We also noticed that average credits provided on the policy increased from 0% during the first policy to 35% on the third. The increase in credits was concurrent with the insured's agent switch from a smaller agency to Beacon's largest agent.

We located a letter, dated 9/29/1999 on the agency's letterhead, from the agent to an underwriter that stated that the premium for renewal was "$33,365" and that a "three year rate lock" would apply. An accompanying fax had "50%" written towards the top of the page. For the 10/1/1999 policy year and the two years following, this insured received a 50% credit.

Selected Individual Insureds

Overview

In addition to exceptions and anomalies discovered through various comparisons and queries already covered in this report, we were also made aware of several additional accounts during the course of the Examination through interviews or reading other documents including Email. We performed focused procedures on these accounts based on information from a variety sources.

Procedures

For many of the additional accounts we selected, we performed the following procedures to gain an understanding of the issues raised and to attempt to substantiate the information we received from interviews and sources. The nature and specifics of the potential issues raised for each of the accounts below varied and we tailored our procedures accordingly to address those issues. Therefore, the exact procedures performed on each account may not have been identical. Generally, we performed the following procedures:

- Generated a report including an Account Summary and other relevant policy and premium information from PowerComp,
- Read electronic AuditLynx data for audit results and alerts,
- Read electronic PowerComp Notepad data for "Policy" comments,
- Read documents in selective underwriting and premium audit sections of OnBase,
- Performed focused searches of Emails that matched our forensic keyword listing and
- Discussed the policy with underwriting and premium audit personnel.

Relevant Findings

We discuss each of the additional policies below, explaining our reason for selecting the policy, and the relevant findings that resulted from our work.

<u>Relevant Finding 1</u>

An underwriter informed us that a municipality received a special deal, where the city's total payroll was locked at the same amount for three years. PowerComp data supported the underwriter's statement. The underwriter said the deal was provided because the city was close to bankruptcy and needed to project its cash flow for multiple years. This deal was not disclosed to, or filed with, DBR and the payroll lock feature was a variation compared to most multiple-year deals into which Beacon entered.

A Beacon renewal form dated 9/2/1999 indicated that the city was self-insured until 1998, when it began receiving coverage from Beacon. Based on a letter dated 9/8/1998 from the insured's office of the finance director to an underwriter at Beacon, the city accepted Beacon's proposal for "a two year guaranteed premium and option for a third year." PowerComp data showed that this guaranteed premium was achieved by locking the payroll figure for multiple years.

During this initial three-year period, the account experienced a loss ratio of 135% and incurred losses exceeded premium by approximately $255,000. Payroll was listed as exactly $11,875,456 for each of the first three years in the Account Summary. Despite the loss history (the cumulative-to-date loss ratio on the account is approximately 90%) this insured has been provided credits no lower than 47% since the inception of the policy.

Relevant Finding 2

An underwriter notified us that the pricing of a community service organization might have been influenced by the fact that Donald Vass and an agent from one of Beacon's largest producing agencies were on the board of directors of the insured.

We located a renewal form dated 3/18/2002 that supported this assertion. This form, prepared by an underwriter, stated, "Generous pricing has been allowed to this insured in the past due to relationships between the insured, agent and Beacon." Also, we identified an Email on 2/19/2002 where the underwriter stated that this insured was inadequately priced due to a multiple-year deal.

We did not locate a multiple-year agreement or letter for this account; however, it appeared that this multiple-year deal began in 1999, as evidenced by the Account Summary, which showed the credits were unchanged at 60% from 1999 through 2001. During the three-year deal, credits were locked at 60% despite loss ratios of 158%, 95% and 94% during the three years, respectively. Losses exceeded premium by approximately $30,000 during this period. We did not find any documents that indicated that Vass or the agent explicitly influenced the pricing on this account.

This deal varied from other multiple-year deals in that it began six years after the policy was originally written (most multiple-year deals were made to at the initiation of the relationship with Beacon).

Relevant Finding 3

DBR received a written complaint from the bookkeeper of an insured against Beacon and an agent that alleged "insurance practice violations and perhaps even fraud." We performed additional procedures on this account.

Our procedures showed that Beacon covered the out-of-state exposure of a company in North Carolina despite knowing that it was not a Rhode Island employer. This coverage was not allowed under Beacon's statutes, but was done as a favor for one of Beacon's largest agents.

In his written complaint, the bookkeeper claimed that both Beacon and the agent failed to provide the insured with the policy declaration pages for 2001 and 2002. He also contended that Beacon and the agent ignored updated payroll submissions, and wrote the policy at much lower payroll estimates, which resulted in high additional premiums at the time of the premium audits. Also, the bookkeeper asserted that applying the appropriate rates to the additional exposure should have resulted in a lower additional premium than Beacon charged.

Based on this complaint, DBR contacted the bookkeeper and learned that the insured was not affiliated with a Rhode Island business.

The agent met with DBR in April 2006, and stated that he believed that the insured was affiliated to a Rhode Island company already insured with Beacon when he produced the policy. The agent agreed after the meeting that placing the North Carolina insured with Beacon may not have been appropriate.

We found a Beacon memo that explained that the supposedly-related Rhode Island account was owned by two brothers. The North Carolina company was owned by a third brother who continued to purchase insurance for this company through a Rhode Island agency after his move south. An Email from the agent to the underwriter of the policy indicated that the agent and the brothers have known each other for "30 years."

A Notepad entry dated 11/20/2003 documented a call between the underwriter and an employee from the Rhode Island business, who inquired about a balance for the North Carolina company on their invoice. The underwriter investigated the issue and sent a corrected invoice through the insured's agency. The Notepad entry stated that the two companies were "related" as a favor to the agent for the purpose of providing out-of state coverage under the Fairfield fronting arrangement:

> *Did reminder* [sic] *her via voicemail that we "related" the two policies as an agency accommodation so the [Fairfield out-of-state policy] could originally be written, and that the final audit balance must be paid.*

According to an underwriting manager, they believed that there was a corporate relationship based on representations made by the agent. There were several collections issues with the out-of-state policy and Beacon attempted to cancel both policies. When the Rhode Island insured responded that they were "not related" to the North Carolina entity, Beacon realized that they should not have written the business. The underwriting manager believed the agent had knowledge of the lack of relationship at the time the policy was brought over to Beacon.

Relevant Finding 4

Our procedures revealed that the insured was on a three-year deal, and that the agent was heavily involved in pricing.

Notepad entries and underwriting documents indicated that this insured was on a three-year deal for policy periods 1999 through 2002. We did not locate a formal agreement or letter that outlined the deal, but we did locate referral documents that noted that at the time the insured joined Beacon, its agent was the chairman of Beacon's Agent Advisory Council. The referral forms explained that the insured was a "key account" for the agent. Specifically, an underwriting manager wrote on a 7/7/2000 renewal form that the "Agent is chairman of Agents Advisory Committee…center of influence in community…will participate with Beacon on training video…credit is required for agency to retain."

During the three years of the multiple-year deal, the loss ratio for this insured was 124%. The loss ratio on this account from inception through the last completed policy year (3/7/2006) was 96%. Both of these loss ratio figures are significantly higher than Beacon's target loss ratio of 65%. Despite the poor loss performance experienced on this account, the insured continued to receive credits ranging from a low of 42% to a high of 64%. Based on Beacon's target loss ratio of 65%, writing the account caused Beacon and its mutual policyholders to lose approximately $315,000 from inception through 3/7/2006.

A letter from the agent, dated 3/1/2000, stated that the EMod factor utilized by Beacon was calculated by the agent by removing a Deny and Dismiss ("D&D") claim. A D&D claim is one for which an employer's liability for the injury is never established. The letter stated, "Under our understanding with Beacon Mutual, these [D&D] claims will not be counted in the experience modifier calculation in those cases where it can clearly be shown that the case was in fact a 'deny and dismiss' (where the employers liability for the claim is never established)." Our understanding is that any changes to an NCCI-promulgated EMod must be submitted to NCCI for consideration and approval. PowerComp data showed that an EMod of 0.85 was used for policy year 2000, which was lower than the two NCCI EMods issued for that policy year of 0.89 and 1.00, which were released on 1/5/2001 and 2/13/2001, respectively.

According to a Notepad entry, Beacon calculated the 2004 EMod using ModMaster for the same reason. Removing the D&D claim brought the EMod down from the 1.17 NCCI EMod available at the time of renewal to 1.16 as calculated by Beacon. NCCI did not approve this EMod.

<u>Relevant Finding 5</u>

Underwriting personnel explained that this insured might have received preferential pricing related to a change in agents. We queried PowerComp data for this insured and noted that it switched agents four times over the course of its term with Beacon, and credits usually increased upon a change in agent. We also identified the existence of a "special shared earnings" program that Beacon offered to this insured that was not in compliance with DBR filings.

The Account Summary showed that when the insured switched agents the first time, its credits increased by 41 percentage points effective as of 4/15/1997. The insured's loss ratio deteriorated and remained high for the next four policy periods (twice over 375%), but credits remained at 50% or higher from 4/15/1997 through 12/31/2000. The insured experienced a loss ratio of 192% for the first five policies that this agency produced, covering the period 4/15/1997 through 12/31/2001.

Beginning with the fifth policy under this agency, credits were reduced to 0% to account for the poor loss history. Over the period 12/31/2001 through 12/31/2004 credits remained at 0% and the loss ratio improved to 34%. Credits were reestablished when the insured switched agents effective 12/31/2004 to one of Beacon's largest agencies. Originally, they were provided credits of 15%, but that was increased to 47% effective as of 12/31/2005.

Our procedures also showed the existence of a "special shared earnings" program that was proposed by this agency and approved by Clark. This special shared earnings program was not compliant with any of the four shared earnings programs that Beacon filed with DBR.

An Email chain between the agent and the underwriter, beginning 11/24/2004, showed that the agency negotiated with Beacon to develop a customized credit and shared earnings plan. On 11/29/2006, the agent suggested a new pricing scheme because, "We are concerned that [a competing carrier] is in there quoting this [workers' compensation] policy now." The agent concluded her Email by writing, "Dave [Clark] basically told [the agency] what you told me last week: you trust us to make the right decision."

The underwriter responded and wrote, "…if you wanted to offer a 'creative' dividend plan at 10% credit, we're fine with that also." The last two Emails in the chain were from the agent and attached was a document that calculated premium given various credit and dividend plan scenarios. The document suggested that if the loss ratio was 38%, the insured would have been part of Beacon's filed shared earnings plan called SE-9601, whose minimum payout was 9.7% of standard premium pending loss prevention performance. If the loss ratio was between 38% and 50%, [the insured] would have received a 10% dividend, and if the loss ratio was between 50% and 55%, they would receive a 7% dividend.

According to Beacon's Underwriting Manual, "Beacon has 4 shared earnings plans. These are filed plans and can not [sic] be deviated from." Our understanding, which Beacon's filing with DBR supported, is that the inclusion of an insured in a shared earnings program "would be clearly identified upon issuance." The "special shared earnings" program described above apparently relied on actual performance to assign the shared earnings plan after the fact.

The valuation date for loss ratios relative to shared earnings plans is generally 18 months from the inception of the policy, which translates to six months after the policy expiration. The policy that participated in the special shared earnings plan ended on 12/31/2005. We were provided with the Account Summary as of 7/31/2006, which showed that the loss ratio for this policy year was 44%. This would have qualified the account for a 10% shared earnings payment of approximately $49,000. On 8/28/2006 Beacon's finance manager confirmed that Beacon did not pay out any dividends to the insured in July 2006 along with the payments to qualifying policies that expired in December 2005. We asked Beacon personnel whether it was their intention not to comply with the agreement and not pay the $49,000 and the underwriter responded on 9/1/2006 confirming that nothing had been paid out at that point. The underwriter also forwarded an Email where the agent asked about how much the dividend may be and the underwriter responded that it would be further discussed at a team meeting taking place in late September. On 9/25/2006, we were notified that Beacon's management decided, "[the insured] will be receiving a payout based upon our filed SE9601 plan. Using the standard calculation factors for that plan, their loss ratio as of 6/30/06 is 44%, which equates to a payout of $53,703, which will be processed this week."

An underwriting manager claimed that Clark approved the special shared earnings plan, but that it was eliminated on the renewal because it was not a filed plan. The underwriting manager explained that additional credits were granted on the renewal to make up for the difference. Beacon increased credits from 15% to 47% on the 12/31/2005 policy and added the SE-9601 shared earnings plan, which Beacon's Underwriting Manual described as "the most aggressive plan."

Relevant Finding 6

Our procedures showed that this insured negotiated with Beacon to receive a lower Class Code rate. The company has been insured with Beacon since 1/1/2002, and is in the business of providing record storage, management and destruction.

Based on the procedures performed, the insured disputed Beacon's use of Class Code *8292 Storage Warehouse NOC*, which carried an NCCI rate of $11.96, for record librarians and filed a complaint with DBR. It appeared that Beacon negotiated with the insured and agreed to a different Class Code rate of *8013 Store: Jewelry – Retail or Wholesale,* with a rate of $1.87, in return for the withdrawal of the complaint. DBR did not take a position on the complaint as it was withdrawn before the investigation was complete.

The loss ratio for this account was 219% from the inception through the policy ended 1/1/2006 despite the lack of any credits including schedule, consent-to-rate, CompAlliance or Loss Free credits. In addition, there was a consistent increase in NCCI EMods from 1.11 issued on 2/8/2002 to the most recent EMod in our data of 1.88 issued on 2/14/2006. Both of these factors represented a strong indication of misclassification. Based on Beacon's target loss ratio of 65%, this account resulted in over $200,000 of losses in excess of target losses in only four years of coverage despite not being provided any credits.

An officer of the company wrote to Beacon premium audit personnel on 10/29/2003, and argued that record librarians should be classified as Class Code *8810 Clerical Office Employees NOC*, with a rate of $0.48. She stated that destruction and recycling operations, which caused Beacon to classify record librarians as Class Code 8292, were performed by a third party, and that record librarian duties consisted only of data entry, file retrieval and delivery. The insured argued that over $340,000 of payroll should be reclassified as Class Code 8810.

The insured filed a complaint with DBR on 11/24/2003. A series of Emails between Beacon personnel and the insured's agent, Beacon's largest agent, described the issue and showed that as a resolution to the matter, Beacon and the insured agreed to use the lower

8013 rate. Specifically, an underwriter wrote in a 4/22/2004 Email, referring to a 2/20/2004 visit to the insured:

> *In discussion with the insured and the agent it was agreed that we would be comfortable with the classification of 8013 Wholesale Store Jewelry. In prior discussion with the audit supervisor it was determined that this classification was the lowest rated wholesale classification in the manual available for use. The audit supervisor believed that the exposure was closely matched to a wholesale operation due to the substational [sic] storage activities and the activity of retrieval that are being conducted. The insured agreed to withdraw the complaint filed with DBR if we changed the classification for the record librarians only."*

The insured formally withdrew its complaint with DBR on 2/26/2004.

We read a policy declaration page dated 5/14/2004 that showed an "estimated" premium and an "audited" premium. The main difference between the estimated and the audited premium was $340,168 of payroll that was moved from Class Code 8292 to Class Code 8013. This change resulted in a return premium of $34,632.

We discussed this issue with the underwriting manager, who provided us a page of the January 2006 Scopes manual showing that Class Code 8013 covers a variety of job descriptions under the heading "Stores – Light Merchandise." None of these, however, appear to be similar to the work performed at the insured. Further, the insured is not a store that sells merchandise, but a record management company.

The underwriting manager also claimed that he visited the insured's facility and observed that record librarians were several women who predominantly sat at desks and computer stations and occasionally retrieved files from storage. He said that the files were generally in manila folders or red rope binders and easily moved. He explained that it was his decision to utilize the 8013 Class Code and felt that it appropriately reflected the risk.

In April 2004, the premium audit manager disagreed with the underwriter's characterization of her involvement in the decision to use the lower Class Code rate where he indicated, "the audit supervisor believed that the exposure was closely matched to a wholesale operation due to the substantial storage activities of retrieval that are being conducted." The premium audit manager stated on 4/22/2004, "I did not recommend [Class Code 8013 to] be used…you stated that [the auditor] was correct in using 8292 but if it were to come to a hearing board class code dispute you would argue for *8018 Wholesale Store*…It was your decision to choose 8013 and you should take responsibility for it." The underwriting manager responded:

> *The use of the class averted a full rate hearing before DBR and the associated costs that go with it. I made the decision to use the class and I would stand by it. I also take credit for the results of the activity (the withdrawal of the complaint). No one wins in those situations….I can guarantee that whatever the premium we*

> *are giving away it is less than the cost of litigation involved here…This is the right thing to do for the agency, Beacon, and the insured.*

The workers' compensation statutes provide that an insured dissatisfied with classification codes may appeal the carrier's decision to an arbitration panel with a further appeal to DBR if the insured is not satisfied with the results.[120] The only classification hearing held in the last six years was the same case that the underwriting manager raised in his argument, which resulted in a decision in Beacon's favor. Therefore, the threat of litigation costs should not have swayed the underwriting department to diverge from the appropriate classification.

<u>Relevant Finding 7</u>

Underwriting personnel informed us of an insured, a construction company, which was being priced with a "composite rate." We learned that this account was written with two overlapping in-state policies, for the periods 5/1/2003 through 5/1/2004 and 5/1/2004 through 5/1/2005. There was a main policy and a second policy for a specific construction project. An underwriting manager explained the latter was a retirement community that the company was the general contractor for and the project represented 75% of its operations. He also recalled that the company lost this specific construction project.

Based on the results of our procedures, the use of a composite rate was discussed at Beacon, but it was not clear if a composite rate agreement was entered into.[121] We also found that Clark approved a special commission deal with the agent for five years. Finally, we found that Beacon retroactively modified the credit percentage on a policy in order to generate a $43,605 refund to the insured. See the "Retroactive Credit Adjustments" section for more information on this practice.

The renewal for the policy period 5/1/2004 through 5/1/2005 noted the "policy will be based upon a 'net composite rate' (excluding experience modification) of $12.77 per $100 of payroll. If the program maintains a loss ratio below 70% the composite rate will remain the same. If the program loss ratio goes between 70% and 90%, then a 5% maximum rate increase could be applied. If the program loss ratio exceeds 90%, then a maximum rate increase of 10% could be applied." The contingent pricing deal described above was never filed with DBR and represented a deviation from standard, approved

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[120] The underwriter's characterization of this procedure as a rate hearing is incorrect. A rate hearing is a proceeding before DBR to determine a whether a proposed rating *system* is appropriate. It appears that the employee was referring to a classification hearing where an individual insured has appealed the carrier's payroll classification. These appeals are significantly less complex and less costly than a rate hearing.

[121] Just as multiple-year deals appear as "Book Method" policies according to the paperwork on file and the policy declarations issued, the substance of the policies drives the appropriateness of the underwriting methodologies. If both the insured and Beacon understand it is a composite-rated deal, and Beacon intends to follow its word, it is a composite-rated deal.

"book method" pricing. See the "Statutory Violations" section for more information on composite rating.

We also found that a special commission deal was entered into with the insured's agent. Notepad entries stated that a "5-year deal" was made with the agent at the inception of the second policy, 5/1/2003, to pay his agency an 8% commission each year. This commission rate was accurate for the first year of the policy as it represented "new business;" however, the additional 2% on subsequent renewals represented an amount in addition to Beacon's contractual obligation. Notepad entries indicated that the existence of this commission was known by underwriting personnel and approved by Clark. According to Beacon's Underwriting Manual, Clark himself declared, "Never give [an] 8% commission renewal. The only commission we have on a renewal is 6%." See the "Statutory Violations" section for information on commissions paid in excess of contractual obligations.

We also found that Beacon entered into a "Special Shared Earnings Plan" with the second policy and that Beacon retroactively increased the credits on the policy after expiration in order to generate a refund to pay the shared earnings. A Notepad entry dated 3/7/2005 stated, "Per [the underwriter's] request I changed the 03 [credit] to 42% and processed a revised even audit to move the remainder to the ar. Premium from original audit was $169,880.... premium from credit changed audit is $126,275 so the correct return premium amount of $43,605 is on the AR." See the "Statutory Violations" section for more information on special shared earnings programs.

The terms of the "Special Shared Earnings Plan" indicated that the plan was developed by Beacon and the agent to value job site losses at the specific construction project, and include losses and premiums generated by subcontractors working on the jobsite whose annual payroll exceeded $10,000. It was a five-year plan, with profitability calculated twice per policy year after expiration with a portion returned to the insured dependent upon the profitability of the project. The first calculation was made six months after expiration with a 75% payout of the calculated amount and the second calculation was to be made a year and a half after expiration when the remainder would be paid.

We obtained the profitability calculations that showed the change in credits from 22% to 42%. Based on these documents, the insured "earned" the additional credits because its calculated loss ratio was 45%. Based on the results of the procedures performed in the "Retroactive Credit Adjustments" section, we found that Beacon retroactively adjusted the credit structure to generate a refund in accordance with the "Special Shared Earnings Plan."

Specifically, we found that, on 3/7/2005, Beacon increased the credits on the 5/1/2003 through 5/1/2004 policy from 21.8% to 42.0%. This change occurred approximately 10 months after the expiration of this policy period and generated a premium reduction of $43,605, which was posted to the accounts receivable balance. On 3/15/2005, Beacon paid the insured 75% of this amount, $32,704. The remaining $10,901 remained as a credit in the accounts receivable balance and appeared to be applied against a future invoice.

Relevant Finding 8

An underwriter mentioned that the account of a general contractor who builds commercial, industrial and educational facilities in both the public and private sectors had combined pricing of in-state and out-of-state policies. See the "Out-of-State" and "Statutory Violations" sections for more information on combining policies.

This insured's Rhode Island policy cumulatively experienced a loss ratio of 92% through the last completed policy period of 4/1/2006, which was 27 points higher than Beacon's self-reported target loss ratio of 65%. We read the Account Summary, which showed that the out-of-state policies had a cumulative loss ratio of 105% through its last completed policy period of 4/1/2003. Notepad entries indicated that Beacon attempted to recover some of its losses on the out-of-state policy by charging a 50% debit on the 4/1/2001 – 4/1/2002 Rhode Island policy.

The year the 50% debit was given resulted in a loss ratio of 4% for the Rhode Island policy and a loss ratio of 20% for the out-of-state policy. An underwriter entered the following Notepad entry, dated 2/26/2001, that showed that the amount of the debit on the Rhode Island policy was dependent on the pricing of the Fairfield (FWC) policy:

> *In preparation for renewal meeting with agt on 2/27 we are doing 4 quotes. 2 w/ interim payroll 20% and 50% debit and 2 at expiring payroll 20% & 50% debit. Amount of debit depends on FWC.*

A renewal form dated 2/21/2002, for the 4/1/2002 through 4/1/2003 policy year, showed that Beacon was concerned about the high loss ratio of the out-of-state policy. Clark had a handwritten note to the underwriter on the form that stated, "The FF [Fairfield] has killed us – Is it necessary to renew the FF policy?"

We found that Beacon did not debit this account until the agent was switched from one of Beacon's largest producing agencies to a much smaller agency[122] effective 4/1/2001. In the three policy years before switching to the smaller agency, the insured's combined loss ratios (in- and out-of-state) were 170%, 143% and 163%, respectively. Despite these high loss ratios, Beacon provided credits of 33% to 60% on its in-state policy. For the policy year effective 4/1/2001, the first year with the smaller agency, Beacon eliminated the in-state credit and applied a 50% debit. As a result, the combined policy premiums increased from $317,988 to $613,033 (a 93% increase). The following table summarizes the combined premium and loss experience on the account.[123]

[122] According to PowerComp data for the period 2003 through 2005, this smaller agency ranked 111th in terms of total written premium compared to the other agency, which ranked as the 2nd largest agency.

[123] Beacon did not renew the out-of-state policy after the completion of the 4/1/2002 through 4/1/2003 policy year.

Policy Effective Date	Combined Payroll	In-State (Credit) / Debit	Combined Premium	Combined Losses	Combined Loss Ratio
4/1/1998	$ 5,553,476	-60%	$ 244,746	$ 415,745	170%
4/1/1999	$ 6,424,167	-33%	$ 441,162	$ 628,939	143%
4/1/2000	$ 5,622,221	-34%	$ 317,988	$ 518,628	163%
4/1/2001	$ 7,265,703	50%	$ 613,033	$ 87,491	14%
4/1/2002	$ 5,549,614	0%	$ 316,874	$ 445,511	141%
4/1/2003	$ 1,765,431	0%	$ 70,497	$ 10,492	15%
4/1/2004	$ 1,815,792	-5%	$ 51,403	$ 1,449	3%
4/1/2005	$ 2,068,138	-5%	$ 57,711	$ 3,284	6%
TOTAL			**$ 2,113,414**	**$ 2,111,539**	**100%**

During the period 4/1/1998 through 4/1/2003, Beacon offered out-of-state coverage to the insured. In each of these years, the out-of-state premiums were higher than the in-state premium. In fact, the out-of-state premiums for each of these five policy years were 90%, 94%, 72%, 64% and 60% of the total combined premiums, respectively. See the "Out-of-State Policies" section of this report for more information.

Relevant Finding 9

This insured was a professional employer organization ("PEO") that contracted with client companies to provide workers' compensation and other employer-related services. For a period of time, this insured's policy was the largest policy written by Beacon.

Based on the results of our procedures, we found that Beacon agreed to a single composite rate for the 1999 and 2000 policy and a dual composite rate for the 2001 policy. We also found Beacon provided the insured with a multiple-year deal and other concessions, as detailed below.

Composite Rate – An Email dated 10/29/1999 from the insured's agent, which was one of Beacon's largest agents, to Beacon requested confirmation for a few outstanding items for the 12/31/1999 policy. The agent requested confirmation of the $2.986 composite rate for this policy, as well as confirmation that any additional premium resulting from the audit would be based on this rate. According to the Email, the rate was calculated by dividing the "Premium Necessary to Cover" of $2,866,677 by $96,000,000 in payroll.

The agent also wrote, "We suggest using a Composite Rate for the $3,172,680 of Modified Standard Premium of $3.305 ($3,172,680 divided by $96,000,000 in payroll) to determine the final premium that will be used to determine the dividend. The composite rate is higher because you used a lower payroll number - please support this payroll number."

An underwriter informed us that "For the 2001 renewal term we [Beacon] went from a single composite rate to a dual composite rate based on class code. The rates were 1.40

and 4.73." We followed up with the underwriter on 9/18/2006 and asked if they could provide the reasoning and the calculation behind the dual composite rate, but they could not recall the reason.

Multiple-Year Deal – The agent also asked an underwriting manager to confirm the details for the multiple-year deal as well as the terms for the shared earnings program that was established. The agent asked the underwriting manager to confirm that the first year payment would be $2,666,677 divided by 10 monthly installments of $266,667.70. The Email indicated that Beacon's response was, "We are willing to defer $200,000 of the premium in anticipation of projected future shared earnings distributions. Depending upon the shared earnings plan selected, we will require the premium deferral to be paid when the incurred losses reach either 1,250,000 or 1,500,000 respectively."

Class Code Exclusions and Risk Manager Subsidy – An Email from an underwriter to Clark on 6/29/2000 also showed that the policy was priced with a composite rate. The Email contained documents that listed the 1999 policy composite rate, as well as multiple 2000 policy composite rate projections based on different payrolls. The projection sheets listed one projection where Beacon had excluded certain Class Codes that had loss ratios greater than 70% and were characterized as "Bad Guys." There were six Class Codes ranging in loss ratios from 157% to a high of 5,709%. By excluding these Class Codes, Beacon was able to calculate a composite rate that equaled the 1999 composite rate. There was also an "Assumptions" page that noted that the insured should hire a Risk Manager and that Beacon would subsidize $3,000 per month for the individual's employment with the adjustment to be made at the final audit.

Pricing and Financial Performance – Beacon covered the account from 8/31/1999 through 12/23/2002 and throughout that period, Beacon covered over $189.9 million of the Rhode Island payroll totaling approximately $6.8 million in Rhode Island premium. Throughout the same period, Beacon covered over $101.6 million in payroll totaling approximately $3.5 million of out-of-state premium.

The insured's in-state and out-of-state policies were unprofitable in terms of absolute dollars over the years. Based on Beacon's target loss ratios of 65% for in-state business and 47% for out-of-state business, writing this account cost Beacon and its mutual policyholders approximately $3.1 million as highlighted in the table below. (The following data was based on a February 2006 Account Summary, and considered completed policy periods only.)

Policy Location	Number of Completed Policy Periods	Total Earned Premium	Total Claims Incurred	Actual Loss Ratio	Target Loss Ratio	Target Losses	Excess Losses
Rhode Island	5	$ 6,810,277	$ 5,738,267	84%	65%	$ 4,426,680	$ 1,311,587
Out-of-State	5	$ 3,537,392	$ 3,467,915	98%	47%	$ 1,662,574	$ 1,805,341
Total		**$ 10,347,669**	**$ 9,206,182**	**89%**		**$ 6,089,254**	**$ 3,116,928**

An underwriting manager explained that as a PEO, Beacon invoiced the insured, which then billed its client companies individually, but that Beacon did not have visibility to the amounts paid by the clients. The underwriting manager maintained that Beacon considered the individual payrolls and classifications of all client companies when they priced the account and that a "composite rate" was not used.

The underwriting manager recalled that this account was referred to Beacon by their second largest agency and Solomon "jumped on it." Beacon not only covered the insured's in-state policy, but over 30 different out-of-state policies through Fairfield as well. Loss prevention discovered that the insured might have been using a contractor that would pose extreme risk to Beacon. According to the underwriting manager, the insured denied having a relationship with this contractor, but Beacon did not feel comfortable continuing to insure the company, and, they cancelled the policy at the end of 2002.

<u>Relevant Finding 10</u>

An anonymous source called DBR during its Market Conduct Examination in the fall of 2005 and claimed that excess and improper credits were issued to a large bank and other financial services institution.

In addition to the procedures conducted for the majority of insureds in this section, we included this insured in our SIC Code queries (see the "SIC Code" section for procedures performed). The findings on this bank from the SIC Code section have been incorporated into the discussion below.

Through our procedures performed, we noted the following:

- Over 85% of combined Rhode Island and out-of-state premiums, as of effective date 1/1/2005, were from out-of-state policies.
- Beacon provided very significant credits on its in-state policies to offset the high out-of-state rates.
- The combined in-state and out-of-state policies were unprofitable in terms of absolute dollars over the years, resulting in $3.4 million in losses in excess of Beacon's target losses.
- There was little due diligence performed in the schedule rating process for the 2006 out-of-state policies.

- The insured received more preferential pricing compared to its peers in the same SIC code.
- There was a multiple-year deal, where the EMod was locked for several years.
- Beacon employees expressed concern that the account was too large for Beacon to handle.
- Beacon "forced" a retroactive increase to the credits on the 2002 policy in order to force a refund of approximately $139,000 which was applied to pay off the balance of their out-of-state policy.

Pricing and Financial Performance – Beacon began writing the account on 5/1/1998 and started covering some of its out-of-state exposure two years later as of 5/1/2000. Since 2000, the bank has grown through acquisition of financial services companies across the United States. Beacon continued to cover much of the bank's out-of-state exposure under their fronting arrangements. For the policy year 1/1/2005 through 1/1/2006, Beacon covered over $578.4 million of the insured's non-Rhode Island payroll totaling approximately $2.2 million in out-of-state premium compared to $163.7 million and $0.3 million of in-state payroll and premium, respectively.

In order to price the "whole package," including the in-state and out-of-state premiums, Beacon provided very significant credits on its in-state policies ranging between 60% and 71%. For the policy effective as of 1/1/2006, Beacon's credit structure of 71% translated to a discount of over $972,000 on the Rhode Island policy. See the "Statutory Violations" section for information on combining policies.

Despite the fact that Beacon was limited in pricing flexibility on the out-of-state policies, both the in-state and out-of-state policies were unprofitable in terms of absolute dollars over the years. Based on Beacon's target loss ratios of 65% for in-state business and 47% for out-of-state business, writing the account cost Beacon and its mutual policyholders approximately $3.4 million as highlighted in the table below. (The data below was based on a February 2006 Account Summary, and considered completed policy periods only.)

Policy Location	Number of Completed Policies	Total Earned Premium	Total Claims Incurred	Actual Loss Ratio	Target Loss Ratio	Target Losses	Excess Losses
Rhode Island	8	$ 2,361,798	$ 2,756,339	117%	65%	$ 1,535,169	$ 1,221,170
Out-Of-State	6	$ 7,150,332	$ 5,497,125	77%	47%	$ 3,360,656	$ 2,136,469
Total		**$ 9,512,130**	**$ 8,253,464**	**87%**		**$ 4,895,825**	**$ 3,357,639**

Schedule Rating – Underwriting, premium audit, and loss prevention personnel did not visit out-of-state branch locations. In fact, we were told that other than several trips by loss prevention personnel to certain processing facilities, Beacon personnel have not seen the operations of this multibillion dollar corporation for which they wrote $2.5 million in premium in 2005. We read the schedule rating plans for the 1/1/2006 out-of-state policy renewal. There were 20 schedule rating plans for each of the states outside of Rhode Island where Beacon covered the bank's exposure. Our understanding of schedule rating, which was confirmed in discussions with underwriting personnel, was that each location (state) should be evaluated for its performance in each of the schedule rating characteristics against its class. One schedule rating plan was copied 19 times, assigned the maximum 25% schedule credit (with a few exceptions), and a different state name was written across the top of the page alphabetically from Arizona to Virginia. The schedule rating plan for New Hampshire varied slightly, but still offered the 25% credit listing "Good Housekeeping," "Training," and "Safety Committee" as the support. The comments at the bottom of the page were exactly the same for every other state:

> *Discussed with…VP of Safety at [insured]. All branches + processing ctrs have the same safety program + standards throughout the country.*

The schedule rating plans for Georgia, Indiana and Virginia deviated from the 25% schedule credit and awards 15%, 50% and 15% credits, respectively. The form used on the Indiana schedule rating plan indicated that the maximum credit was 25% despite the fact that 50% credits were provided. It did not appear that the appropriate level of due diligence was performed in the schedule rating process for these out-of-state policies.

We asked an underwriting manager about the schedule rating process and documentation for this renewal and he explained that it was "unacceptable."

SIC Code Comparison – We performed a comparison of peer companies assigned to the bank's SIC code, which revealed that the bank's pricing was not comparable to its industry, on average. For the comparison, we queried the data for all insureds in SIC code *7389 Business Services NEC* that had similar business operations to the insured.[124] The data was limited to Rhode Island policies only due to the lack of credible out-of-state policy data in PowerComp. The data showed that the bank was the largest insured in its industry, with average payroll of approximately $137 million, almost eight times that of the second largest insured in its SIC code. At the same time, its cost per $100 payroll was the lowest in the industry, averaging approximately $0.22.

Incorrect EMod – We also noted that for 1998 through 2000, the EMod listed in PowerComp did not tie to any of the NCCI EMods issued during those years. According to the Beacon account summary, the EMod for those three years remained constant at

[124] SIC codes are entered by underwriting when new business is entered into PowerComp. There was no check performed to determine whether the SIC code entered accurately represented the business operations of the insured. In many cases, we found that the SIC codes appeared to be inaccurate. This SIC code appeared to be over-inclusive and contained businesses with operations substantially different than the insured. For the purpose of this test, we scanned the list of Beacon insureds in this SIC code and judgmentally isolated financial service institutions for our comparison against the insured.

0.91. Maintaining a stable EMod was one of the ways that Beacon had affected stable pricing plans for some of its insureds.

We re-performed the premium calculations based on the NCCI-promulgated EMods for 1998, 1999 and 2000 premiums as reported. There were multiple EMods issued by NCCI for each of the three years. For the purpose of our recalculation, we calculated an average NCCI EMod for each year of 1.27, 1.26, and 1.29 for 1998, 1999 and 2000, respectively. The calculation was based on Rhode Island data only.

Year	Original EMod Factor	NCCI EMod Factor	Original Written Premium	Adjusted Written Premium	Difference
1998	0.91	1.27	$ 179,462	$ 250,403	$ 70,941
1999	0.91	1.26	$ 184,528	$ 253,397	$ 68,869
2000	0.91	1.29	$ 214,028	$ 301,118	$ 87,090
TOTAL			**$ 578,018**	**$ 804,918**	**$ 226,900**

Based on the table above, our calculations showed that Rhode Island premiums would have been $226,900 higher over the three-year period 1998 through 2000 had Beacon utilized the NCCI EMods.

Multiple-Year Deal – We also noted a 5/5/1998 Notepad entry written by an underwriter that stated, "[The underwriting manager] has agreed to a 3 year rate guarantee on this policy." We asked underwriting personnel to provide us with any information relating to the above Notepad entry and the underwriting manager stated in an Email on 9/14/2006, "It was not unusual at that time for us to take a risk out of self insurance and to guarantee [sic] pricing stability over a 3 year period. I believe that was the case for [this insured]. There is no written record of such an agreement…We have tried to maintain pricing stability on this account since our involvement." An Email from the underwriting manager to Clark and the underwriter on 2/25/2004 further supported the claim that Beacon discussed maintaining pricing stability and stated the "…original telephone conversation with me indicated [the agent] was not sold on the 3year [sic] deal."

Servicing the Account – During interviews, Beacon underwriters expressed concern about the size of the account and the lack of resources to handle it. We discussed the fact that Beacon personnel did not travel to many out-of-state operations. In addition, the underwriter mentioned that premium audits were conducted only at the Rhode Island headquarters. The insured sent branch payroll and other information to headquarters for processing. The insured was also not cooperative with Beacon on premium audits. The lack of cooperation contributed to excessive delays in the completion of premium audits. For example, the premium audits for the policy years 5/1/2002 through 5/1/2003 and 5/1/2003 through 5/1/2004 were completed approximately 10 and 21 months after their respective policy expiration dates.

The underwriter repeatedly asked to be removed from the account and felt that Beacon should not have renewed the out-of-state policies because they were too cumbersome to handle. Another underwriter also mentioned that the account was too large of an account for Beacon to handle and explained that underwriting this account was "a full-time job." Underwriting personnel claimed that they "couldn't even talk about non-renewal [of the out-of-state policies]" because of the size of the account. One day after the Almond Report was issued, the underwriter wrote an Email to Clark and reiterated his request to be removed from the account. Clark reportedly approached the underwriter and warned him, "never put something like this [the request for removal] in writing," and refused to change the underwriting assignment on the account.

An underwriting manager stated that he developed the original proposal for the insured's business. At the time, all Beacon wanted was the Rhode Island exposure but, two years later, Beacon was given the opportunity to bid on the out-of-state business and management jumped at it. The underwriting manager said that he was "not sure it was the right thing to do." He said that the account was "misaligned" with Beacon's resources. "We wanted to believe we could handle it, but we couldn't."

Retroactive Adjustments – Based on the procedures we performed described in the "Retroactive Credit Adjustments" section, we identified a retroactive adjustment to the credit structure that was posted after the expiration date of the policy.

An underwriter explained that, on 10/3/2005, Beacon increased the credits on the policy period 5/1/2002 through 5/1/2003 from 50.0% to 62.4%. This increase in credits, approximately two and a half years after the policy expiration, resulted in a decrease in premium of $139,445 which was posted to the accounts receivable balance. Based on the accounts receivable summaries, we found that Beacon used $139,386 of this amount to apply to the out-of-state policy. According to the underwriter:

> *The credit was increased to 62.4% on policy # 19104 to force a return premium large enough to transfer to policy # 1100000793 to pay off the balance due on that policy of $139,386. The return premium of $139,445 that was developed from the 62.4% credit was as close to $139,386 as we could come to the $139,386 amount that was needed. The $139,386 was then moved from policy #19104 to policy # 1100000793 and the difference of $59.00 was left on policy #19104.*

The underwriter further explained this situation to us and said that Beacon had quoted the bank a "firm price" for their out-of-state policy one to two months before the renewal period. He claimed that during the period between the quote and the renewal, several of Fairfield's rates had changed without notice to Beacon and an additional out-of-state location was added to the policy.

These changes resulted in a higher out-of-state premium, and the underwriter noted, "It was decided that because we had quoted [the bank] a firm price for the renewal we could not charge them any additional premium for that policy term. It was then decided to increase the credit on the RI policy to get enough of a return premium so that we could transfer the return premium to the Fairfield policy and off set the monies due from the rate increases that had taken place after we quoted the premium." The underwriter explained that the underwriting manager made this decision.

Relevant Finding 11

We found that there appeared to be a *quid pro quo* arrangement involving this insured and a vice president. The insured, a general contractor in the business of remodeling kitchens, baths, installing replacement windows and doors, deck work, along with small additions for residences, performed work on the houses of a Beacon vice president and president of Beacon's largest agency (whose agency is also producer of this account). The contractor inquired about a discount and the vice president referred him to this agency. Our procedures showed that the insured received 20% credits for three years totaling approximately $13,000 in discounts.

We selected this insured based on an Email dated 6/20/2005 between two underwriters that indicated a "…contractor that got [received] a 20% credit for fixing up [a vice president's] house." Based on the results of the procedures performed, the facts appeared to support the existence of a *quid pro quo* arrangement involving this contractor and the vice president.

This policy was produced by Beacon's largest agency from its inception on 12/23/2002; however, credits were not applied to the account until the 12/23/2003 policy year.

Beginning with the policy period effective as of 12/23/2003, the insured received 20% credits for three years totaling approximately $13,000 in discounts. The vice president confirmed that the insured performed work on both his house and the house of the agency president. The vice president also confirmed that the insured complained about the price of his workers' compensation premium so the vice president suggested that the insured talk with the president of his agency. The vice president recalled saying "whatever I could do for you, [the president of the agency] could do much better."

We located an Email dated 10/24/2003 where an underwriter indicated that they proposed a 5% schedule credit for the 2003/2004 policy after the contractor's wife called and inquired about a reduction in price. The same underwriter forwarded this Email on 10/31/2003 to Clark with a blind copy to an underwriting manager and stated, "We allowed a 20% schedule credit...[An agent from the agency] also called [the agency president] after he talked to [the vice president] and or you because he did not get an answer. He is [the agency president's] next door neighbor. Just in case you get a call."

We located a schedule rating form dated 12/18/2004 prepared by an underwriter which supported a 20% schedule credit on the 2004/2005 policy period. To support this credit, the underwriter wrote, "talked to [the vice president] of Beacon who just had his home redone by insd...good housekeeping, safety glasses used during operations, very cooperative with homeowner during remodeling operation."

On 1/8/2007, Beacon's counsel delivered us a copy of a Report of Investigation and supporting information related to this matter. It is our understanding that Beacon's board of directors authorized Beacon's counsel to perform an investigation into the pricing of this account and Beacon's counsel hired a third party to perform the analyses and interviews. We read the report, which was dated 12/18/2006 and its supporting documentation which included interview summaries and transcripts. In addition to Beacon employees, the investigators also interviewed representatives from the agency and the insured.

The report indicated that the underwriter recalled a meeting they had with Clark between 10/24/2003 and 10/31/2003 and during this meeting, Clark informed the underwriter that the insured was performing work on the vice president's residence and that the underwriter should increase the schedule credit on the account to 20%. The underwriter reportedly "did not feel the 20% credit was fair, as it appeared to be based on the fact that the insured was doing work on [the vice president's] house and not because of a favorable loss history." The underwriter also indicated that, in the normal course, the policy's credits probably would have increased from the original 5% proposed credit on subsequent renewals because of the positive loss performance, but was not able to state that a 20% credit would have been warranted in hindsight.

The investigative report also included the following findings deemed relevant to this matter by DBR:

- The investigators were not able to determine how Clark learned of the relationship between the insured, the agency president or the vice president. Clark reportedly denied Beacon's counsel's request for an interview on the advice of counsel.
- The vice president, when questioned by Beacon's counsel's investigators, "denied ever requesting or receiving any benefit [from the insured]…in exchange for [their] influence and position at Beacon" and denied having any discussions with agency personnel, Clark or the underwriting manager concerning the account.
- The vice president did recall several conversations with the underwriter about the account in passing during November 2003. He reportedly relayed a message to the underwriter that the contractor was expecting a telephone call from Beacon related to a complaint, perhaps relating to a premium audit. The vice president recalled "several men's room discussions" between himself and the underwriter where the work the insured was doing on his home was mentioned. He also indicated that the discussions were in jest and characterized them as "a running joke."
- "[The vice president] denied having influenced or attempting to influence any employee of Beacon in the performance of their duties, other than [their] position requires."
- When asked about these bathroom conversations, the underwriter could only recall one conversation with the vice president. The underwriter reportedly

initiated the discussion and "mentioned to [the vice president], in jest, that [the contractor] had received a discount." The underwriter reportedly recalled that this was "the only conversation he had with [the vice president] about the…matter."

- The underwriter admitted that the comments included on the 12/18/2004 schedule rating form attributed to a conversation with the vice president were based on assumptions. The underwriter did not have a direct conversation with the vice president before making these statements. The underwriter explained that these comments were added "to cover" himself. According to a transcript of this interview, the underwriter explained, "Well, it's a little unusual that we gave a credit originally for what I had thought was work being done on [the vice president's] house. So I just put it down to cover myself."
- According to the interview transcript, the underwriter indicated that he was uncomfortable with the pricing decision, but he had no choice but to follow Clark's directions.
- The report indicated that the contractor "stated that he did not receive any favoritism on his Beacon policy due to his working on the [Beacon vice president's] job. He also denied giving [the Beacon vice president] any discounts or credits due to [the Beacon vice president's] position with Beacon or the premium credits on the account."
- The insured reportedly "recalled one conversation with [the Beacon vice president] in the fall of 2003 concerning possible credits on his policy." The contractor reportedly recalled that the vice president referred him to the agency. He claimed that this was "'probably' the only discussion he had with [the vice president] about the Beacon policy."
- The agency president reportedly "denied talking to anyone at Beacon, including Clark, about the…policy." The agency president reportedly explained that the contractor had performed construction services at his residence "off and on for fifteen to twenty years."
- Another agent from the agency reportedly explained that "going from a proposed 5% schedule credit to a 20% schedule credit, in his experience is unusual. [The agent] felt that such a change in credit would probably have to be justified to Beacon Mutual Insurance. [The agent] said that [the underwriter] may have justified the change to him, but does not recall any such discussion, and agreed that no justification would be necessary for [the agent], as he would welcome the credit for his firm's client."

Relevant Finding 12

We found that the policy for this insured was cancelled for nonpayment; however, Solomon directed underwriting, as an agency accommodation, to reinstate coverage, which required the policy to be backdated three months. We selected this insured based on an Email dated 3/4/2005 that was sent from Solomon to Clark with a copy to the underwriter. In this Email, Solomon indicated that the agent for the insured had asked him for a favor. Solomon wrote, "[The agent] personally stands behind this insured and asked that we make accommodations. The urgency stems from the Department of Labor's involvement with a gap in coverage…I have asked [the underwriter] to…accommodate whatever [the agency's] request maybe [sic]…." The underwriter stated that this insured's 12/1/2004 policy was cancelled due to a large premium audit adjustment on 12/23/2002 through 12/23/2003 policy that they did not pay. The insured asked for reinstatement, and the underwriter told the insured that Beacon would need cooperation and the payment of past due balances in order to reinstate the policy. The insured did not comply and the decision was made not to reinstate the policy.

The underwriter recalled that in March 2005, after a three-month lapse in coverage, Solomon made the decision to reinstate the policy retroactive to the previous December. The underwriter was adamant that backdating should not have happened in this case, or any other, unless the cancellation was Beacon's fault, but this was Solomon's decision.

A Loss Prevention Inspection Request dated 4/20/2005 from the underwriter to loss prevention personnel stated that this was a "special handling acct" and that the insured had been uncooperative in the past. Also they wrote, "[The insured is] being investigated by [law enforcement]. All records seized by Federal Government. Policy had been nonrenewed for nonpayment on 12/1/[2004]. In March 2005, [the agent] personally guaranteed to [Solomon] that he will be responsible for payments if insd [insured] defaults and he requested we backdate coverage 3 months and reinstate policy. [Solomon] requested we accommodate [the agent's] request."

<u>Relevant Finding 13</u>

The former agent of this insured complained that Beacon gave certain perks to their larger agents, and we learned that this insured received a 15% credit when it switched from this agent to Beacon's largest agent.

Parent forwarded us the agent's complaint. Based on the memo provided to us, the agent called a member of Beacon's board of directors on 5/5/2006 with the complaint.

We spoke with the agent via telephone on 5/9/2006 and he mentioned that when he was the agent on the account, Beacon quoted a premium with no discounts. When the account was transferred to Beacon's largest agency in 2002 with no changes in management or loss ratios, Beacon quoted the account with a 15% credit. The agent recalled visiting Beacon to ask why Beacon gave two different quotes. The agent was told that the underwriter could not speak to him about it any longer because he was not the agent of record on the account. The agent claimed to have pressed the underwriter who reportedly said the decision was made at a much higher level than his own and that the agent would have to speak to his manager or someone higher about his concerns. The agent said he confronted the underwriting manger and claimed that he was told that in order to get the same discount, he would have to deliver more volume to Beacon. The 15% credit added to the 2002 policy resulted in a discount of approximately $47,000 according to the Account Summary.

A 2002 renewal form confirmed that Beacon intended to write the policy with a 0% credit, even though the new agent from the larger agency originally wanted a 25% credit. The renewal form noted "on a BOR [broker of record] letter from [the new agent], [he] told the insured they could get a lower premium with Beacon because of the volume of business they write with us." There was a handwritten note dated 6/20/2002 by the underwriter that stated, "After meeting with [the underwriting manager] we both agree to allow a 15% credit on the renewal." Notepad entries drafted by the underwriter further discussed the change in credit from 0% to 15%.

We also found an Email from the vice president of the new agency to the underwriter on 6/13/2002 that informed Beacon that the agency was taking over the account, and that they would like to see the insured get a 15%-20% credit.

The Account Summary showed that the insured was provided a 15% credit the first year that they were produced by the new agency. The policy continued to receive credits of at least 15% thereafter, with a high of 45% in 2006. The account cumulatively experienced a loss ratio of 20% through the last completed policy period of 2/1/2006. We also noted that the insured joined the SIMA safety group for their 2/1/2006 – 1/1/2007 policy and received the group credit of 45%.

<u>Relevant Finding 14</u>

Our procedures showed that Beacon knowingly used an incorrect EMod to price the 2005 policy of this insured. An underwriter mentioned that he had reduced the credits on the policy to be more conservative based on the industry. The underwriter also indicated that Solomon was involved in the pricing of this account. We also found an Email, dated 11/8/2005, between the underwriter and the strategic risk executive with the insured's agent, which discussed the account. The executive wrote, "I believe you had agreed to keep the experience mod to .95." The underwriter responded, "Our system will keep switching the mod back to the NCCI mod, and each time I will have to manually override it."

For the policy period 10/1/2005 through 10/1/2006, the NCCI EMod effective at the time of renewal was 1.21. The Account Summary showed that Beacon wrote the policy using an EMod of 0.95. We performed a recalculation of premium based on NCCI's EMod of 1.21. Based on our calculation, this change would have increased written premium by approximately $106,000 for this policy year.

<u>Relevant Finding 15</u>

An Email between Solomon and an agent at one of Beacon's largest agencies revealed that Solomon's influence might have resulted in a 10% credit for this policy that was added after the policy effective date. See the "Retroactive Credit Adjustments" section for more information on this practice. Our procedures also showed that the insured was enrolled in a shared earnings plan after the policy effective date for 2004.

Documents indicated that the insured was added to the Level 10 shared earnings plan for the 12/23/2003 through 12/23/2004 policy year in August 2004. In an Email dated 1/21/2004, the agent requested on the insured's behalf to be provided credits or to be added to the RICC safety group. The underwriter told the agent in an Email on 1/28/2004, that Beacon "can't go back and backdate someone's membership in the chamber program. Likewise, we really can't adjust schedule credits after the renewal takes effect." The underwriter offered to add the insured to a shared earnings plan instead. Discussions between Beacon and the agent dragged on and the agent eventually sent an Email on 7/15/2004 to Beacon requesting the endorsement of the shared earnings plan discussed earlier in the year. On 7/21/2004, the underwriter agreed to the request and added the Level 10 shared earnings plan. According to one of Beacon's filings for its shared earnings program dated 5/8/1998, Beacon stated that "Participating policies would be clearly identified upon issuance."

PowerComp showed that for the 12/23/2004 through 12/23/2005 policy, the shared earnings plan was changed to the SE-9803 plan just before the effective date. On two separate occasions, 10/27/2004 and 11/1/2004, the agent again requested credits and for the insured to be a part of the RICC safety group. The underwriter told the agent in an Email on 11/1/2004 that the insured did not qualify for RICC because of its hazard code and because its premium was too high. In an Email dated 12/20/2004, the underwriter made a request to add the SE-9803 shared earnings plan, "per [the agent]." The SE-9803 shared earnings plan provided a higher dividend payout than the Level 10 plan.

We also learned that Beacon applied a 10% credit to the 12/23/2005 through 12/23/2006 policy after the policy effective date at the direction of Solomon. An Email chain between Solomon and the agent on 12/7/2005 discussed that the insured may not be happy with the upcoming renewal for the 12/23/2005 through 12/23/2006 policy because rates for Class Code *8293 Trucking* were higher in Rhode Island than in other states that the insured conducted business. Solomon asked the agent why the insured did not receive any credits despite their low loss ratios. The agent responded, "Please don't get me in trouble with Dave [Clark] and [the underwriter] if I tell you this but there's a strong resistance in [underwriting] to give schedule credits on truckers." The agent further explained, "Dave [Clark] and [the underwriter] are always very good about working with us but knowing the overall Beacon philosophy on tougher classes like this we tried to be team players and not push too hard. Try to save the favors so to speak to where it makes better sense all around." Solomon responded back with "If you do not mind, I want to follow up with Dave [Clark] and get them some help...."

An Email dated 12/22/2005 from a loss prevention employee to the underwriter explained that loss prevention requested ergonomics training for the insured following one of their visits. A Notepad entry dated 2/3/2006 indicated that a 10% credit was added to the 12/23/2005 through 12/23/2006 policy because the insured completed the loss prevention training. An Email dated 2/3/2006 supported the fact that insured completed the training and was provided a 10% credit as a result.

Overall, this account's performance has been favorable to Beacon, with a cumulative loss ratio of only 12% through 12/23/2005.

<u>Relevant Finding 16</u>

A special underwriting agreement was entered into with a construction company, and for six years this policy was priced with an incorrect Class Code, which may have resulted in approximately $818,000 lower premiums over the term of the agreement.

A premium auditor authored a Notepad entry dated 7/29/1998, which raised concerns related to the potential misclassification of payroll on this account. This entry stated, "…The excavation is classified under code 6217, but all other activities involving the bridgework are being classified under code 5221 per special underwriting agreement issued by [the] underwriting supervisor." The premium auditor noted, "A letter outlining that agreement which was sent to the agent is in my possession if needed...." Based on the results of our procedures, we found that an incorrect Class Code was used for six years, beginning with the policy effective 5/24/1997.

We found a letter from an underwriter to the agent dated 1/14/2003 that stated, "we also discussed the addition of class code 5222 to account effect [sic] 5/24/03, and deletion of code 5221. The insured is a concrete contractor specializing in concrete construction/bridge work, the present code of 5221 is incorrect. The insured will have a substantial increase in premium due to the rate class code 5222 is $43.44." When questioned, the underwriter said that this account was one of the underwriting manager's assigned accounts and that the manager entered into a special underwriting agreement with the insured to allow an incorrect Class Code rate on the account. Based on the 1998 NCCI Class Code rates, the rate for 5221 was 63% less than 5222, $16.24 versus $43.44, respectively.

The underwriting manager explained that the company was a Beacon account that had an outstanding unpaid balance and that he met with the company's controller to negotiate repayment of the past debts. He said that he entered into a special underwriting agreement where the company would pay the previous debts, and Beacon would allow the *5221 Concrete or Cement Work: Floors, Driveways, Yards or Sidewalks And Drivers* Class Code to be used instead of the *5222 Concrete Construction in Connection With Bridges or Culverts* Class Code for one year. He further elaborated in an Email "...that if the audit was billed one way (with class code 5222) the a/p would have amounted to a substantial number. If the audit was billed the other way…(with Class Code 5221) the a/p would have been less. The client was withholding all payments because of this dispute. From the client's view all of the jobs were bid using one code and we were attempting to change the code after the jobs were completed…"

The underwriting manager also explained that this agreement had Solomon's blessing, but said it was clear that the letter allowed the misclassification for one year only. The correction was not made for five additional years, until it was discovered on an audit. We found the letter outlining the special underwriting agreement in OnBase. It was dated 1/28/1998 and stated, "We [Beacon] have agreed to the continued use of code 5221 for this insured operation for this year. Although the manual would indicate some justification for the 5222 code we agreed this insured's exposure and history would continue to justify the existing code…We also agreed that our invoices would be paid promptly."

We performed a calculation to determine the difference in premium if the correct Class Code had been utilized.

Policy Year	Class Code Exposure	Rate Used by Beacon (5221)	NCCI Rate (5222)	Manual Premium Discrepancy	Written Premium Discrepancy
1997	$ 542,596	$ 15.11	$ 38.54	$ 127,130	$ 77,187
1998	$ 977,722	$ 15.11	$ 38.54	$ 229,080	$ 113,637
1999	$ 961,529	$ 16.24	$ 43.44	$ 261,536	$ 121,580
2000	$ 1,338,532	$ 16.24	$ 43.44	$ 364,081	$ 152,228
2001	$ 1,522,831	$ 16.24	$ 43.44	$ 414,210	$ 158,620
2002	$ 1,571,731	$ 16.24	$ 43.44	$ 427,511	$ 194,693
TOTAL	**$ 6,914,941**			**$ 1,823,548**	**$ 817,945**

Our calculation showed that premium would have been approximately $818,000 higher over the six-year period if the NCCI rate for Class Code 5222 had been used instead of 5221.[125]

VIP Accounts

Overview

The underwriting department maintained a listing of "VIP Accounts." Based on Emails read during the course of this Examination, discussions regarding VIP accounts appeared to begin in February 2002. Clark emailed underwriting personnel on 2/12/2002 regarding one of the accounts mentioned in the original whistleblower allegations (see Allegation 3 in the "Original Whistleblower Allegations" section) and instructed them to "Please mark this file to show that no notice of cancellation should ever go out without my sign-off. This should be treated as a VIP account. Please keep me totally aware of everything that goes on with [this account]."

[125] The class code rates for 1997 and 1998 in this table were from the 1996 NCCI loss cost rates.

The Almond Report indicated that Solomon directed Clark to delete the VIP listing from his electronic records. Furthermore, the report stated that Solomon initially denied the existence of the document and commented that he had never seen an actual list.

We found a memo that Solomon had written to the board of directors, dated 4/13/2006, where he clarified his position:

> *This list, which I still content [sic] I have never seen, does not indicate preferential treatment. The list might be better called "when an action is taken on this account, please notify the Beacon representative, so they are not embarrassed for not knowing when they next come into contact with the insurer [sic]."*
>
> *I fully recognize the appearance of a VIP list and as such, I have repeatedly stated over the years that "if a list exists, please get rid of it." I am also many times the face of Beacon. I have policyholders constantly approaching me when they have a problem – no matter where I might be. I am also active in the business community and I make personal commitments to policyholders to make sure issues are resolved. Over the years, I have stated, "Please put this on your list" or "put a note in your notepad to follow-up and get back to me when resolved." I understand my comments are contradictory, but this is the truth of what I have said.*

Solomon's administrative assistant explained that this memo was faxed to each of the board members and provided to Parent on 4/13/2006, before his termination.

We read the minutes of Beacon's board of directors meeting that was held on 4/19/2006. According to these minutes, the board asked both Clark and Solomon about the VIP list. Clark reportedly indicated that he initially denied the existence of the VIP list when questioned by GSS, but subsequently changed his story. At the meeting, Clark produced a version of the VIP list. The minutes indicated that Clark said "the list was never used for pricing…[or] for premiums." He also said that Solomon directed him to delete the listing on 2/8/2006.

According to the minutes of the 4/19/2006 board meeting, Solomon told the board three times that he had never seen the VIP listing and he claimed that he also told employees not to have such a list. Solomon also stated that he never instructed Clark to delete the VIP list from his computer.

We located several Emails that contradicted Solomon's statements regarding his involvement with the lists:

- In an Email from Clark to Solomon and Beacon vice presidents dated 3/5/2002, Clark wrote, "I have created a listing of what I call 'VIP Accounts' and will be monitoring them monthly. Please let me know if there are any accounts that should be added to the list. I already watch all accounts over $350,000 and have a subset of that list over $250,000 so no need to have me watch an account just because of premium size. I view the VIP List as accounts that you have a personal involvement with be it business of [sic] personal."

- Solomon responded to Clark's Email with the following response, "Dave, looks good. I will provide new VIP account as [they] come about. Great idea. Something we should have done years ago. Thanks."
- As late as July 2005, we found an Email where Solomon referenced the listing. Solomon wrote an Email on 7/21/2005 with the subject "VIP Accounts," where he instructed Clark to add two more insureds to the list.

Based on Emails read during the Examination, the distribution of the VIP listing included the CEO, vice presidents, underwriting managers, and loss prevention managers. Our interviews with senior underwriters revealed that knowledge of the VIP list was widespread throughout the underwriting department.

Deletion of the VIP List

We located an Email from Clark to his wife dated 2/8/2006 that discussed the VIP list. He indicated that the original intention of this list was simply organizational, and did not, at first, signify accounts intended to receive preferential treatment. He wrote, "I made it [VIP Accounts folder] years and years ago of the accounts that I thought were important to us. It was the only way I could remember people's names." He went on to state, "It was no big deal. It was never used for anything." He continued, "Joe [Solomon] just came to me and told me to delete it [the VIP List] from my computer." He worried that it could not be permanently deleted, and that it would appear that he was hiding something. He reiterated that the VIP list was "never anything to do with favorites." He wrote, "I feel so uncomfortable. I guess I have no choice but to delete it [because] if I don't and Joe [Solomon] finds out that I didn't, he will kill me."

VIP List Versions

During the course of the Examination we located several versions of the VIP listing. Three of the versions were attached to Emails dated 9/16/2002, 10/8/2002 and 12/7/2004. We located several other versions in some of the Custodians' network file folders and one version on the forensic image of one of Clark's computers. Most of the VIP list versions located in Custodians' network file folders and computers were identical to those versions in the Emails referenced above.

With a few exceptions explained later in this section, most of the insureds included on the VIP list appeared to be owned, or otherwise related (i.e. board membership, etc.) to Beacon's senior management team or members of the board of directors. The lists generally included the insured's name, the relationship to Beacon, the agent and premium pricing characteristics such as total premium, loss ratio and credit structure. The following table is an example of data included for some of the larger accounts on the 12/7/2004 version of the VIP list.

VIP Account	Relationship	Written Premium	Credit Percentage	Loss Ratio – Prior Year	Loss Ratio – 2nd Year Prior	Loss Ratio – 3rd Year Prior
Account 1	VP Legal Services	$ 691,108	40%	48%	159%	160%
Account 2	Former Board Member	$ 134,707	42%	146%	14%	10%
Account 3	Former Board Member	$ 114,425	12%	64%	142%	97%
Account 4[126]	Solomon	$ 67,618	58%	21%	299%	6%
Account 5	Sollosy	$ 62,089	15%	50%	205%	363%
Account 6	Board Member	$ 28,108	35%	120%	23%	315%

One version of the VIP list located in Clark's administrative assistant's network file folder was substantially different than the others. This version, dated 1/28/2005, included 37 accounts. The highest number on any other list was 17 accounts. Furthermore, while other versions of the list appeared to be generally limited to senior management and board member-related accounts, the 1/28/2005 listing included 23 insureds that were attributed to Rhode Island politicians.

Insureds Included on the VIP Listing
There were 45 different accounts[127] included on the VIP list at least once based on all of the variations of the VIP lists we located during the Examination. We performed procedures on the following six of these 45 accounts elsewhere in this report: Allegations 1, 3 and 4 in the "Original Whistleblower Allegations" section, and three accounts discussed as Relevant Findings 1, 2 and 5 in the "Standard Industrial Classification Code" section.

Of the 39 remaining insureds included on the VIP list, we performed additional procedures on 15 accounts. These 15 accounts were selected based on their relative size compared to other accounts on the VIP list, concerns raised during our Examination through interviews performed or documents read, or poor financial performance evidenced in queries performed on PowerComp data.

The following table discloses those insureds that were included on Beacon's VIP lists for which we did not perform additional procedures. The table shows the VIP relationship according to Beacon's VIP lists and certain financial information extracted from

[126] The information in this table for this account pertains to the Rhode Island policy only, and excludes out-of-state information.
[127] This figure represents 44 accounts identified within Microsoft Excel spreadsheet versions of the VIP listing located during the Examination, plus one account included in an Email from Solomon to Clark on 7/21/2005; however, we did not find this account listed on any versions of the VIP listing we discovered.

Beacon's PowerComp system. We did not confirm the VIP relationship for any of these accounts. In addition, the data below was limited to Rhode Island policies only.[128,129]

Insured Name	VIP Relationship	Average Annual Premium	Average Credit	Overall Loss Ratio
Insured 1	Former board member	$ 7,257	-1%	0%
Insured 2	Representative	$ 1,176	0%	0%
Insured 3	Insurance agent	$ 875	-6%	0%
Insured 4	Senator	$ 398	0%	0%
Insured 5	Representative	$ 5,552	0%	13%
Insured 6	Sollosy	$ 7,486	0%	43%
Insured 7	Governor	$ 5,892	-8%	48%
Insured 8	Representative	$ 3,692	0%	0%
Insured 9	Former board member	$ 206	0%	0%
Insured 10	Senator	$ 380	0%	0%
Insured 11	Representative	$ 7,361	-24%	46%
Insured 12	Representative	$ 546	0%	0%
Insured 13	Corporate counsel	$ 11,327	-13%	0%
Insured 14	Senator	$ 6,404	-28%	2%
Insured 15	Senator	$ 2,173	-5%	104%
Insured 16	Senators (2)	$ 14,268	-13%	28%
Insured 17	Former board member	$ 2,055	0%	1%
Insured 18	Senator	$ 151,155	0%	26%
Insured 19	Representative	$ 3,789	0%	26%
Insured 20	Representative	$ 3,140	-10%	0%
Insured 21	Senator	$ 12,152	-8%	39%
Insured 22	Senator	$ 1,398	0%	7%
Insured 23	Former board member	$ 283	0%	0%

We performed the following procedures on the selected accounts:

- Generated a report with Account Summary and other relevant policy and premium information from PowerComp,
- Read electronic AuditLynx data for audit results and alerts,

[128] Two of the insureds in the following listing appear to be outliers. The first account is comparatively large, with an average premium of approximately $150,000. It was not selected because Beacon has not provided this account with any discounts and its overall loss ratio was favorable at 26%. The other account's loss ratio of 104% is the highest on this listing, however, since the relatively low average premium ($2,173), the loss ratio was skewed by two large claims (one loss of $12,807 from 1994, and another loss of $9,295 in 2004).

[129] Of the 45 different accounts identified from the VIP lists, we performed procedures in this section or other sections of the report on 21 accounts leaving 24 accounts on which we did not perform additional procedures. The following table, however, only includes data for 23 accounts. One account appeared on the 2002 versions of the VIP list as an association to a former Beacon board member. PowerComp did not have reliable data on this account for the purpose of our query and thus we excluded it from the table below. According to the VIP list, the premium on the account was only $444 and there were no losses on the account.

- Read electronic PowerComp Notepad data for "Policy" comments,
- Read documents in selective underwriting and premium audit sections of OnBase and
- Searched for relevant Emails.

Relevant Findings

Based on our interviews, there were varied opinions raised by underwriting personnel with respect to the VIP accounts. Some underwriters claimed that pricing on VIP accounts needed to be approved by Clark before issuance. Underwriters explained that they needed to be very cognizant of how they treated these accounts and expected that their pricing decisions would be overridden by management. Others said that VIP accounts were handled "with kid gloves."

Below we discuss the relevant findings from the procedures we performed on the 15 selected insureds.

<u>Relevant Finding 1</u>

This insured was attributed to a state senator and was included on the 12/7/2004 list, and documents showed that Clark, Solomon, and another vice president all monitored the account. The underwriter responsible for the account indicated that no special treatment or favors were extended to the account, and we understand that the senator appeared to be vocal in his opposition of the Beacon legislation. He did, however, vote in favor of the bill during the June 2005 and January 2006 legislative sessions. We did not find preferential treatment extended to this account.

On 2/7/2003, Clark sent an Email to Solomon and another vice president with the senator's name in the subject. He called it "our policy" and provided some statistics on the account. He said that the out-of-state portion of the policy was non-renewed in January 2003 and was placed in the Connecticut pool. The policy, he stated, had an unfavorable 229% loss ratio, but "we have spoken to the agent and will take [the out-of-state coverage] back in 2004." Clark also announced that he added the account to the VIP list "so we will watch it," saying "I am on it guys!" The vice president responded and thanked Clark.

We obtained the hard copy Account Summary showing the out-of-state information and noted that Beacon provided out-of-state coverage for this insured from 1/1/1999 through 1/1/2003. The out-of-state portion was loss free in all four years with Beacon.

We located another Email from a vice president to Solomon that did not discuss the account, but did discuss donations to the senator. In the Email, dated 4/4/2005, they asked Solomon whether they would be buying tickets for a fundraising event for the senator. Solomon responded, "It hurt, but we did one [donation] from the PAC [Political

Action Committee] and a personal one from me as instructed by [one of Beacon's lobbyists]." We scanned the listing of PAC distributions and found four payments to the senator from 2003 through 2005 totaling $700. Refer to the "Political Action Committee" section for more information on the PAC.

Relevant Finding 2

Two accounts on the VIP list were attributed to an individual who was a member of the state's Workers' Compensation Advisory Council. This council, according to a vice president, was formed legislatively under R.I.G.L. § 28-29-30 as a "clearinghouse" for workers' compensation issues. According to this law, "It shall be the duty of the council to advise the governor and the general assembly, on an annual basis, on the administration of the workers' compensation system" R.I.G.L. § 28-29-30(b). Beacon has a representative seat at the council under R.I.G.L. § 28-29-30(a)(10). Both policies' performances showed that they were priced inadequately. According to a member of Beacon's senior management, the individual was an employee of one of the insureds and managed their workers' compensation and he might have been a consultant to the other insured.

The Almond Report determined that Clark provided one of the two accounts a premium that "deviate[d] substantially from conventional pricing," and, "Mechanically, the agreed upon pricing for this account was ultimately achieved through adjustments to the NCCI experience mod and through the utilization of the 'Consent to Rate' credit." The Almond Report also stated that "the pricing was determined by the Vice President of Underwriting and that he had a personal relationship with a member of [this insured's] senior management."

With respect to the other insured, Clark told another vice president in an Email dated 3/5/2002 that he did watch both accounts each month, and the second account was one that the individual mentioned above was "advising."

The following table illustrates the estimated loss to Beacon and its mutual policyholders based on Beacon's self-stated target loss ratio for both of these accounts during the individual's association:

Account Name	Period of Coverage(*)	Total Premium	Total Incurred Losses	Loss Ratio	Target Loss Ratio	Estimated Loss to Beacon Based on Target Loss Ratio
Insured 1	4/1/01 - 4/1/05	$ 230,831	$ 405,167	176%	65%	$ 255,127
Insured 2	2/5/02 - 2/5/04	$ 146,023	$ 326,596	224%	65%	$ 231,681
Total		$ 376,854	$ 731,763	194%	65%	$ 486,808

(*) - Completed policy years at the time of our data extraction - timeframe attributed to the individual's involvement
(+) - Loss ratio on first year of policy was 22%, second year was 442%

We found that the second insured changed ownership during 2004. An underwriter directed the account to be removed from the VIP list in a Notepad entry on 3/17/2004 because "[The individual] no longer [was] associated with [the] account." The company had been insured with Beacon from 2/5/1998 through 2/5/1999, but then returned to Beacon effective 2/5/2002 until 5/19/2004. A 7/21/2004 Email indicated that Beacon cancelled the second account due to nonpayment on 5/19/2004, and they went out of business around the same time.

We did not find documents or any other information that indicated the insureds influenced the pricing of their accounts.

<u>Relevant Finding 3</u>

A board member is the president of this insured. Renewal forms showed that Beacon underwriters were conscious of this relationship; a renewal form showed that Beacon considered this a sensitive account. In addition to other issues mentioned below, we found that this insured had considered joining the MCGRI safety group, but did not join. Beacon instead provided the insured with credits as if it were a part of MCGRI.

The Account Summary showed that an EMod of 0.72 was used for the first three years of coverage. We have noted other insureds who have had locked EMods as part of a multiple-year deal, but we found no documentation that indicated this insured received a stable pricing deal. We located a Notepad entry dated 10/20/1998 that explained the 0.72 EMod was calculated by the insured's previous carrier. The entry stated that Beacon had calculated an EMod of 0.79 in 1996 for submission to NCCI, but that the proper forms had never been submitted. The policy was ultimately written with an EMod of 0.72, and continued to be written with this EMod for three years. NCCI did not issue an EMod for this insured until 8/12/1998, at which time the EMod issued was 0.79. On 12/10/1998, NCCI issued an EMod of 0.81, which Beacon used for the 1999 renewal.

The insured also received credits above 25% since inception. In policy years 1998, 2000 and 2001, the insured had loss ratios of 217%, 315% and 130%, respectively. Upon renewal after each of these years, Beacon extended credits of 47%.

We also found that this insured received credits in line with the MCGRI program (see the "Safety Groups" section for more information); however, the insured was not a part of the safety group. An underwriting manager indicated that Solomon had specifically asked about placing the insured in a safety group, despite some concerns about the exposure of the insured. Renewal documents for 2005 and 2006, dated 10/7/2004 and 11/18/2005, respectively, stated that the insured considered joining the MCGRI safety group, but opted not to join, even though they qualified. The forms also stated that because of the insured's recent improved loss ratio (0% in 2003, 2004, and 2005), Beacon gave the insured the same credits as if they had been a part of the group in 2005 and 2006. The 2004 renewal form showed that the insured began selling off its manufacturing operations in 2003. The reduction of this division also reduced risks and loss injuries, leading to improved loss ratios.

The cumulative loss ratio for this account through its last completed policy year (1/1/2006) was 85%, 20 points higher than Beacon's target loss ratio of 65%. Our procedures did not show that the board member was involved with or influenced the pricing of this account.

Relevant Finding 4

This insured was also on the VIP list as a relation of a former board member. The insured received credits of 50% and above despite high loss ratios; however, its credits were reduced when it changed agents from Beacon's largest agency to a smaller agency.

We did not determine the former board member's relation to the insured. The Beacon executives and employees we questioned appeared to be aware of the relationship, but claimed to be unaware of the nature of the relationship. We did not find documentation detailing the insured's connection to the former board member.

The Account Summary, a referral form and an Email showed that this account had high loss ratios, collections problems, and there was a lack of cooperation from the agent. Despite these issues, the account received credits of 50% and 60% in five of the ten policy periods with Beacon. For example, in 1995, 1998, and 2000, the insured's loss ratios were 100%, 339%, and 104%, respectively, but the credit awarded upon renewal after each of these years was 60%. The initial large increase in credits occurred on the 1998 policy, when the insured came back to Beacon after a two-year break in service, with Beacon's largest producing agency as its new agent.

The credits for this insured dropped in 2002. At this time, the insured changed agents to a smaller agency. A referral form for this policy year, dated 12/2/2002, highlighted the high loss ratios. It also documented, "We have had major collection problems with this account over the last two years…because of the poor attitude of the insured and no help from the agent, we have taken away the 50% schedule credit the insured had last year and are quoting the renewal at 0%." An Email dated 1/3/2003 from Clark also stated, "Regarding the agency, he is not a fan of ours. He will place business with us only if he has no other market available to him. I will not do any favors for this account or this agency." The year that the smaller agency produced the account, credits were reduced from 50% to 12% on renewal.

Relevant Finding 5

This insured was included on the VIP list as a relation of a Beacon vice president, but we did not find that the insured received preferential pricing treatment. Emails indicated that the vice president was on the board of directors of this insured. This account generated a cumulative loss ratio of 32% since inception, below Beacon's self-stated target loss ratio of 65%. Our procedures did not show that this insured received preferential pricing treatment because of its relationship with the vice president, nor that the vice president was involved with or influenced the pricing of this account.

Relevant Finding 6

This insured was also attributed to the same former board member mentioned in Relevant Finding 4. Documents and a Notepad entry showed that for policy years 1995, 1998, and 2005, Beacon adjusted the pricing for this insured to retain the account at the threat of competition. As with the other insured attributed to this former board member, we could not determine his relationship to the insured. Despite credits of over 40% in eight of the 13 years that this account has been with Beacon, as well as loss ratios of over 100% in three of the policy years, the cumulative loss ratio of approximately 65% was in line with Beacon's target loss ratio. We did not find that preferential treatment was given to the account only because of its relation to the former board member.

Relevant Finding 7

This insured, a local library, was listed as a relation of Sollosy's. We found that this account received credits of over 40% and above despite high loss ratios, as well as a $100,000 donation from Beacon.

The insured's website indicated that Sollosy was a trustee from 1982 to 2003 and became a Trustee Emeritus in 2004. Donald Vass was also a board member of this insured.

The Account Summary showed that the account cumulatively experienced a loss ratio of 84%, which was above Beacon's self-stated target loss ratio of 65%. The Account Summary also showed that the insured received credits of 40% and above for policy years 1998 to 2001, despite loss ratios of 105%, 543%, 363% and 210%, respectively.

A renewal form, for the policy period 7/1/2002 – 7/1/2003, prepared by the underwriter, noted:

> *The current policy is written at a premium of $29,956 with a 47% schedule credit and an exp mod of 1.40. With a 3 year loss ratio of 405%, we need a renewal premium of $81,115, to cover our projected losses. In order to get this premium, we would have to renew as follows. The premium would be $81,843 and we would have to delete the current 47% credit and add a 32% debit to the policy. The experience mod has also gone from 1.40 to 1.73.*
>
> *Don Vass and Sheldon [Sollosy] are both on the Board of Directors of the Library. I recommend we go with the $81,843 premium on renewal"*

An unsigned handwritten note on the form said that the premium should be priced at $53,082 with a 15% schedule credit and a 10% CompAlliance credit. According to the Account Summary, the eventual premium was $64,784, with a 15% schedule credit and 10% CompAlliance credit. The loss ratio for this policy year dropped to 49%. Our procedures did not show that Sollosy or Vass were involved with or influenced the pricing of this account.

The procedures we performed around cash disbursements identified a commitment Beacon made to pay the insured $100,000 in five installments of $20,000 over the years 2001 through 2005. We identified five $20,000 payments in April 2001, March 2002, May 2003, September 2004 and July 2005. We requested the related supporting documentation for the 2003 and 2004 disbursements and both showed that these were installment payments towards the total capital campaign pledge of $100,000 made to the insured by Beacon. Beacon's board of directors approved this capital campaign and we noted Solomon's approval signature on the supporting documentation for each payment. See the "Financial Controls and Cash Disbursements" section for more information on this donation.

<u>Relevant Finding 8</u>

This insured was mentioned in the Almond Report because GSS was informed the account "did not follow the standard pricing protocols." The Almond Report indicated that Beacon provided one of its largest agents with an "agent accommodation" and that Beacon and the agent agreed on an "additional incentive plan" in the form of a special shared earnings plan, different from any of the four filed programs. The report also showed that Beacon retroactively adjusted historical premium pricing data in order to generate a return premium check by increasing the credits on the account after expiration. See the "Retroactive Credit Adjustments" section for more information on this practice.

We found that the special shared earnings agreement was for the 9/1/2001 through 9/1/2002 policy year and was based on the combined in-state and out-of-state losses (minus expenses). It stated that if losses as of a measurement date of 12/1/2002, were less than $85,000, Beacon would return $10,000 to the insured. In addition, if their losses fell between $65,000 and $85,000 Beacon would return an additional $5,000. The agreement further stated that if losses were under $60,000, the insured could earn another $10,000 of premium savings. In an Email dated 2/4/2003 stated "losses valued at 12/1/2002 were $80,767 minus expenses. Therefore they are due a return of $15,000 for the 2001/02 term." We scanned the accounts receivable summary from PowerComp that showed $15,011 was paid on 2/7/2003. The Email further stated that to generate the reduction to accounts receivable, Beacon would have to revise the total policy credits for the 9/1/2001 through 9/1/2002 policy year from 44% to 50.8%. We noted two schedule rating forms for the 9/1/2001 – 9/1/2002 policy. The first was the original form dated 8/7/2001 that had total credits of 44%. The second was the same form except with a handwritten note dated 2/4/2003 that said "Loss incentive program agreed to at 9/1/01 renewal," with a new credit total of 50.8%.

Our procedures did not result in any findings that contradicted the Almond Report, nor did we uncover any additional information not already included in the GSS workpapers relating to the substantial agent involvement.

Relevant Finding 9

This insured appeared on the VIP list and was listed as a relation of Solomon's. Underwriting personnel told us that the president of this insured and Solomon were friends. We found that there may have been a *quid pro quo* arrangement involving this insured and Solomon. An underwriter said that Solomon wanted to use this company to help build a facility for Beacon. The project was a union job, however, so the insured was precluded from participating on the contract. Solomon approached the underwriter directly and told him to provide the insured with a 40% credit on the account for this reason.

We read the Account Summary, which indicated that credits had been provided to the account since the inception of the policy on 5/8/1996. Over the first three policy years, credits of 15%, 25% and 25% were provided on the account. Beginning with the policy issued effective as of 5/8/1999, however, credits increased to 50%. Since 1999, credits have ranged between 35% and 50%. The increase in credits on the account was around the time construction would have begun on the new Beacon facility, which, according to Beacon's 2001 Annual Report, was opened on 9/27/2000, approximately a year and a half later.

We located an Email dated 5/19/2003 from an underwriting manager to Clark with a copy to the underwriter on the account that noted that the insured was a "VIP" account and that "the account is priced competitively with a 40% schedule credit. We should be able to continue to make a profit on this account with pricing at this level." Based on the Account Summary for this insured, the account has had a favorable loss ratio of 33.4% through the most recently completed policy year included in our data. We did not find documents or any other information that indicated the insured influenced the pricing of the account.

Relevant Finding 10

We located an Email from Solomon to Clark on 7/21/2005 that requested the addition of this insured to the VIP list. We also found another Email from an agent to Solomon, dated 12/10/2004, in which the agent recommended the insured to Solomon for some electrical work to be performed on his house. The Email indicated that the insured would be willing to do this work as a "favor" to the agent, which was also one of Beacon's largest agents. Solomon sent an Email to the president of the insured directly on 12/14/2004 to discuss the job.

The Account Summary showed that the insured received an increase in credits from 20% on the 10/1/2004 through 10/1/2005 policy to 40% on the 10/1/2005 through 10/1/2006 policy. However, PowerComp showed that the insured joined the RIBA-USP safety group on 8/1/2004, before Solomon contacted the company relating to the electrical work. RIBA-USP members received at least a 20% credit for the 2005 policy year, plus additional credit based on loss ratio for a potential maximum credit of 50%. This insured has had a cumulative loss ratio through the latest completed policy year of 11% so it appears to have qualified for the maximum RIBA-USP credit. We did not find documents or any other information that indicated the insured influenced the pricing of the account.

Relevant Finding 11

The same 7/21/2005 Email from Solomon to Clark requested that this insured be added to the VIP list. We located two additional Emails in which Solomon discussed this insured, and the Emails appeared to indicate that the state representative attributed to this account did not view Beacon favorably, but he did support the Beacon-backed legislation.

The insured has been insured with Beacon since 1999, and its premium has been less than $2,000 in each year. The insured has had only one claim since it began coverage. The insured has not received any schedule or CompAlliance credits, but did receive Loss Free credits in four of the eight years of coverage.

On 2/18/2005, a loss prevention employee sent an Email to Solomon and relayed a conversation he had with the state representative. First, the employee confirmed that the representative was affiliated with the insured. He also stated that the representative expressed his disapproval of Beacon, calling it a "monopoly with a big beautiful building." The employee wrote that the representative said that "[Solomon] makes too much money" and "the only reason his rates are now better than they were ten years ago was because of the legislative changes made in 1992!" Solomon forwarded this Email to a former Beacon board member and one of their lobbyists, and asked whether Solomon should contact the representative to prevent him from spreading "misinformation."

A second Email, dated 6/19/2005, was in response to an inquiry from another state representative, who had asked Solomon to answer some "frequently asked questions" about Beacon and its history. Solomon promised to answer the questions later, and then mentioned he had spoken with the representative affiliated with the insured, who "indicated he wants to continue to support the bill. He has concerns however with the absence of language stating 'lowest possible cost.'" Solomon proposed some language changes to the bill and requested this representative's opinion.

We found no apparent changes to the premium calculation elements of the account after these Emails.

Relevant Finding 12

The 1/28/2005 VIP list attributed this account to a state senator. We selected this account to perform additional procedures because based on preliminary financial analysis, the premiums for this company were relatively high (average annual premium greater than $275,000), its cumulative loss ratio (89%) was above Beacon's target loss ratio and the insured received credits from Beacon.

According to the insured's website, the senator has been on the company's Board of Commissioners since 1993. The senator sponsored the Beacon-supported legislation that was introduced to the Rhode Island Senate in 2005 and 2006 (S1143 and S2009, respectively).

PowerComp data indicated that Beacon has insured this company continuously from 1/1/1993 through the date of this report with the exception of a 21-month break in service between 2/1/1999 and 11/21/2000. During its coverage period, the insured has become one of Beacon's largest insureds; the last three completed policy years each had premiums over $500,000. Beacon began offering credits of 25% in 1995. Following the break in service noted above, the insured was produced by Beacon's largest agency and its credits were increased from 25% to 45%. The loss performance on the account deteriorated during the period of largest credits. The table below compares the loss ratio experience on the account based on its agent:

Agent	Coverage Period	Loss Ratio
Agent 1	1/1/1993 - 9/1/1998	48%
Agent 2	9/1/1998 - 2/1/1999	57%
Agent 3	11/21/2000 - 2/1/2004	164%
Agent 4	2/1/2004 - 2/1/2006	40%

We did not find documents or correspondence that indicated any involvement of the senator or senior management related to the pricing of this account. During the period that the insured was produced by Beacon's largest agency, we found that the agent appeared to influence the pricing on this account. On December 16, 2002, an underwriter sent a fax to the agency related to the 2/1/2003 renewal and indicated that Beacon "reduced the renewal credit from 35% to 10%...the reason for the reduction in credit is due to losses." An agent responded via Email and indicated that "the increase sought is dramatic and causing problems. [Another agent] has already prepped the insured and they're 'screaming.' There is the possibility of them exploring self-insurance. I'd like to do the following, cut the schedule credit to 15% and allow the 10% CompAlliance Credit which they do not have. That still cuts the credit and you still get a substantial increase due to the experience modification increase. Can we do this?" We did not find support for CompAlliance program participation provided with the agent's request. PowerComp data indicated that Beacon accommodated the agent's request, and the pricing structure on the 2/1/2003 renewal included a 15% schedule credit and a $62,544 CompAlliance discount. The loss ratio during that policy period was 208%.

Relevant Finding 13

Beacon included this insured, a school, on its 1/28/2005 VIP list and attributed the account to a politician. We selected the account for further procedures because preliminary financial analysis of PowerComp data showed that the account had cumulative loss ratio above the Beacon target loss ratio, yet still received some credits from Beacon.

According to the school's website, the politician and two other apparent family members are members of the school's Advisory Board or its Honorary Board. With a one-year exception, Beacon has insured the school since 10/5/1993, according to PowerComp data. Our queries showed that its overall loss ratio through the last completed policy period included in our data (7/1/2005), was approximately 95%, 30 points higher than Beacon's target loss ratio for in-state policies.

For the coverage period between 10/5/1997 and 7/1/2002, Beacon extended the school schedule credits of 10% per year. We did not find correspondence or other documentation that supported the credit during this period, nor did we find that the insured, agent or the politician influenced the pricing during this period. We noted that the 10% credit was added onto the policy after a one-year break in service from 10/5/1996 through 10/5/1997. For the first few years after returning to Beacon, the insured's loss ratio was favorable compared to Beacon's target loss ratio. The loss ratio increased to 82% for the 2000 policy year, and 79% for the subsequent year. Due to this increase, credits were withdrawn from the policy beginning in 2002. Loss ratio continued to increase after the elimination of credits; the loss ratios for the 2002 and 2003 policies were 178% and 307%, respectively. Credits have not been reinstated to date.

Relevant Finding 14

Preliminary financial analysis showed that this account had a cumulative loss ratio greater than 65% but it was still granted credits by Beacon. The listing indicated that the VIP relationship was with a politician According to the insured's 2004 annual report filed with the Rhode Island Secretary of State the politician was listed as director of the corporation. He was not included in the listing of corporate directors on the 2005 or 2006 annual reports.

Beacon's PowerComp data indicated that Beacon insured this company from 12/20/1993 through 7/1/1996 and again from 7/1/2000 through the date of this report. Over the period of coverage, there were only two years where its loss ratio exceeded Beacon's target ratio of 65%, and its cumulative loss ratio through 7/1/2005 was 78%. The loss ratio for the policy year 2000/2001 was 477%, despite having only three claims. Excluding this year's experience, the overall loss ratio through 7/1/2005 was approximately 19%. Beacon extended credits between 5% and 20%.

We did not find documents or any other information that indicated the insured, agents or the politician influenced the pricing of this account.

Retroactive Credit Adjustments

Overview

During the course of our procedures in other sections of the report, we became aware of four instances where Beacon retroactively adjusted the credit structure of a policy after its effective date to reduce the balance owed to Beacon. In three of these instances, the increase in credits occurred after the policy *expiration* date. These instances are discussed in the "Notepad," "Selected Individual Insureds" and "VIP Accounts" sections as Relevant Findings 1, 7 and 8, respectively.

We asked the underwriting managers if the credit structure of a policy was allowed to be changed after the issuance of a policy. One underwriting manager responded and claimed, "…while [the] changing of credits are not the usual practice, there is no restriction in the schedule rating program as to the timing of the credit. If the physical conditions of a risk should change during a policy period it is permissible to adjust the credits accordingly…However I would add that it is highly unusual to amend…[credits] after the expiration date of a policy."

We read the 2001 NCCI Basic Manual and found that Appendix D, Rules 2(d) and 2(e) appeared to address this issue. They state:

- At the time that the schedule rating factor is applied, the carrier must have documentation on file detailing the basis for the credit or debit. This documentation must be provided to the insured on request (2001 Basic Manual, Appendix D, Rule 2(d)).
- The effective date of the schedule rating factor must be on or after the date of the carrier's receipt of the documentation supporting the basis for the schedule rating factor (2001 Basic Manual, Appendix D, Rule 2(e)).

These rules do not appear to allow for the retroactive adjustment to credits. While Beacon may be allowed to prospectively make an adjustment to credits during the policy period on a prospective basis, adjustments post-expiration date would not be allowed.

We performed a query on the PowerComp data to identify additional instances of this practice.

Procedures

Using PowerComp data we performed queries to identify instances where there was an increase to the credit percentage of a policy after the policy expiration date. We limited our query results to return only those increases in credits from 1/1/2003 forward that resulted in a decrease of premium of $10,000 or more.

Our queries returned transactions involving six different insureds. Two[130] of these insureds had been identified as a result of other procedures during the course of the Examination. We did not perform additional procedures on these accounts in this section. For the remaining four insureds, we:

- Generated the accounts receivable summary reports from PowerComp and compared the transaction dates and amounts with the premium derived dates to understand the transactional process, and
- Accessed PowerComp and OnBase systems, printed and read the workers' compensation premium adjustment reports and other selected documents.

Relevant Findings

Our procedures showed that two of our selections initially received a discount, but subsequently were adjusted so that the net effect of the adjustments did not result in a discount to the insured. One of the four remaining insureds was the bank and financial services institution discussed in the "Selected Individual Insureds" section (see Relevant Finding 10) and we moved the findings related to these procedures to that section. We discuss the remaining insured, a manufacturing company, below.

<u>Relevant Finding 1</u>

Our queries of the PowerComp data showed that Beacon retroactively increased the credits on the 11/1/2002 through 11/1/2003 policy of this insured by 15 percentage points on 8/24/2004, approximately 10 months after the policy expiration.

AuditLynx data showed that a premium audit was completed for the 11/1/2002 through 11/1/2003 policy on 1/14/2004. An audit alert note entry from this audit read, "All machine operators, welders, polishers, supervisors with direct supervision, wood shop, etc. are included in code 3066 per NCCI Inspection." The rate for this Class Code *3066 Sheet Metal Work Shop* was $7.10 compared with the previous payroll classification, *3076 Fireproof Equipment Manufacturing* with a rate of $3.53.

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[130] See the "Selected Individual Insureds" and "Notepad" sections of this report for Relevant Findings 7 and 1, respectively, for more information on these policies.

We noted that the Almond Report indicated that the credits for an insured (see Relevant Finding 8 in the "VIP Accounts" section) were adjusted after the policy expiration date, which resulted in a $15,011 refund payment to the insured. Our query described above did not return this insured. We looked at the PowerComp data for this insured and found that the credit adjustment appeared to have been posted retroactively to the first premium calculation. We discussed this with an underwriting manager, who provided screenshots from the legacy system, WINS, which showed the original endorsement of the policy with a 44% credit, and the final endorsement, dated 2/5/2003, which included the increased credit of 50.8%. When the data was converted to PowerComp in October 2003, only the final endorsement was carried forward, which explained why our query did not show this insured as having met our criteria.

Following this audit, there were multiple changes to the 2002 policy. We queried Beacon's PowerComp data to show each premium calculation iteration and we isolated the factors that affected the changes in premium. Based on these calculations, our queries showed the following changes in premium for the 2002 policy (each of the changes is explained in the following section):

Calculation Number	Date	Premium Adjustment	Resulting Premium	Class Code	EMod	Credit
1	11/1/2002	N/A	$ 69,040.30	3076	1.13	10%
2	5/21/2004	$ 97,757.20	$ 166,797.50	3066	1.13	10%
3	8/24/2004	$ (65,508.71)	$ 101,288.79	3066	0.82	25%
4	11/4/2004	$ (49,453.08)	$ 51,835.71	3076	0.82	25%

1. The original premium of $69,040.30 was based on 3076, the lower Class Code, with a rate of $3.53, using an EMod of 1.13 and schedule credit of 10%.
2. The second premium calculation on 5/21/2004 reclassified $2.7 million of payroll from the lower rate to Class Code 3066 with a $7.10 rate, resulting in an additional premium of $97,757.20.
3. On 8/24/2004, Beacon changed both the EMod and schedule credit percentage to 0.82 and 25%, respectively. This caused a $65,508.71 decrease in premium to $101,288.79.
4. On 11/4/2004, Beacon again reclassified the payroll out of the higher 3066 Class Code and back to 3076, keeping the EMod and schedule credit at 0.82 and 25%, respectively. This change resulted in another premium reduction of $49,453.08 to a final premium value of $51,835.71.

We identified a Notepad entry dated 7/26/2004 that explained the change in the schedule credit:

> *Met with [the agent] on 7/22/04 to discuss this account. The final audit for the policy term 11/1/02 to 11/1/03 produced an a/p [additional premium] of $97,758 bringing the total premium from $69,000 to $166,000. The large increase was due to a class change from 3076 to 3066. We have already amended the 03/04 renewal policy and the premium for this term is at $104,000. [The agent] requested that we add some credit to the 02/03 policy term and get the premium down to around $105,000 and the insured would be able to pay the premium. The insured did not expect such a large premium increase and is unable to pay the premium at this time and is currently in cancel pend to be eff on 8/1/04. I agreed to amend the credit and reduce the premium to Approx. $105,000.*

We did not find any documentation that supported the decrease in EMod from 1.13 to 0.82. Based on data we received from NCCI, the EMod that Beacon originally utilized to price the account, 1.13 was the only EMod issued by NCCI for the 2002 policy. Based on

NCCI's data, a 0.82 EMod was issued by NCCI, but not until 3/27/2004 and this was only effective for the 2004 policy.

The audit alert mentioned above indicated that NCCI performed an inspection of the insured's operations and determined that the higher Class Code was appropriate. Furthermore, the PowerComp data indicated that Beacon applied the higher Class Code rate, 3066, on the 2003 policy. Therefore, it appeared that Beacon knowingly misclassified the 2002 policy.

The net effect of these adjustments was a reduction of premium from $69,040 to $51,836, or $17,204. Based on the accounts receivable summary, this amount appeared to be applied to reduce the amount paid by the insured on its 2004 policy.

See the "Statutory Violations" section of this report for more information on applying incorrect EMods and payroll misclassifications.

Late Reductions to Accounts Receivable

Overview

It is our understanding that premium audits should be performed within three months of the policy expiration date. After estimated payrolls are compared to audited payrolls, the premium audit would result in a return premium (reduction in premium) or an additional premium (increase in premium), recorded in PowerComp's accounts receivable balance as a credit or a debit, respectively. Such changes to a policy balance are labeled "audit report premium adjustments."

During the course of the Examination we found that one policy, discussed in Relevant Finding 7 of the "Selected Individual Insureds" section, received an audit report premium adjustment credit of $43,605 on 3/7/2005, which resulted in a refund of $32,704. Based on this adjustment activity, which occurred almost one year after the policy end date, we conducted additional procedures on the PowerComp accounts receivable transactions described below.

Procedures

We performed queries on the PowerComp data to identify instances where there were reductions to Rhode Island insureds' accounts receivable balances posted to their accounts six months after the policy expiration date or later. We performed additional procedures on those insureds that received reductions in their accounts receivable balances of $50,000 or more after 1/1/2003. Based on these parameters, our queries showed 23 qualifying transactions with corresponding accounts receivable credits totaling approximately $2.3 million.

For each of our selections, we requested and read supporting documentation that included, but was not limited to, the following:

- Premium audit reports,
- Workers' Compensation Premium Adjustment forms from PowerComp,
- Refund checks, if applicable.

For certain selections, we also used PowerComp data and performed the following additional procedures:

- Generated a report including an Account Summary and other relevant policy and premium information from PowerComp,
- Read Audit Alerts and results pulled from AuditLynx data and
- Read Notepad entries for policy comments from PowerComp.

Relevant Findings

Of the 23 audit report premium adjustments we selected, we noted 12 instances of revised audits, three estimated audits, and four adjustments related to certain general systems and operational issues, "PowerComp Issues." The details of these findings are further described below.

We also noted one adjustment for the manufacturing company mentioned in Relevant Finding 1 of the "Retroactive Credit Adjustments" section and three adjustments for the bank and financial services institution also addressed in Relevant Finding 10 of the "Selected Individual Insureds" section.

For 17 of the 23 instances, the return premium adjustment did not result in a refund to the insured; the accounts receivable balance was simply adjusted and, if necessary, the credit was applied to the outstanding balance. In six instances, however, Beacon did issue a refund check related to the return premium adjustment. We conducted procedures targeted specifically to PowerComp refunds; refer to the "PowerComp Disbursements" section for more detail.

<u>Revised Audits</u>

During discussions with premium audit personnel, we learned that only the results from the last audit of a period are recorded in AuditLynx. For example, if an initial audit and a revised audit took place for the same audit period, then the premium audit report would only record the payroll information and audit alerts from the revised audit. Unless underwriting generated a workers' compensation adjustment form related to the audit, there would be no record of the findings from the original audit. We noticed that premium auditors often entered an audit summary or certain audit alerts into Notepad after each audit, thus creating a record in case an audit was revised.

Also, we found that AuditLynx records the audit complete date as the completion date of the last audit for each period. Therefore our queries showed that audits took place more than six months after the policy end date; however, because more than one audit took place, the initial audit could have occurred on time, but this date was not recorded in AuditLynx data.

We noted 12 instances where Beacon conducted an audit that resulted in an additional premium adjustment, but the audit was subsequently revised with new or updated information, resulting in a reversal of the increase, which was then followed by a decrease, or return premium adjustment. The reasons for these revisions were documented and appeared appropriate, with one exception.

Notepad entries indicated that an insured disputed an audit and Beacon revised its audit apparently based on the insured's complaints. The insured, a construction company, had a premium reduction of $97,270 booked on 9/2/2004 related to the 12/1/2002 through 12/1/2003 policy period. The PowerComp accounts receivable summary and other documentation showed that this insured's first additional premium adjustment, for $159,790, was posted on 6/9/2004. Documents indicated that this adjustment was revised down to $62,520, (the difference between the original adjustment of $159,790 and the revised adjustment of $62,520 was $97,270), on 9/2/2004.

An audit alert from the 4/8/2004 audit of the 12/1/2002 through 12/1/2003 policy indicated that "Payroll is much higher than estimates. Code 5445 and 5222 added on audit. Per decision of underwriter we are using code 5222 for all concrete form work done on bridges. This will generate a substantial [additional premium]." Per PowerComp, Class Code *5222 Concrete construction in connection with bridges or culverts* has a rate of $43.44, and Class Code *5445 Wallboard installation-within buildings-& drivers* carries a rate of $13.83. Prior to this audit, the majority of the company's payroll had been classified to Class Code *5213 Concrete construction NOC*, which carries a rate of $18.23.

Notepad entries after the posting of the additional premium adjustment indicated that the insured was not pleased with the results of the audit. A Notepad entry dated 9/2/2004 stated:

> *Per discussion with [an underwriting manager] we will revise the 2002 Final Audit- the newly added codes of 5222 & 5445 will be amended to zero payroll. The [additional premium adjustment] on policy will be reduced to $62,520, Total Audited Premium is $116,678 (inception premium is $54,158). The class codes will be added to 2003-04 policy term.*

We asked the underwriting manager to explain the reason behind amending the class codes the response was that "The decision was very straight forward...At the time, all things considered, we felt it was fair to apply those codes on a prospective basis."

We checked the estimated and audited premium calculations in PowerComp to see if these two class codes had been added in subsequent years. For the 2003/2004 policy, neither Class Code 5222 nor 5445 appeared in the estimated premium calculation. The final audit for this policy year was completed on 4/10/2005, and contained multiple audit alerts that discussed the application of Class Code 5222. An alert indicated that the original final audit placed "all" payroll in the bridge construction class code. It also explained that the estimates for this year had not been updated per last year's recommendation to add Class Code 5222, and thus this year's audit generated a large additional premium of $485,000, which the insured disputed. Another alert read as follows:

> *The audit was first revised using figures provided to [premium audit] allocating 20% of payroll to bridge construction. The insured is working solely for [another construction company],[131] who pays all of the insureds WC premiums. [This other construction company] wanted some payroll allocated to Street and Road Construction sub surface work for form work the [insured] did on road work. I did not feel comfortable doing this, so I decided to [put] all payroll under 5213 and everyone agreed.*

A third alert summarized the course of events for the last two years, and indicated that the auditor had recommended and the underwriter had endorsed Class Code 5222 for the 2002/2003 and 2003/2004 policies; however, the alert indicated that in both instances, this endorsement was reversed and payroll placed in Class Code 5213.

PowerComp data and the accounts receivable summary corroborated these alerts. A PowerComp premium adjustment form dated 3/11/2005 showed an increase from an estimated payroll of zero to an audited payroll of $1,432,974 for Class Code 5222. This, along with increases in other Class Codes, resulted in additional premium of $485,215 that was posted to the accounts receivable summary on 3/11/2005. The second premium adjustment for this policy year, calculated on 4/11/2005, reported zero payroll for Class Code 5222, but had $1,268,879 of payroll in Class Code 5213. The total additional premium from the second premium adjustment was $132,352. A credit of $352,863 was posted to the accounts receivable summary on 4/11/2005, reversing the original additional premium down so that the net result of the 3/11/2005 and 4/11/2005 additional premium calculations would only be the revised additional premium amount of $132,352.

Class Code 5222 was finally added to the 2004/2005 policy and 74% of payroll was assigned to this code. Written premium for the 2004/2005 policy was $463,394, compared to $116,678 and $218,943 for the previous two years.

Estimated Audits

For three insureds, audit alerts indicated that Beacon initially performed an "estimated" audit. In these three instances, documentation revealed that Beacon was unable to schedule an audit with the insured, and as a result, increased the payroll estimates resulting in large additional premium adjustments to accounts receivable. After the insured was billed for this additional premium, the insured contacted Beacon and

[131] Refer to Allegation 2 in the "Original Whistleblower Allegations" section for more information on the allegations of payroll misclassification for this other construction company.

arranged for a premium audit. The final audit of one of the insureds resulted in a slight increase in payroll and additional premium, and the final audits of the other two insureds resulted in return premiums. The reductions to accounts receivable that triggered our query were the reversals of the estimated audits that had been booked net of the final adjustments resulting from the premium audits.

During the course of the Examination, we found that Beacon did not consistently apply its policy of increasing payrolls and sending additional premium notices to insureds that were uncooperative with scheduling premium audits. For example, two audits for the financial services institution discussed previously were delayed over 10 months from the premium expiration date, but they were not charged additional premium. We noted that for one of the three insured's policies mentioned above, the policy estimates were surcharged approximately 100% and on the other two insured's policies, the policy estimates were surcharged 300%. Although not specifically addressing uncooperative audits, Beacon's enabling act permits them to assess a premium surcharge of up to three times the applicable premium on certain insureds "who present higher than normal risks within a class" subject to an appeal to the DBR (2003 P.L. ch. 410 § 11(d)(3)).

We asked finance personnel what the financial impact would be for those policies that had increases in payroll that occurred prior to a fiscal reporting period, such as year-end, but then the reversal of those amounts having occurred subsequent to year-end. The finance manager responded that receivables are increased and revenue is booked as earned premium until the audit is resolved. It is also her understanding "that this type of situation represents a limited population of the entire book of business and, therefore, there is not a material impact on overall premium."

<u>PowerComp System Issues</u>

We noticed two instances where a PowerComp system glitch caused the posting of an unauthorized return premium adjustment. Beacon noticed the error on both of these accounts two months after the problem, and corrected the issue. An underwriting manager researched the issue and believes that it was an isolated incident and "truly a glitch…a defect [log] was not submitted for this." The underwriting manager also mentioned that an underwriter manually corrected the accounts rather than information systems personnel.

In a third instance, a Notepad entry indicated that a defect in PowerComp was affecting accounts receivable for over 100 policies during September 2004, resulting in an overcharge on many policies. A credit had to be issued to the insured in order to correct the overcharge.

We followed up with an underwriting manager about this issue as well. They explained that when Beacon notices a problem with an account, the problem will be analyzed to determine if it is a "user error" or a "system defect." In this case, Beacon identified that it was a system defect, and notified the PowerComp vendor of the problem. The vendor investigated the issue, and discovered that a total of 107 policies were affected by this defect. According to the underwriting manager, the vendor fixed not only the problem with the 107 accounts, but the actual glitch as well in October 2004. During the few weeks that the vendor was troubleshooting the problem, Beacon suspended the processing of premium audits. Refer to the "Underwriting at Beacon" section for more information on the moratorium placed on premium audits during this time.

We noted a fourth instance where the workers' compensation adjustment forms did not agree to the premium adjustment posted to the accounts receivable summary as a result of the system conversion. An underwriter explained that Beacon became aware that the two sources did not reconcile. The insured had been in a pending cancellation status just before conversion, and when the data converted, PowerComp changed the pending status to an actual cancellation status. When Beacon attempted to reinstate the policy after receiving payment from the insured, the underwriter explained, "we could not get the new system to calculate the premium correctly using data from the old system. We had several IT people involved in this policy because this was one of many system defects we were discovering at the time…IT told us this policy was never going to calculate correctly because of this." The underwriter explained that the credit adjustment that we selected was manually entered by Beacon in order to bring the premium in the system to the correct amount.

Accounts Receivable Write-Offs

Overview

During the course of the Examination, we became aware of two questionable and significant write-offs of insureds' accounts receivable balances. See the "Political Activities" section of the report for more information on these two accounts. We performed the following procedures to identify additional write-offs that might have been problematic.

Procedures

We queried Beacon's PowerComp data and identified all transactions coded as "general write-offs." We focused our query to show general write-offs posted to accounts receivable balances of Rhode Island policies during 2003 through 2005. During this period, our query showed that there were 1,074 write-offs, totaling approximately $3.0 million. We judgmentally selected all general write-offs greater than $40,000 during this three-year period and there were 12 transactions that met this criteria resulting in total write-offs of approximately $1.2 million (40% of the total).

We requested and read supporting documentation for each of these selected write-offs including:

- Premium notices,
- Workers' compensation premium adjustment forms,
- Billing history reports,
- Authorization requests,
- Court judgments and
- Correspondence with collections attorneys.

Relevant Findings

Our 12 general write-off selections included the two instances discussed in the "Political Activities" section. Based on the results of our procedures, the remaining 10 general write-offs were supported by documentation that indicated that the insured companies were deemed insolvent, in bankruptcy, receivership, could not be located, or an installment payment agreement had been entered into. Collections agents were involved in most instances.

POLITICAL ACTIVITIES

Cornerstone Communications Group

Overview

The Almond Report raised several concerns related to Beacon's retention of Cornerstone Communications Group. Beacon entered into contracts with Cornerstone, a political consulting and public relations firm, between April 1, 2002 and March 15, 2006.[132] The Almond Report concluded that the owner and operator of Cornerstone "submitted invoices to Beacon with incorrect descriptions of the expenses on those invoices" and inferred that the payments that Beacon made relating to those invoices may have gone to cover the costs of a golf outing to North Carolina.

We did not note any contradictory information or findings in the Almond Report or GSS workpapers; however, our procedures resulted in additional findings not mentioned in the Almond Report.

Procedures

We performed the following procedures:

- Read the Agency Service Agreement, dated 4/1/2002, between Beacon and Cornerstone, the First Amendment to the Agency Service Agreement, dated 12/15/2004, and the termination letter of the agreement, dated 11/15/2005,
- Read the Lease Agreement, dated 4/1/2002, between Beacon and Cornerstone,
- Requested and read selected invoices and check copies supporting certain selected payments that were made from Beacon to Cornerstone for the years 2002 – 2005,
- Compared the MAS200 disbursements data with the hardcopy invoices and check copies that reflected payments made to Cornerstone from Beacon, for the years 2003, 2004 and 2005,
- Obtained and read and recalculated the 2002 – 2005 rental income calculations for the property that Beacon rented to Cornerstone free of charge,
- Performed keyword searches on financial data to identify irregular or miscellaneous payments, charges, and non-cash records related to this vendor,
- Interviewed certain underwriting and Beacon personnel involved with Cornerstone,
- Searched for relevant Emails relating to Beacon's relationship with Cornerstone and its owner,

[132] As described in further detail in following sections, Beacon terminated its Agency Service Agreement with Cornerstone effective as of 11/15/2005. By letter, Solomon continued to allow Cornerstone to occupy the office space it leased in Beacon's building for a period of 120 days from termination. March 15, 2006 represents 120 days from the termination effective date.

- Conducted Internet research and searched publicly available records on individuals and their affiliate organizations.

Relevant Findings

Based on the results of the procedures performed detailed in the sections to follow, we noted:

- The monthly agency service fee paid to Cornerstone increased from $7,500 to $9,500 effective as of 10/1/2002, but the increase was not officially documented in the contract until 12/15/2004.
- Beacon, at no charge, provided 1,500 square feet of furnished office space and office services to Cornerstone.
- There were approximately $98,000 of charges on Cornerstone invoices which were not adequately supported, or where the benefit to Beacon was not understood.
- After the termination of the Cornerstone relationship, Beacon hired Checkmate Consulting Group, which was affiliated with Cornerstone and a state representative.
- The owner of Cornerstone was not registered as a Beacon lobbyist according to the Secretary of State website in 2005 despite our understanding that he performed a lobbyist function during that period.

<u>Agency Service Agreement</u>

The Agency Service Agreement between Beacon and Cornerstone, dated April 1, 2002, stated the scope of services that Cornerstone would provide. The services included public relations, advertising, marketing and external events coordination in addition to "monitor all state and local legislation" and "represent [Beacon] at external events as directed by [Beacon]." Lobbying services were not specifically mentioned in the agreement.

The original agreement provided that Beacon pay a monthly fee to Cornerstone of $7,500. In October 2002, without a contract amendment, Beacon began paying Cornerstone $2,000 additional per month. According to a Beacon vice president, Cornerstone's increase was related to the fact that Beacon was able to eliminate another internal position and more effectively leverage Cornerstone for services. The $2,000 increase was not officially documented in a contract until 12/15/2004 when the parties executed the First Amendment to the agreement.

In addition to the monthly fee for services, the Agency Service Agreement stipulated that "[Beacon] shall also provide 1,500 square feet of furnished office space to [Cornerstone], including utilities, cleaning service and maintenance."

<u>Lease Agreement</u>

We read the Lease agreement between Cornerstone and Beacon dated April 1, 2002. Beacon provided the 1,500 square feet of office space to Cornerstone free of charge. In addition to the space, the lease specified a number of utilities and services that it was required to provide Cornerstone with including: "heat, water and sewer, hot water, electric, gas, oil, trash storage and removal, and janitorial and maintenance services." Cornerstone remained liable for telephone services and any costs not specifically identified in the lease.

We understand that for statutory reporting purposes, Beacon needed to determine the value of rent that it provided to Cornerstone. We queried the financial data which indicated that Beacon had booked $87,756 in rental income related to the space. Since Cornerstone was not obligated to pay for rent and the income was not realized in cash, Beacon offset this income against an advertising expense account.

The Agency Service Agreement indicated that "[Cornerstone] shall perform all services hereunder strictly in the capacity of an independent contractor." Although Beacon calculated the non-cash advertising expense on its books and records it does not appear that they issued Form 1099[133] tax forms to Cornerstone to cover the free rent benefit. We have not read Cornerstone's financial statements or tax filings and we do not know whether or not this benefit has been included as reported income for tax purposes.

"Free Rent" Calculations – The Almond Report indicated and we found through queries of the financial data that there was a discrepancy in the calculation of rental income and advertising expense between 2002 and subsequent periods. Beacon's journal entries in 2002 were based on a factor of $26 per square foot per year, resulting in rental income/advertising expense of $39,000 during 2002.[134] Beginning in 2003 and through the termination of the lease agreement, this journal entry was booked based on a factor of $13 per square foot[135] per year. Finance personnel told us that the latter rate was equal to the rental rate Beacon charged for use of its neighboring training facility and that use of the $26 rate was an error.

We performed a search of real estate values in the Warwick, Rhode Island area using a real estate valuation resource which indicated that the average price per square foot for office space in this region was $16 per square foot per year. We performed a search of real estate listings as of 5/9/2006 and identified seven listings for office rental space, which ranged between $11 and $17.

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[133] Form 1099 is used to report amounts paid to independent contractors or non-employee compensation. U.S. tax law may require businesses to submit a Form 1099 for contractors paid more than $600 dollars for services during a year. This requirement usually does not apply to corporations receiving payments.

[134] The lease agreement did not commence until 4/1/2002, so this $39,000 actually translated to an annual rate of approximately $34.67.

[135] Beginning in 2003, the square footage for the calculation decreased from 1,500 to 1,250.

Invoices and Checks

The Almond Report identified a number of payments to Cornerstone for which "adequate support [was] not provided." During the Examination we identified additional information pertaining to these and other payments. There was a total of $762,794 paid to Cornerstone between 2002 and 2005. The table below illustrates the bifurcation of these payments into the agency service fees and all other charges:

Year	Agency Service Fee	Other Charges	Total Charges
2002	$ 73,500	$ 228,715	$ 302,215
2003	$ 114,000	$ 17,721	$ 131,721
2004	$ 114,000	$ 22,187	$ 136,187
2005	$ 104,500	$ 88,171	$ 192,671
Total	**$ 406,000**	**$ 356,794**	**$ 762,794**

During the course of the Examination, we judgmentally selected 31 payments totaling $568,211 and applied further procedures to these selections. The table below shows the dollar amount of the two types of payments we selected for each year:

Year	Agency Service Fee	Other Charges	Total Charges
2002	$ 47,000	$ 171,528	$ 218,528
2003	$ 19,000	$ 1,825	$ 20,825
2004	$ 114,000	$ 22,187	$ 136,187
2005	$ 104,500	$ 88,171	$ 192,671
Total	**$ 284,500**	**$ 283,711**	**$ 568,211**

We requested and read the supporting materials provided by Beacon and our findings are detailed below.

Selected Cornerstone Payments – 2002 – We judgmentally selected six payments from 2002 totaling $218,528. We read the supporting documentation for these payments and found that in addition to the monthly agency service fees, these invoices included media expenses of $44,466 related to advertising in papers, magazines, airports, and other locations and third-party printing expenses of $127,062. Printing expenses included letterhead, envelopes, business cards, posters, safety alerts, annual reports, and other miscellaneous print materials.

Based on queries of financial data that we produced, there was a noticeable decrease in amounts paid to Cornerstone after October 2002. Third-party printing fees and other advertising charges were no longer included on Cornerstone invoices. We scanned the general ledger accounts for advertising and printing expenses and found that payments to two printing vendors increased significantly in the beginning of 2003. The vice president of community relations' responsibility was to review and approve the Cornerstone invoices each month, specifically the agency service fee and marketing and printing materials. This vice president explained there were some issues with Cornerstone's handling of third-party expenses at the beginning of the relationship in 2002. Specifically, he recalled that Cornerstone was not relaying payments to its vendors on a timely basis and the vendors began to complain directly to Beacon. After three months, the vice president insisted that Beacon pay for its printing services directly to avoid the loss of reputation.

Selected Cornerstone Payments for 2003 through 2005 – The Examination revealed several charges on Cornerstone invoices between 2004 and 2005 above and beyond the monthly agency fee payments. The vice president of community relations explained while it was his responsibility to review and approve the Cornerstone invoices each month he was not responsible for approving charges specific to lobbying activities or "special projects." He claimed that Solomon was responsible for approving charges other than the monthly agency service fee. The table below illustrates seven specific instances where charges for "special projects" or alternatively titled items were included on Cornerstone invoices. The amount of additional charges totaled $97,875 during this period,[136] as seen in the table below.

Description	Amount	Invoice Date
Beacon share of public information campaign with DLT and IIARI on Workers' Compensation Insurance Law	$ 21,000	1/12/2004
Special Project for Independent Insurance Agents on Contingency Commission Issue	$ 5,000	1/27/2005
Special Project for Independent Insurance Agents on Contingency Commission Issue	$ 5,000	2/22/2005
Concept, Design & Implementation of Opinion Leader Program	$ 5,000	7/25/2005
Agent Focus Groups	$ 20,000	8/30/2005
Agent Focus Groups	$ 14,000	9/27/2005
Special Project – Safety Video Production	$ 11,500	11/4/2005
Special Project – Safety Video Production	$ 16,375	11/28/2005
Total	**$ 97,875**	

We performed additional procedures outlined below related to these payments. We did not have access to Cornerstone's books or records; therefore, we could not verify the ultimate disposition of payments for any of the above-mentioned additional charges.

$21,000 Public Information Campaign – We asked representatives of the DLT regarding the first charge in the table above which was described on the Cornerstone invoice as $21,000 for "Beacon share of public information campaign with Dept. of Labor and Training and Independent Insurance Agents of RI on Workers' Compensation Insurance Law." DLT representatives confirmed that discussions with Beacon and the owner of Cornerstone took place relating to the program but "there never was a campaign." A DLT representative specifically stated that "we could [have entered] into the arrangement with Beacon and the agents under their guidelines but [the owner of Cornerstone] did not choose to do that so we stopped the process."

[136] We scanned the data for 2003 payments but did not find additional charges.

We located a memo dated 12/14/2003 from the owner of Cornerstone to Solomon and a vice president that discussed Beacon participating in a campaign with the DLT and the IIARI to increase awareness of workers' compensation for employees at food and entertainment venues and concert arenas. After the Station nightclub fire in Rhode Island in February 2003, there was a renewed focus by the DLT on these industries related to workers' compensation coverage. We asked a vice president about the $21,000 payment and he recalled senior staff discussions on ways that Beacon and its agents could increase awareness about the need for workers' compensation for this industry in a way that did not sound like a Beacon sales pitch. This vice president also stated he could not recall what the final outcome of these concerns was and could not find any advertisements or reports that would have supported the charge.

We also asked another vice president regarding the public information campaign. He said that Beacon wanted to participate in an information campaign, but felt that it might be viewed as self-serving. This vice president said that he mentioned the campaign idea to representatives at the DLT and told them to get in touch with the owner of Cornerstone to organize it. The owner "dragged his feet for six to ten months" before responding to the DLT. Ultimately, the vice president said the DLT called off the plan because they would have to go through a formal bidding process. He stated, "to the best of my knowledge, the campaign never happened" and described the $21,000 charge as "puzzling."

$27,875 Safety Video Production – A memo dated 9/7/2005 from the owner of Cornerstone to Solomon and a vice president explained the need for new workplace safety videos for their policyholders. The memo explained that Cornerstone had analyzed Beacon's safety videos and concluded that "it is clear that many are out-of-date and tired…and lack any local connection." The memo detailed two different options, each costing about $50,000. The first option was to purchase the videos from a third-party vendor and the second option was to create the videos themselves using policyholder locations and employees as actors. The memo also mentioned that the benefit of the second option would be the "potential for retention of these larger accounts down the road." There was a handwritten note on the memo from Solomon saying he liked the second option because it "brings a local connection and would better resonate with RI employers and employees."

Parent provided us a package that he received from one of Beacon's loss prevention managers. We were told that the package was the support for Cornerstone's safety video charges. Parent indicated that the loss prevention manager had concerns about the contents of the package. Based on discussions held with the loss prevention manager, no one in the loss prevention department had any knowledge that Beacon had commissioned Cornerstone to create safety videos. To the contrary, the loss prevention manager explained that Beacon stopped using videos "six to seven years ago" because the loss prevention department determined that they were not effective tools for workplace safety. Beacon has been moving towards on-line trainings rather than video-based trainings over the past few years. In addition, DLT maintained a library of workplace safety videos that

Beacon, or its insureds, could access if needed, but Beacon did not maintain an inventory of videos. This fact was troubling to the loss prevention manager because of the claim, made by the Cornerstone owner, that Cornerstone had analyzed the "existing videos."

The loss prevention manager told us that his concerns were brought before Beacon's board of directors. We read the minutes to the board of directors' meeting on 4/19/2006, which indicated that Beacon's counsel brought the matter before the board. During this meeting, both Clark and Solomon were questioned about the safety video charges. According to the minutes, Clark "indicated that he didn't know about the safety videos order until the prior Friday, [and] that the [Loss Prevention] Department did not use safety videos anymore." Clark was the vice president with oversight of the loss prevention department. According to the minutes of this meeting, Solomon:

> *"…indicated the project was brought to him by…[the owner] of Cornerstone over the summer. Beacon uses vendors like [Cornerstone] for projects like videos. When in November, 2005 when issues arose with respect to [the owner of Cornerstone], he asked…where things were because he knew Cornerstone was going to get terminated. He wanted to pay what was owed and for what was going on. He paid Cornerstone to get the project completed. The project was a $50,000 - $60,000 project. He was asked whether videos were needed by safety [loss prevention] people since Mr. Clark said they were not used. He said, 'News to me' if not used. Did not check on what he was told by [the owner of Cornerstone]."*

The package included both Cornerstone invoices with the "safety video production" charges totaling $27,875 as well as loss prevention pamphlets, posters, and a videocassette. According to the loss prevention manager, none of the content on the pamphlets and posters represented new material in 2005, and some of the information was "at least two years" old. The only new documentation was the memo and a video proposal dated September 2005 that included a video storyboard and the video. The loss prevention manager explained that the script and storyboard materials, however, were developed from the preexisting loss prevention programs already in place and did not represent new content

We watched the video contained on the videocassette. The video consisted of four very short segments, approximately one to two minutes in length each, which included several placeholders for narrator comments. The loss prevention manager, who also viewed the video, described it as "poor quality" that was put together "rather quickly." At least one of the actors in the video was a Cornerstone employee, according to the loss prevention manager.

The Cornerstone invoices included charges for "special project reimbursements" related to "safety video production." The table below details the charges included on each invoice.

Description of Charge	11/4/2005 Invoice		11/28/2005 Invoice		Total	
DV 24P Camera	$	3,200	$	3,200	$	6,400
Sound technician	$	1,100	$	1,100	$	2,200
Director	$	1,200	$	1,200	$	2,400
Grip	$	500	$	500	$	1,000
Editing	$	3,500	$	1,750	$	5,250
2D Graphics	$	2,000	$	625	$	2,625
Script writing	$	-	$	8,000	$	8,000
Total	**$**	**11,500**	**$**	**16,375**	**$**	**27,875**

It is difficult to support the above charges based on the quality of the videocassette provided. Overall, the loss prevention manager described the safety video production charges as "extremely disturbing." Another vice president we asked about the videos recalled that the charges "smelled funny" but Solomon approved them anyway.

$34,000 Agent Focus Groups – According to the Almond Report, "[Solomon] approved these charges for payment [but] has stated that there were no agent focus groups held and he is not sure why they would have been billed as such. He has indicated that he believes that the charges were incurred by Cornerstone in the 'Trusted Choice' re-branding campaign conducted on behalf of the Independent Agents Association, however, the documentation that we have been provided is not sufficient for us to conclude that this in fact is the case."

The Almond Report aligned the $34,000 in charges from August and September 2005 with a golfing trip that Solomon, the owner of Cornerstone and others made to Pinehurst, North Carolina in April 2005; however, the report indicated that "we have not been able to definitively link the two events."

On 4/13/2006, Solomon drafted a memo addressed to the board of directors in which he responded to some of the allegations made in the Almond Report. This memo, which was faxed to members of the board of directors, claimed "In no manner did the trip to Pinehurst, which occurred in April, get billed as an expense to agency focus groups in September." The memo indicated that Solomon researched the issue and found that the agent focus groups were, in fact, conducted as part of the Trusted Choice Campaign in which Beacon agreed to participate. He explained that IIARI approached him to be part of an effort to gain financial support for the agents' national branding campaign called Trusted Choice. He recalled that IIARI asked for $50,000 contribution from Beacon. Solomon claimed that he told IIARI that, since Beacon was a predominately Rhode Island insurance writer, he did not feel comfortable donating to a national campaign. He indicated that Beacon would remain interested in helping, but could not be listed as a supporter/sponsor of the Trusted Choice Campaign. He continued to say that the owner of Cornerstone, who was hired by the IIARI to coordinate the campaign by IIARI and the executive director of the IIARI, approached him with an alternative. Solomon agreed to fund a portion of the campaign by covering the cost of Cornerstone's involvement up to

$40,000. The costs were not to exceed $40,000 and during the process Cornerstone conducted agent focus groups as part of the Trusted Choice Campaign.

We received a letter on 7/21/2006 from Beacon's counsel that stated that Solomon, after being suspended on April 15, 2006, gave a file to the CFO, which she turned over to Beacon's counsel. The attorney wrote that his review of the file showed that the Agent Focus Groups project "somehow morphed into part of what is known as the Trusted Choice Program." The attorney wrote that he was not sure whether GSS had seen the documentation.

The attorney also sent us a copy of the documents he referred to in his letter. We have not been able to confirm the creation dates of these documents, but they included:

- The Trusted Choice Branding Campaign Final Report developed by Cornerstone Communications, dated 10/25/2005, and addressed to the Independent Insurance Agents of Rhode Island. Per their website, Trusted Choice "are insurance and financial services firms whose access to multiple companies and commitment to quality service enable us to offer our clients competitive pricing, a broad choice of products and unparalleled advocacy."
- A memo from the owner of Cornerstone to Solomon, dated 2/7/2005, which stated the campaign was going to be aided by a $50,000 national grant and that Beacon's cost would be around $40,000.
- A memo from the owner of Cornerstone to a vice president and Solomon, dated 7/19/2005, which explained that Cornerstone was going to start scheduling agency focus groups in the fall and that the fee would be $34,000: $20,000 billed in September and $14,000 in October. We read these two invoices, one for $20,000 dated 8/30/2005 and the second for $14,000 dated 9/27/2005. This memo did not mention the Trusted Choice campaign.
- A memo from the owner of Cornerstone to Solomon, dated 7/26/2005, which discussed merging the Trusted Choice review with some of the base focus group issues about Beacon. The last sentence in the memo stated, "the cost to Beacon will be lower by billing the Trusted Choice work within the focus groups." According to Email correspondence, Beacon personnel did not provide a clear explanation as to what a "base agency focus group" was, but from their explanations, the reference might have been to periodic business meetings between Beacon and their agents.
- A memo from the owner of Cornerstone to Solomon, dated 10/25/2005, reported that the final cost of the Trusted Choice Campaign was $34,000. The memo stated, "I am pleased to report that agent support remains strong and they almost universally want you to fight for the legislation." It was not clear what connection the legislation issue had related to either the Trusted Choice campaign or agent focus groups. The amount, $34,000 corresponded to the charge for "Agent Focus Groups" on two Cornerstone invoices.

- A memo from the owner of Cornerstone to the executive vice president of the IIARI, dated 10/25/2005, which attached third-party invoices for billboard and television advertising fees totaling approximately $156,000 related to the Trusted Choice campaign.

We read the Branding Campaign Final Report, which consisted of Cornerstone's summarization of the strategy, costs, and results of polling questions. The report does not mention Beacon at all, nor does it cover workers' compensation insurance. The poll questions were asked of consumers, not employers (Beacon's customer), and asked about auto, health, homeowners and life insurance, but not workers' compensation. Further, the campaign appears to be focused not on carriers, but on agents.

If Beacon paid $34,000 for this program, it is not clear what benefit it would have received. Even the vice president of community relations, whose role involves the oversight of marketing, said that he did not know whether the agent focus groups actually took place. The report appeared to breakdown the distribution of costs of the campaign, which it split into: National IIARI Grant, IIARI Share and Agency Share. Nowhere in the report did Cornerstone mention partial funding from Beacon.

During the course of the Examination, we have not found documents or correspondence which linked the special charges to the Pinehurst trip; however, in the "Accounts Payable Disbursements" section we showed that Beacon executives and selected agents regularly planned golfing excursions each year during April. Beacon appeared to pay a substantial portion of the charges related to many of these trips through corporate credit cards, expense reimbursements or payments to participants. We noticed that the Beacon-paid cost of the Pinehurst trip was substantially less than previous trips as illustrated below (see the "Financial Controls and Cash Disbursements" section for more detailed information):

Month of Trip	Location	Beacon Cost
April 2003	Palm Springs, California	$ 12,846
April 2004	Miami, Florida	$ 20,096
April 2005	Pinehurst, North Carolina	$ 2,841

Also noted in the "Accounts Payable Disbursements" section was an Email correspondence between the trip attendees stating they should "send [their] payment to [the owner of Cornerstone] ASAP."

The Almond Report also indicated that the owner of Cornerstone provided GSS with a copy of his credit card statement, which detailed charges related to the Pinehurst trip totaling $16,759.

$15,000 Special Projects – In addition to the public information campaign, agent focus groups and safety video costs, there were three other charges, each for $5,000, which were included on Cornerstone invoices during 2005. Two invoices, dated 1/27/2005, and 2/22/2005, stated that the charges were for a "special project for Independent Insurance

Agents on Contingency Commission Issue." The 1/27/2005 invoice also included the note that the charge was for "individual meetings [several agencies]…50 hours @ $100 per." These charges were supported by a memo from the owner of Cornerstone to Solomon and another vice president dated 12/27/2004 where the owner of Cornerstone explained that there "[was] a tremendous amount of confusion [on the contingent commissions investigations in New York]…it would be a shame to have Beacon caught up in the backwash of this unfortunate publicity."

The third $5,000 charge was referenced as "Concept, Design & Implementation of Opinion Leader Program." A memo from the Cornerstone owner to a vice president and Solomon, dated 7/5/2005, explained, "the resultant publicity around the Beacon legislation could be hurtful to the company…I will dedicated [sic] 50 hours of additional time this month at $100 per hour to assist company officials in drafting letters, direct mail, and opinion editorial pieces to…selected audiences."

It is not clear why these types of services would have been supplemental to the contractual services Cornerstone was obligated to provide as outlined in the Agency Service Agreement.

We asked the vice president that was copied on these memos if he could provide us more information into the purpose of these services along with why they didn't fall under the scope of the Agency Service Agreement. He responded via memo on 9/27/2006, first stating "From time to time Cornerstone would do projects that [Solomon] had agreed were outside the scope of the PR contract. How he determined that these or others were out side the scope of the contract I don't know. That decision appeared to be his alone, but he could have talked to the board on them."

The vice president further explained that the contingent commission issue related to two of the $5,000 payments above related to a lawsuit that the New York Attorney General filed that triggered a nationwide review of "placement service agreements (PSA's) and contingent commission" in insurance companies. He said that Beacon had a "vested interest in understanding the impact on agents and educating the agents, press and public on contingent commission's role in the industry." The vice president said that Cornerstone's role was to understand "the agents' attitude and direction during a highly volatile time and making sure comments made by all concerned were made from an educated and knowledgeable position, as Beacon's image and reputation could have been impacted." The documentation that the vice president provided did not include what the end result of Cornerstone's finding was or the results of the New York Attorney General lawsuit.

The vice president also stated that Cornerstone's involvement with the Opinion Leader Campaign "involved in helping the committee [Public Issue Committee] develop a communication strategy." The campaign was developed because of the negative publicity Beacon was receiving in relation to Beacon legislation. The owner of Cornerstone wanted to notify agents, policyholders and public officials, who he referred to as the "opinion leader market," that Beacon "should not be tarnished for actions that will save policyholders money." The vice president said that "much of what Cornerstone did for us was a product of conversation and not report/document intensive." He also said that Cornerstone wrote a letter for all the legislators and provided an undated, unaddressed, unsigned draft letter that talked about Beacon's success and their support for the legislation.

Checkmate Consulting Group, LLC

In November 2005, the owner of Cornerstone made several disparaging comments related to the Governor during a taped, pre-show recording of his show. In order to distance Beacon from him, Beacon terminated the Agency Service Agreement with Cornerstone in mid-November and provided 120 days[137] for Cornerstone to vacate the facility. According to an Email dated 11/9/2005 from Solomon to the CFO, Solomon suggested it would be a good idea for Beacon to discontinue the relationship with the owner of Cornerstone as a lobbyist and consultant. On 11/10/2005 a news article issued by the Providence Journal, talked about the comments the owner of Cornerstone made about the Governor. Beacon reportedly issued a statement explaining the termination of Beacon's relationship with him. Despite the announcement of the separation, Beacon personnel indicated that the owner of Cornerstone continued to maintain a presence at Beacon.

In the Email referenced above, Solomon referred to the owner of Cornerstone as a lobbyist. According to the Secretary of State's website the owner of Cornerstone was a registered lobbyist in calendar year 2005, but was not on the registered list for 2006. In 2005, the website indicated that the owner of Cornerstone lobbied for other organizations, but not for Beacon (the website does not list lobbying activity prior to 2005). According to the Secretary of State's website, a lobbyist is anyone who, "engage[s] in acting directly or soliciting others to act for the purpose of promoting, opposing, amending, or influencing in any manner the passage by the general assembly of any legislation or the action on that legislation by the governor as the appointed representative of another."

We located an Email from the public relations firm hired to replace Cornerstone to Parent, dated April 25, 2006, addressed to Cornerstone's owner's son, who, according to news sources, was employed by Cornerstone. The letter was a draft, terminating the relationship with a company by the name of Checkmate Consulting Group ("Checkmate").

According to documents filed with the Secretary of State's office, the registered address of the company was 481 Kilvert Street, Warwick, Rhode Island and the registered agent was a state representative.[138] Also, the Secretary of State's website reported that Cornerstone's owner's son had the identical lobbying history as his father, as outlined

[137] The Lease agreement stipulated a 90-day notice.
[138] See the "Politically-Motivated Write-Off of a Temporary Employment Agency" section that follows for more information on this state representative.

above. Neither of these two individuals appeared to be registered as lobbyists for Beacon in 2005 or 2006.

We interviewed several Beacon employees regarding the relationship with Checkmate. Some employees interviewed told us that the former employees of Cornerstone formed this new company in order to continue providing graphics and printing services. They said that Checkmate continued to occupy Cornerstone's space in the Beacon facility although there were discussions about moving them to Beacon's adjacent training facility located at 481 Kilvert Street.

No one could explain why Cornerstone's owner's son was associated with Checkmate if the only services they expected to provide were marketing, printing, and mailing services. Parent said that he felt "uncomfortable" with the connection to the owner of Cornerstone, which led to the termination of the firm. Beacon provided us a copy of the finalized termination letter which was dated 5/1/2006. The address on the termination letter was located in East Greenwich, Rhode Island.

We requested and read documents pertaining to the relationship between Beacon and Checkmate and found that there was an unsigned Agency Service Agreement drafted in late March 2006. The version of the draft agreement we read contemplated a monthly fee of $7,000 and the scope of services included the design and placement of marketing and advertising materials, printing and mass mailing services and maintenance of Beacon's website. The scope of services did not include public relations or legislative responsibilities. The draft did not appear to offer free rental space. The vice president of community relations told us that he refused to sign the contract because he knew the relationship to the owner of Cornerstone. He said that although the contract was never executed, Beacon allowed Checkmate to remain as a tenant and Beacon began paying them $7,000 a month beginning in March 2006 until the termination letter was sent.

Beacon representatives provided us an invoice, dated 5/1/2006, and a check copy, dated 5/5/2006, that showed Beacon paid Checkmate $11,235. The invoice was for the monthly retainer and the fees for graphic design and printing services rendered between 3/16/2006 and 4/30/2006, plus 7% sales tax.

Politically-Motivated Write-Off of a Temporary Employment Agency

Overview

We were informed that a certain temporary employment agency and its successor insured received a special deal structured by Solomon. According to Beacon employees interviewed, the insured was a problem account. Beacon cancelled the policy in July 2004 after its owner refused to pay the balance due related to a large audit adjustment. The company procured coverage in Massachusetts after the Beacon cancellation, but that policy was cancelled by the Massachusetts carrier after they discovered the company had undisclosed Rhode Island exposure. As we describe in more detail below, the decision to write off this insured's balance and to retain an attorney occurred during negotiations for reinstatement with Beacon in the summer of 2005. Unexpectedly, Solomon made the decision to write off all existing debts and reinstate the account in August 2005.

Others alleged that "a lot of money" was paid to the attorney, who was also a state representative, in order to broker the deal. Several employees with knowledge of the transaction claimed that the deal was made to "buy votes" for Beacon's legislation. The attorney hired by the insured to deal with the settlement was the brother of another state representative.

Procedures

We performed the following procedures to learn more about the insured's history with Beacon and to confirm other information related to these matters:

- Generated a report with Account Summary and other relevant policy and premium information from PowerComp,
- Read electronic AuditLynx data for audit results and alerts,
- Read electronic PowerComp Notepad data for "Policy" comments,
- Read documents in selective underwriting and premium audit sections of OnBase,
- Searched for relevant Emails,
- Interviewed Beacon personnel,
- Requested Beacon to provide any additional documents they had related to the insured and
- Read all documents provided by Beacon, including Emails, memos, underwriting and premium audit documents, and Beacon personnel meeting notes.

Summary of Relevant Findings

Based on the results of the procedures we performed, we found that Beacon wrote off approximately $130,000 of receivables due from this insured and also wrote off an additional $159,000 of receivables for companies affiliated with the owner. Based on information obtained through interviews, we understand that Beacon's decision to write-off some of these balances may have been politically influenced. We understand that a certain state representative was a vocal opponent to the Beacon legislation.

Despite the fact that Beacon wrote off approximately $289,000 of receivables related to this insured and related companies, Solomon and Clark made the decision to reinstate coverage for the insured in August 2005 without pursuing prior debts or attempting to collect from the insured's client companies. We understand that failing to pursue these avenues represented a deviation from Beacon's policies and procedures. See Relevant

Finding 3 in the "Notepad" section for a discussion about another insured whose prior debt was uncollected before reinstatement.

We found that Beacon paid $25,000 to a law firm where one of the partners was a state representative reportedly for services performed related to the collections on this account. The partner[139] signed the contract for the $25,000 payment; however, we have not been able to determine what services, if any, he or his firm performed related to the failed collections efforts on the account.

We read an Email that indicated that the partner was also asked to assist on another account, discussed below. We found that this other company was related to another brother of a state representative and that this account also experienced a significant write-off in the summer of 2005. See the "Politically-Motivated Write-Off of another Insured" section for more information on this account.

Detailed Findings

Interview subjects, Notepad entries, and Emails explained that Beacon discovered that the insured was underreporting payroll in 2003. This discovery resulted in an audit adjustment that charged an additional premium of $141,147 on the 12/1/2003 policy. The insured paid only $10,930 of this amount and Beacon cancelled the policy in July 2004 for nonpayment. At the date of cancellation, the uncollected balance on the account was $130,216.

We understand that the insured relocated its headquarters to Massachusetts and obtained coverage from an insurance company in Massachusetts, but continued to send temporary employees to Rhode Island locations. An Email dated 1/25/2005 from Beacon's Special Investigations Unit to employees and vice presidents warned that the insured may attempt to come back to Beacon because the Massachusetts carrier found out about the Rhode Island exposure.

A vice president explained that the Massachusetts carrier discovered the Rhode Island exposure when it received a claim on a Rhode Island employee. It paid the claim, and then took the insured to court. The DLT investigated and found that the insured placed a large portion of its employees in Rhode Island. The case was heard in the Rhode Island Workers' Compensation Court. Per an Email from this vice president to the Beacon senior management team, dated 4/10/2006, as well as a Providence Journal article, dated 7/12/2006, the insured settled this case for $75,000.

The vice president explained that representatives from the DLT notified him of the lawsuit. He said he began to attend the court hearings because the owner of the company and its lawyer (the brother of a state representative) were "bad mouthing" Beacon and

[139] During the course of the Examination, we noted that this representative was listed as the registered agent for Checkmate Consulting Group, according to Secretary of State records. Refer to the "Cornerstone Communications Group" section for more information on Checkmate Consulting Group.

also because the Workers' Compensation Advisory Council was considering legislation on temporary agencies at the time. According to the vice president, the judge suggested the lawyer to talk with the vice president and determine how to get coverage for the insured through Beacon. The vice president set up a meeting with the lawyer and Clark, which appeared to have been held sometime between 6/16/2005 and 6/29/2005, according to Emails. Additional Emails indicated that the underwriter, Clark, and the vice president discussed setting up a meeting on 6/16/2005 and that a formal meeting was held with the insured's representatives on 6/29/2005. It appeared that the initial meeting with the lawyer and Clark was held in between this time period. During the initial meeting, it is our understanding that Clark advised the insured to get an agent because it was clear it did not have a clear understanding of workers' compensation insurance. Beacon also brought counsel into the meeting.

The vice president who attended the hearing said that a second meeting with the insured's agent was held at Beacon. Emails indicated that the second meeting was held on 6/29/2005.

Right before the second meeting, an Email chain from 6/27/2005 discussed the problems with this insured. An underwriter argued that it was "unfair" not to charge for the unreported exposure that was discovered. The underwriting manager responded and explained, "as we discussed with Dave [Clark] 2 weeks ago, some of these goes [sic] beyond underwriting principles and reaches into the business decisions stratosphere."

Employees interviewed indicated that Clark and Solomon had told them that this issue was a political matter. Underwriting personnel recalled Clark specifically stating that he did not want Beacon to acknowledge that the insured's lawyer was involved and to make sure that no one mailed any Beacon materials to the lawyer's office.

Public records searches revealed that the lawyer and a state representative said to have opposed Beacon legislation were brothers. A Beacon vice president indicated that the state representative lead a dissenting group of democrats against the proposed Beacon legislation. The Journal of the House of Representatives for the June 24, 2005 assembly indicated that the representative was not present for the vote on the bill. The House voted in favor of the bill, as did the Senate, but the Speaker of the House chose not to transmit the bill to the Governor. We understand that the Governor had announced that he was going to veto the bill, and there was a question whether the House had enough votes to override a veto. We located an Email dated 7/13/2005 from a vice president to a director with the Workers' Compensation Association of Rhode Island Employers that implied that Beacon "asked that [the legislation] not be transmitted yet as we are trying to dialogue with the Governor." Without submission to the Governor in the 2005 session, the bill was not enacted into law. The legislation was resubmitted in the Senate in the 2006 session for a vote on 1/26/2006, where it was passed. The bill was not introduced in the House in 2006. The vice president explained that the lobbying that Beacon was doing in the summer of 2005 was focused on procuring the necessary votes to override the Governor's veto rather than concerns over initially passing the House and Senate.

Beacon employees interviewed stated that Solomon and Clark instructed them to "forget the past" when it came to the insured and to reinstate the policy. An Email from Clark to Solomon on 8/4/2005, one day before the effective date of the new policy, stated that he and another employee had met with the lawyer and the owner that morning and "as you [Solomon] requested [Beacon] cleared the air on past monies and advised them that we are going to only be addressing the future." Clark also asked Solomon's opinion on Beacon's treatment of the insured's client companies, and whether "is it you [sic] desire that we start from now and now [sic] look back at any earned premium?" Solomon responded the next day, and included the owner of Cornerstone in the response, "we want to start fresh…but if we have exposure with client companies then we want to collect the earned premium." It is unclear why the owner of Cornerstone was included in the Email chain. Interviews and documents showed, however, that the balance was written off and that Beacon did not pursue collection from the client companies. Specifically, an Email dated 9/8/2005 confirmed "…a management decision has been made Not to Charge the client companies…[because the insured] had provided each client company with a COI [certificate of insurance] of WC [workers' compensation] from [their other carrier]."

We were provided with a handwritten letter from the owner of the insured to a Beacon employee dated 9/6/2005. It appeared that the owner was upset with Beacon's request to review the company's contracts with its client companies. The owner also stated that Beacon was attempting to purposely hurt him and put him out of business. Towards the end of the letter, the owner wrote, "I already know that Beacon give [sic] that policy [the new policy] because of [Beacon's] own interest only."

We located an Email chain between one of Beacon's largest agents and Clark on 12/23/2005 that discussed Solomon's attitude towards the Beacon legislation. The agent wrote that the hiring of a new political consultant was "typical" and expressed the attitude that "if we 'buy' enough people, we get it passed - - **just like the whole [temporary employment agency] leasing deal**" (emphasis added). Other than this Email, we did not find any documents that indicated that this agent was involved or had knowledge of this matter.

<u>Write-Off of Receivables</u>

We located an Email chain between underwriting, finance and collections that discussed the write-off of $130,216 owed from the insured. An underwriting manager wrote to the finance manager on 9/14/2005, "We have made the decision that we will NOT be collecting this overdue premium…" This chain also contained an attachment with a spreadsheet with the write-off amount and signature lines for the underwriter, underwriting manager, vice president of underwriting, and account assistant. We also checked the Accounts Receivable Summary in PowerComp for this policy, which also showed that $130,216 was written off. We were told that Clark authorized the write-off of the receivable.

Four other companies that were related to the owner of this insured were cancelled before the June 2005 negotiations. The balance due at cancellation for all of these accounts (not including this insured) totaled $158,680. Beacon wrote off $26,204 related to one of these companies in 1997. The remaining $132,476 was written off by Beacon after meetings with the insured's lawyer and the retention of the state representative's law firm.

It is our understanding that Beacon's policy for prior debts of insureds and their predecessor companies need to be repaid before Beacon writes a new policy.[140] Underwriting personnel also explained that Beacon had a policy whereby temporary agencies' clients were liable for uninsured exposure in the case of underreported payroll. As stated above, Beacon decided not to pursue the client companies of the insured for premium.

<u>Involvement of the State Representative's Law Firm</u>

We searched Beacon's financial data for the last name of the state representative and found that Beacon made a payment to a law firm containing this state representative's name for $25,000 on 8/5/2005 (the date of the reinstatement of the temporary employment agency). This payment was charged to the Consulting Fees expense account. An Internet search for the law firm revealed that the state representative was an attorney of the firm.

We also located Emails that mentioned the representative. The first Email we found was dated 7/25/2005 in which Clark emailed the representative at his personal Email address and asked if he was working on both the temporary employment agency and another account (see "Politically-Motivated Write-Off of another Insured"). An Email dated 7/27/2005 indicated that Solomon inquired whether underwriting had put together a package of documents for the representative on the temporary employment agency matter.

No one we interviewed could explain what the representative's law firm did to earn its $25,000 fee. The Beacon employee responsible for managing collections was unaware of the contract with the representative's firm. A vice president said that he was confused when he learned of the representative's potential involvement in the matter. He said that the representative sided with the Speaker of the House and thought the representative would have voted for the bill anyway.

Parent explained that a flat fee of $25,000 was paid to the representative purportedly for services related to the temporary employment agency, but that to his knowledge, the representative did not perform services relative to this account. The fee agreement provided as support for the payment indicated Beacon agreed to pay, "an initial retainer of $25,000.00. No other fees will be charged other than the retainer of $25,000.00." The agreement stated that "You are hiring us as your attorneys to represent you in the following matter: For the period August 1, 2005, through December 31, 2005, we will

[140] 2003 P.L. ch. 410 § 11(b)(2) allows Beacon to deny an application for "nonpayment of premium for current or prior policies issued by [Beacon] to the applicant."

provide collection and/or litigation services on overdue accounts." The representative and Solomon signed the agreement for the law firm and Beacon, respectively.

After we raised questions on this arrangement to Beacon senior management, Beacon's counsel, on Beacon's behalf had requested that the representative provide a description of its services performed and any files they may have kept related to Beacon matters. Furthermore, Beacon requested the return of the $25,000 retainer if a description of services could not be identified. The representative explained it was a "flat fee" arrangement and that he kept no files related to billing or services performed. He explained that the payment was not a retainer, and therefore, no "excess retainer" remains to be returned.

The Journal of the House of Representatives for the June 24, 2005 assembly showed that the representative voted in favor of the Beacon legislation.

<u>2006 Renewal</u>

Parent said that Beacon was "looking for any reason to fight the [August 2006] renewal" of this insured based on all the past history. On the advice of Beacon's counsel, they decided to conduct a surprise audit of the insured's largest client company. Personnel from Beacon's loss prevention and premium audit departments visited the client company (also a Beacon insured). The audit did not find any underreporting of payroll and the policy was renewed.

Politically-Motivated Write-Off of another Insured

Overview

After we discovered the representative's Email address, we ran a search of all Emails for this address and found an Email from Clark to the representative on 7/25/2005 that discussed another insured. Clark wanted to confirm that the representative was working on both the temporary employment agency matter as well as this other insured, and indicated that this other insured "is the account with a large additional premium."

Based on this connection to the representative and the facts of the temporary employment agency situation, we performed additional procedures on this account.

Procedures

We performed the following procedures to gain an understanding of the issues raised and to attempt to substantiate the information we received from interviews and sources:

- Generated a report including an Account Summary and other relevant policy and premium information from PowerComp,
- Read electronic AuditLynx data for audit results and alerts,

- Read electronic PowerComp Notepad data for "Policy" comments,
- Read documents in selective underwriting and premium audit sections of OnBase,
- Read relevant Emails where the insured was mentioned,
- Searched the Rhode Island Secretary of State website for the insured,
- Discussed the policy with underwriting and premium audit personnel.

Relevant Findings

Our procedures showed that Beacon wrote off $229,085 of past due balances from this insured two years after the policy ended. This write-off may have been politically motivated as we found that an executive of the insured was the brother of the lawyer of the temporary employment agency mentioned previously and thus also the brother of a state representative. Also, as the Email cited above stated, a state representative's law firm was involved with this account.

The insured performed janitorial work primarily in commercial buildings. In September 2002, the insured started another company that cleaned smoke and dirt stains from drop ceilings in commercial buildings. Both companies subcontracted, through a franchise agreement, "all work to individuals and corporations and issued 1099's to the workers," according to an audit summary dated 5/27/2003.

A Beacon employee indicated that the insured applied for a Beacon policy with only two clerical positions and an outside salesperson in 1996. In the first year of coverage, effective 6/17/1996, written premium was only $650. Beacon insured the company for two more years, with the last policy effective 6/17/1998 to 11/1/1998. Written premium in this last four-and-a-half-month period was $4,060. After a lengthy collections process, the insured made a final payment of $1,238 on 3/28/2002 for the 6/17/1998 through 11/1/1998 policy. We noted that Beacon wrote-off the remaining $318 balance due on the policy on 4/24/2002.

The company returned to Beacon effective 7/20/2002 again with only clerical and sales positions on their application. According to the Account Receivable Summary in PowerComp, the initial premium for the 7/20/2002 through 7/20/2003 policy was $740, which was paid by the company. During a new business audit, for the 7/20/2002 through 7/20/2003 policy, an auditor discovered many independent contractors performing janitorial services. We found Emails that showed Beacon's counsel became involved in the legal interpretation over employee versus independent contractor in July 2003. These documents indicated that counsel spoke with the lawyer representing the temporary employee agency above about the issue with this other company. Another Beacon vice president was also involved, and noted that it was Beacon's responsibility to prove to DBR that the company's workers should be classified as employees.

Beacon ultimately determined that the contractors should be classified as employees and billed a premium of $229,085. The insured refused to pay this additional premium and according to Notepad entries dated 10/31/2003 and 11/21/2003, Beacon did not renew the policy and cancelled the policy effective 7/20/2003 because the insured would not cooperate with scheduling and performing a final audit. Beacon continued to invoice the insured through 10/31/2004 for the premium due of $229,085.

Beacon assigned counsel to the collections effort in November 2004, which continued through June 2005. Counsel prepared a complaint and filed for demand payment of the $229,825 [141] on 2/1/2005. On 2/25/2005, the insured's attorney requested a 30-day extension of the filed complaint, which was granted. On 5/2/2005, Beacon's counsel filed a motion for summary judgment relating to the demand for payment of the outstanding premium.

Immediately after the meetings on the temporary employment agency matter between Clark and the employment agency's lawyer in June 2005, Beacon discontinued the collection efforts on the janitorial services company and discussed writing off the $229,085 balance. On 7/1/2005, a finance employee posted a Notepad entry that indicated that the premium audit manager recommended writing off the balance as uncollectible and that Beacon's counsel would hold off on its collection efforts. The premium audit manager responded to our request for information about the write-off on 8/1/2006 and stated:

> *My response was, I suppose [the write-off] is OK and my thought process was Beacon may not win the collection dispute if the case goes to court because [the insured] may be able to convince a judge that the janitorial workers are independent contractors (my opinion only). I was satisfied with the fact that Beacon was not writing a $740 policy with numerous individuals being deemed as independent contractors and issuing certificates of insurance to the client companies of [the insured]. I in no way recommended the write off.*

A 7/14/2005 Notepad entry indicated that Beacon's counsel would continue to monitor the employee versus independent contractor issue, but the decision was made to write off the balance because the time involved would have been substantial. The CFO signed a write-off request on 7/21/2005, for the entire balance owed from the insured. We asked the CFO on 9/15/2006 if she could provide us any information into why the $229,085 was written off and who ultimately approved the write-off. She responded on 9/20/2006 and explained the write-off was part of a "routine collection procedure" that was requested by a finance employee and approved by the finance manager on 7/15/2005. The collection procedure involved moving open premium receivable balances to bad debt expense for a number of different policies.[142] She continued:

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[141] We do not know why the amount in the complaint was slightly higher ($229,825) than the balance due per PowerComp ($229,085).

[142] The CFO faxed us information on 9/20/2006 which listed the policies, including the one discussed herein, which were transferred to bad debt expense. Based on Notepad entries, Beacon's counsel, not the

> *In an attempt to maintain conservative accounting practices and realistic expectations regarding the potential for recovery, it is our standard collection procedure to write off an outstanding debt that has been turned over to a collection agency or attorney to pursue. This does not mean the receivable balance has been forgiven. All outside collection files are monitored by [the finance department] until such time they are recovered or deemed uncollectible by the collection agency or attorney.*

The CFO further stated that to the best of her knowledge, the suit "is still pending and the collection file is still considered by [finance] as an open collection file being handled by [counsel]." This statement appeared contradictory to the Notepad entry above that said Beacon's counsel stopped its collections efforts. Finally, the CFO stated, "I was not instructed by anyone to write off this account."

On 9/24/2006 we received an Email from Parent confirming that the matter is an "active lawsuit" and he instructed counsel "to file a summary judgement [sic] and continue to pursue this."

State Senators' Employee Referral

We located an Email dated 5/25/2005 that discussed a potential employee referred to Beacon by a state senator. The Email mentioned that Beacon's recruiting consultant did not have a good phone interview with the candidate. In the Email, the human resources director stated that the candidate was going to come in for an in-person interview but it did not "sound promising." The human resources director asked Clark, "Do you know if we have to find a home for [the candidate]?" We noted on a 2005 Beacon payroll register that the candidate was hired during 2005. We conducted a public records search but did not determine a connection between the candidate and the senator. The human resources director explained to us in a 9/29/2006 Email that Solomon instructed her to hire the candidate, but that Solomon did not mention the senator.

The senator voted for the Beacon legislation during both the 6/16/2005 and 1/26/2006 assemblies, per the Journals of the Senate from both of these dates.

Beacon Mutual Political Action Committee

We learned through interviews that Beacon established a group called the Beacon Mutual Political Action Committee during 2002. Based on interviews with members of senior management, the purpose of establishing the PAC was to reduce the amount of personal requests that Beacon executives were getting for political donations.

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firm that had received the $25,000 retainer, appeared to be handling the collections on this account, The fax included 40 additional companies, whose outstanding balances totaled $20,836 that were being moved to bad debt expense.

We requested and were provided with all of the PAC's reports, called "Campaign Contributions and Expenditures Reports," many of which were stamped as filed by the Rhode Island Board of Elections. The first report was dated 5/7/2002 and indicated that the cash balance began at $0 as of 3/1/2002.

Between 3/1/2002 and 4/30/2002, each of the six vice presidents and Solomon donated $1,000 for themselves and their significant others or spouses also donated $1,000. The owner of Cornerstone also donated $1,000 in June 2002 for a total of $15,000 during the year.

The same donors contributed equal amounts in 2003 and 2004 (with the exception of the owner of Cornerstone, who did not contribute in 2004). No contributions were made to the PAC during 2005.

We scanned a listing of activity, deposits and disbursements, from the PAC from February 2003 through April 2006 and noted payments between $50 and $1,000 to a variety of political campaigns. The distributions appeared to be widespread and included state and local recipients, democrats and republicans.

It is our understanding that not-for-profit entities such as Beacon are banned from making direct political contributions. According to the schedules provided to us, Beacon money was not transferred into the Beacon Mutual PAC. All contributions were made by the persons noted above.

We interviewed members of senior management about their involvement in the PAC. We asked whether there was an expectation that the $2,000 they contributed to the PAC would be reimbursed by Beacon. Responses varied on this question:

- One vice president said that senior management was expected to contribute money to the PAC each year and claimed that Solomon made it clear that these "donations" would be considered "at bonus time."
- Another vice president also recalled that all members of the senior management team were asked to donate to the PAC, but that it was not mandated. Solomon reportedly told them that he needed, "everyone to contribute, you're all going to get it back in your bonus."
- Another vice president explained that all vice presidents were essentially told, "You're paid well, and we're in this together" and were all expected to donate to the PAC. He did not recall discussions about reimbursement of the PAC donations.
- Finally, another vice president said that no one ever mentioned reimbursements of the PAC donations.

We did not find any Emails or documents that showed that Solomon or anyone else promised or requested reimbursement for PAC donations.

Contributions to a Politician

None of the members of Beacon senior management contributed to the PAC during 2005, however, we found that many of them contributed to the political campaign of a Rhode Island candidate. The contributions were made in May and June 2005, while the Rhode Island General Assembly was considering the Beacon-supported legislation. The following table shows the contributors, dates and amounts from Beacon employees, board members, and consultants extracted from the Federal Election Commission website listing of Schedule A itemized receipts for the campaign:

Position	Date	Amount
Vice President Legal Services	5/27/2005	$ 1,000
Sollosy	5/31/2005	$ 1,000
Vice President Finance and CFO	6/2/2005	$ 1,000
Parent	6/2/2005	$ 1,000
Solomon	6/2/2005	$ 2,100
Executive Assistant	6/3/2005	$ 1,000
Vice President Information Systems	6/3/2005	$ 1,000
Director, Human Resources	6/7/2005	$ 1,000
Vice President Community Relations	6/7/2005	$ 1,000
Clark	6/8/2005	$ 1,000
Attorney	6/23/2005	$ 250
Former Board Member	6/28/2005	$ 250
Cornerstone Communications Group	6/30/2005	$ 4,000
		$ 15,600

These political donations were not directly funded by Beacon; however, we discussed the timing and nature of the contributions with several of the contributors. Five of the respondents indicated that Solomon approached senior management members individually and asked them to donate to the campaign. Three of these employees indicated that Solomon also offered to reimburse them for the donations to the campaign, but that they did not accept the offer. Two employees simply indicated that they were not reimbursed for the contribution.

Two employees retained external counsel related to our inquiry. Both of these employees indicated that Solomon asked them to make a donation to the campaign and that Solomon personally reimbursed them $1,000 each. One of these employees indicated that, after several months, they paid Solomon back for the reimbursement. As we explained above, senior management was not asked to donate to the PAC in 2005, and we asked whether these contributions to the campaign were in lieu of the PAC contributions in 2005. Representatives of senior management questioned did not indicate that there was a direct correlation between the annual PAC donations and the donations to this campaign in 2005. Over the 34-day span from 5/27/2005 through 6/30/2005, Beacon employees and related parties donated $15,600 to this campaign.

During the period 6/16/2005 and 6/23/2005, we found several Emails between Solomon, a vice president, the owner of Cornerstone and the candidate which appeared to provide the candidate with possible material for a commentary in favor of the Beacon-proposed legislation. On 6/16/2005, Solomon wrote to the candidate and provided documents which he claimed, "address the 'lowest possible price' concern."

On 6/16/2005, the candidate replied to Solomon and stated, "[The owner of Cornerstone] said he'd draft something for me to look at, and I'm not sure what your key issues are in all of this. There is the 'lowest rates' issue, the out of state business issue, the mutual fund issue (what does this do to for-profit status?), the NCCI issue, the board changes (BM or just the sub?) and the general great job done point. I need some focus. Thanks." Solomon forwarded this response to the owner of Cornerstone on 6/17/2005.

On 6/22/2005, a vice president sent the candidate an Email with a three-page document, written in the first person, but for which the author is not identified; it appears to be a letter or statement in support of the Beacon-supported legislation. In his Email, the vice president wrote, "please accept this rough draft for your consideration."

On 6/23/2005, the same vice president sent another Email to the candidate and stated, "before you submit anything to the Journal--we may have hit a snag at the state house. Inexplicably, the Speaker put the bill over until Friday. This, of course, limits the availability of a veto override. [Solomon] is to meet with the speaker at some time tonight. he is there now…just wanted to give you the heads up before you submit anything. We're worried about some kind of deal, thus the delay…as always, thanks for the support."

Later on in the day on 6/23/2005, the vice president sent the candidate another Email and copied Solomon and the owner of Cornerstone. In the subject line, he wrote, "I just spoke to [a Beacon board member], can you hold off on the commentary piece until we know the date of the override? Thanks so much."

An Internet search for news stories on or shortly after 6/23/2005 did not identify statements made by the candidate related to Beacon.

Retention of a Political Consultant

The Almond Report indicated that Beacon contracted with a political consultant for "legislative consulting services regarding the 2006 legislative session, at a rate of $3,500 per month."

We found an Email chain between an agent and Clark on 12/23/2005, where the agent informed Clark that Solomon had hired a political consultant. Excerpts of the Email chain stated:

- Agent – "Heard Beacon's hired another political consultant, just what you needed."
- Clark – "Never heard of a new political hire. Why would we be told? We are only the officer[s] of the company. What is his/her function?"

- Agent – "Don't know [Solomon] just happened to mention it to me when he called yesterday…[Solomon] [s]upposedly hired him to help distance Beacon from [the owner of Cornerstone] and to help in the House. [I find] that interesting since I thought that was [another Beacon lobbyist's] big strength."

We requested and read two memos related to the retention of the political consultant. The first, dated 1/12/2006, was from Solomon to the consultant stating "Thank you for agreeing to provide legislative consulting services to Beacon for the 2006 legislative session...Also enclosed, please find a check representing January's monthly retainer of $3,500…" The second memo was a response from the consultant that stated, "As we discussed, this office will provide professional consulting services at a flat rate of $3,500 per month." We read supporting documentation for the monthly payments that showed Beacon continued to pay the consultant $3,500 a month from January through April of 2006.

On 4/25/2006, Parent terminated the agreement with the political consultant by letter, citing "the recent happenings at Beacon" and Solomon's departure as the reason for the termination.

We inquired with a vice president related to the political consultant's involvement. He responded by Email on 8/4/2006:

> *At some point in January or February of this year I learned that Joe [Solomon] was working with [this consultant]. I was not involved in any way whatsoever with this arrangement, nor to my knowledge was anyone else. I do not know whether he was hired to lobby or consult or both. [He] did tell me that he planned to rely upon him like he did on [the owner of Cornerstone]. I am not sure whether this ever took place. I do not think he ever lobbied nor do I believe he ever registered. I never [sic] or spoke to him. I do know that his arrangement was terminated when it came to Senior Management's attention shortly after Joe [Solomon] was terminated.*

According to the Rhode Island Secretary of State website the political consultant is a registered lobbyist, but Beacon was not listed as an entity.

Other Political Matters

Retention of Firm for Government Relations and Lobbying Services

We requested and read all invoices and supporting information relating to the retention of another firm for government relations and lobbying services for 2004 and 2005.

Total payments to this firm were $74,884 and $71,914 in 2004 and 2005, respectively. The majority of these fees related to a flat $5,000 monthly payment that is generally described as "professional services rendered in connection with government relations." We read an invoice dated 12/13/2005 where someone crossed out the $5,000 amount and wrote $6,500. Solomon initialed the invoice and wrote "ok to pay."

In addition to the monthly fee, the invoices often included "out of pocket costs" for telephone, copying, and postage costs, generally less than $150 a month. Several invoices included supplemental services at hourly rates between $177 and $290 per hour. The following table summarizes the supplemental charges on the firm's invoices:[143]

Invoice Date	Brief Description of Services	Hours	Per Hour Rate (Calculated)	Total Fees	Expenses	Total Invoice
6/8/2004	Tax Issues (2002)	9.3	$ 275	$ 2,558	$ 77	$ 2,635
10/14/2004	Tax Issues (2002)	Not Provided		$ 3,273	$ 98	$ 3,371
11/10/2004	Tax Issues (2002)	Not Provided		$ 4,611	$ 195	$ 4,806
12/6/2004	Tax Issues (2002)	Not Provided		$ 2,255	$ 68	$ 2,323
1/20/2005	Tax Issues (2002)	Not Provided		$ 2,943	$ 88	$ 3,031
2/11/2005	Tax Issues (2002)	Not Provided		$ 740	$ 74	$ 814
3/9/2005	Tax Issues (2002)	13.7	$ 177	$ 2,426	$ -	$ 2,426
5/11/2005	Tax Issues (2002)	1.5	$ 290	$ 435	$ 86	$ 521
8/22/2005	Tax Issues (2002)	Not Provided		$ 232	$ 7	$ 239
10/12/2005	Tax Issues (2002)	4.9	$ 290	$ 1,421	$ 43	$ 1,464
11/14/2005	Tax Issues (2002)	Not Provided		$ 116	$ 3	$ 119
TOTAL				**$ 21,010**	**$ 739**	**$ 21,749**

Based on the supporting information, all of the supplemental charges appeared to relate to the federal income tax effects of pending legislation on Beacon.

We summed the monthly charges for professional fees, expenses, and supplemental charges and compared them to total disbursements according to Beacon's accounts payable data:

Total Disbursements Per Accounts Payable Data:	
2004	$ 74,884
2005	$ 71,914
	$ 146,798
Total Per the Firm's Invoices:	
Monthly Fee ($5,000) for 24 months:	$ 120,000
December 2005 Fee Increase	$ 1,500
Average Monthly Expenses ($150)	$ 3,600
Supplemental Charges	$ 21,748
	$ 146,848
Difference	**$ 50**

We did not inquire about the $50 variance above. The employee of the firm that was assigned to work with Beacon was a registered lobbyist for Beacon according to the

[143] Due to some timing differences, the actual payments made by Beacon did not always match the invoice amounts, resulting in several balance carry-forwards not reflected in the table. In total, the amounts of charges and cash disbursements were equal.

Rhode Island Secretary of State website. We performed a search of the accounts payable disbursement data and did not find any direct payments to this individual.

Politically-Themed Emails

During the course of the Examination, we found several Emails that were not directly related to cash disbursements or policies but that were of a political nature. We have summarized some of these Emails below:

- Emails between Solomon and a vice president in May 2003 indicated that they were planning on taking certain senators golfing to private country clubs. We have not confirmed that Beacon paid for these rounds, or that these senators actually attended the events. The proposed dates, locations and attendees were:
  - 6/17/2003 – A vice president discussed golfing at a country club with three senators.
    - On 9/29/2006, Parent explained via telephone that this vice president did not take these legislators golfing. The vice president said that Solomon asked him to do so, but that the vice president did not have a golfing membership to this country club.
  - 6/19/2003 – Solomon discussed golfing at a private golf club with a senator, a politican, two lobbyists, a boardmember and possibly the vice president.
    - On 10/2/2006, Parent explained that there were no charges on the golf club statements for 6/19/2006 and no other charges around this time period that referenced these individuals.
- Solomon wrote an Email to the senior management team, Sollosy, and the owner of Cornerstone on 1/14/2004 indicating that he was expecting a reporter from the Providence Journal to inquire regarding, "entertaining of legislators…tickets to sporting events or inviting them to golfing events." He reminded the recipients that Beacon's policy prohibited them from talking with the media.
- Solomon wrote an Email to a vice president on 5/5/2004, which explained why he was not fully disclosing his meetings with "our chairman, certain board members, consultants, and legistlators [sic]" to members of senior management. Solomon told the vice president, "You knowing about my meeting with the senate leadership [put] you (and me) in a difficult position should I not be able to meet with them. It probably would have been best if you did not know what [he][144] was talking about when he approached you."
- A vice president wrote Solomon on 4/28/2005 and indicated, "I saw [a senator] today. He told me that a mtg took place today with the leadership and everything

[144] Additional context of the Email suggested that this was a senator.

is looking good. I played mickey the dunce and said great…we should very shortly disclose something to [an individual whose]…son is right in the middle of the senate leadership."

- On 6/3/2005, Beacon's counsel sent Solomon proposed language for the pending legislation. Solomon forwarded the Email to a vice president and board member and said, "Attached is a copy of the legislation which needs to make it's [sic] way into the Senate and House Bills. [One of our lobbyists] has taken care of the House and will give [it] to [the senator] next time he meets with him."
- Clark's assistant, sent an Email to underwriting and loss prevention personnel on 6/20/2005 on behalf of Clark. She asked everyone to, "identify accounts that Beacon has done something favorable for and who would have something positive to say to the Governor about Beacon in a letter-writing campaign." We identified several of the accounts covered in the "Premium Pricing" section based on responses to this request. As a follow-up to this Email, Clark wrote to the senior management team and explained that "[One underwriter] did 'think' that [an agent] was not so positive on the idea [of a letter writing campaign] and said he would discuss with [the president of Beacon's largest agency]. I did remind him [the agent] that we need [the agency's] support and the many many insureds that we have done some favors for." Another vice president responded, "maybe you should remind him about [that other individual][145] and how that all evolved from [Beacon's largest agency]?????"
- On 6/21/2005, another agent sent Clark an Email and explained that an article in the Providence Journal reported the "Senate/House leadership [is] trying to convince the [Governor] not to veto the Beacon bill. Sounds like [one of our lobbyists and his firm] has the full court press on. Can only guess how big that check will be!" Clark responded, "Hey, when have you ever known us for not spending a few dollars?"
- On 7/13/2005, a vice president emailed an acquaintance about the legislation that had passed the House and Senate. The acquaintance had asked, "Has this [bill] been transmitted to the Governor and, if so, what do you expect will happen?" The vice president responded, "Good question. We have asked that [the bill] not be transmitted yet as we are trying to dialogue with the Governor—talk about the substance—not the political or talk show rhetoric. He refuses to even talk with us—but we hold out hope."
- Following a hearing before the Senate Labor Committee, where DBR and Governor representatives opposed the Beacon legislation, one of Beacon's largest agents emailed a senator on 1/13/2006 and asked, "Was the Beacon hearing as bad as it sounded in the [Providence Journal]?" The senator responded, "I didn't think it was that bad. Almost everyone spoke in favor except Joe [Torti, DBR] and the

[145] An attorney for a company that has been filing lawsuits against Beacon for years.

Gov's rep. I took issue with a couple of things the Gov had in a statement. One was that 'traditionally market conduct studies came up with problems with a company' and two, that he compared Beacon to Roger Williams Hospital." The agent forwarded this Email to Clark who responded, "I hope he is right. I will delete this (as I do with all your/our) emails."

RECOMMENDATIONS

General

- The Beacon senior management structure should include at least one, or two additional "chief" officers, such as a COO or CFO in order to effectively fulfill these functions. As noted in the body of this report the current CFO is CFO in name only and has not been given the true responsibilities of this position. The COO and/or CFO should report to both the CEO and to the board of directors (or committees).
- Utilization of the executive session of the board of directors should be limited to certain sensitive matters only. These meetings need to be clearly documented and the resolutions of these meetings should be disseminated to other board members and members of senior management, if appropriate.
- Beacon should hire a Director (or Vice President) of Internal Audit from outside of Beacon. The individual should have independent oversight over the internal audit function (outsourced or otherwise). This Director (or Vice President) would be responsible for the design and operating effectiveness of internal controls at Beacon, and should report directly to the Audit Committee.
- All employees and board members must be required to sign an annual ethics representation whereby they disclose:
    - They have read, understand and have complied with Beacon's code of ethics and expense reimbursement policies,
    - The existence of any related parties (insureds and vendors) that conduct any business with Beacon,
    - Any agreement, whether written or verbal, that they have entered into on Beacon's behalf with a vendor, agent or insured, that has not been approved by the legal or finance departments,
- Underwriters should be required to make the following additional representations:
    - I have not priced any accounts outside of filed programs and rates,
    - I do not have any knowledge of accounts priced outside of filed programs and rates,
    - I reported any and all questionable underwriting activity to the independent review committee / internal auditors.

Underwriting

- Beacon should hire a skilled professional with knowledge and experience of workers' compensation insurance, particularly underwriting, to run the underwriting department, and to be ultimately responsible for the underwriting department and decisions (Director or Vice President of Underwriting).

- Beacon should discontinue the interim underwriting-by-committee process that is currently in place, where nonqualified members of senior management (Director of Human Resources and Vice President Information Systems) are making pricing decisions.
- Beacon should complete the restructuring of the underwriting department. The new Director or Vice President of Underwriting should be responsible for appropriately staffing the department. This will include the reallocation of underwriting resources, and may include the termination of certain personnel who are unable or unwilling to adapt to appropriate methods of underwriting and rating.

- Beacon must develop a complete underwriting manual that complies with all applicable Rhode Island statutes and regulations, and includes:
  - All filed and approved programs,
  - The relevant schedule rating and experience rating rules per NCCI,
  - Beacon's policies and procedures relative to out-of-state coverage including:
    - Coverage of out-of-state employers' payroll exposures in Rhode Island,
    - Coverage of Rhode Island employers' payroll exposures outside of Rhode Island through fronting arrangements, including guidelines on limitations (i.e. the proportion of an employer's payroll out-of-state).
  - Beacon's policy of collecting prior debts of related entities before reinstating coverage,
  - Beacon's policy relating to charging client companies of temporary employment agencies for unreported payroll.
- Once developed, Beacon should assure that all filed and approved programs are available to all revelant employees and to all of their independent agents and that these persons are aware that the programs must be followed.
- Beacon should require certification of information necessary for underwriting upon renewal each year. Currently Beacon relies on its premium audits for payroll and classification figures and relies on agents' or insureds' unwritten representations relating to certain program qualifications (i.e. CompAlliance and Safety Groups). Requiring annual certifications and supporting documentation is a sound underwriting practice that ensures eligibility for the underwriting program offered.

- Beacon should require mandatory training on Schedule and Experience Rating for all underwriters. There should be no deviation from filed and approved plans.
- Beacon must immediately discontinue the use of un-filed plans and programs including Safety Groups, Multiple-Year deals, Composite Rating, and Trend and Development pricing – all pricing should be based on filed and approved schedule rating and experience rating plans.
- Beacon must continue to follow DBR's directive prohibiting the use of consent-to-rate "credits". In order to ensure compliance with statutes related to unfair discrimination in rating, policyholders may only be granted "credits" in accordance with consistently applied underwriting criteria following properly filed and approved rating plans.
- Schedule rating underwriting forms must be completed and imaged as of the effective date of the policy and reflect the reasoning for schedule credits and debits including why the insured is significantly better or worse than its class in each schedule rating category.
- Beacon should implement an electronic time-stamp function into the OnBase system that records the time and date of documents imaged. Documents deleted from the OnBase imaging system should be logged and backed-up periodically including the requestor's name, the insured's name and the reason for the deletion. These documents should be subject to periodic audits.
- Beacon should implement a procedure for periodic internal audits of underwriting documentation focusing on completeness of referrals and schedule rating forms and the adequateness of support for credits and debits.
- Establish formal protocol relating to changing credit percentage after the policy effective date.
    - Ensure that these changes are not applied retroactively in accordance with NCCI guidance.
    - Properly document the significant change in physical risk at the insured's location that resulted in the credit change.
    - Disallow ANY changes to the credit percentage subsequent to the policy expiration date.
- Beacon should immediately discontinue the practice of stable pricing agreements, unless the agreement follows an approved form and/or program.
- Beacon should establish limits to, or eliminate the ability of underwriting management to write-off accounts receivable balances without finance department approval.
- Beacon should create a position, such as a Director of Filings and Regulatory Compliance who will oversee a unit responsible for rate filings and other

regulatory compliance matters. The individual hired should have a strong background in rate and form filings and underwriting.

- This individual will be responsible for determining which programs must be filed with the DBR, and will oversee the filings process.
- All approved filings and programs should be clearly posted by Beacon for all underwriters and agents to access as needed.
- Require this individual to be involved in all underwriting meetings.

- Beacon should create an interface to review EMods electronically from NCCI. The Company is currently using a very manual process that has led to delays in posting the appropriate EMod on policies. There should be no ability to allow anyone at Beacon to override the NCCI EMods.
- Beacon should consider assigning a new policy number, adding a second field that contains a suffix for policy numbers, or a similar procedure for each renewal in order to clearly distinguish between policy years.
- Cancellation criteria should be systematic and applied consistently and the underwriting department should not have the option to stop the cancellation.
- Cancellation notices should clearly state the reason for policy cancellation, and may only be made for reasons permitted pursuant to statute.

Regular Internal Review of Underwriting Practices

- Beacon should begin to apply data analytics to select certain pricing practices and account activity to be reviewed internally.
- Beacon should consider establishing an independent review team that meets regularly to oversee this process, and which reports directly to the Board or Audit committee.
- Beacon should develop a process where the underwriting department works with the loss prevention department to assess the underwriting implications of the proposed changes to loss prevention programs (see "Loss Prevention" below).

Premium Audit

- Beacon should hire, or assign from existing personnel, a Vice President of Premium Audit or equivalent position, conferring upon this individual the authority to challenge the Vice President of Underwriting.
- Beacon should require the automatic posting of all premium audit adjustments. Audit adjustments that result in a "significant" increase or decrease in premium should be tabled for a consensus meeting between premium audit and

underwriting before posting. The resolution of classification issues should be clearly documented.

  - If a consensus resolution is not found, Beacon should arrange for an NCCI inspection and determination.

- New business, interim and final audits should be completed within the timeframe specified by Beacon policy. A report of audits not completed within the specified timeframe should be reviewed jointly by the premium audit and underwriting departments to determine if insured behavior is cause for cancellation or other appropriate action.
- "Not endorsed" premium audits that would have resulted in large changes in premiums should be investigated regularly and summarized for review by the CEO and board of directors.

Loss Prevention

- Beacon should hire, or assign from existing personnel, a Vice President of Loss Prevention or equivalent position, and this individual should not be employed by the underwriting department. On a regular basis, at least quarterly, the Vice Presidents of Loss Prevention, Underwriting and Premium Audit should discuss a listing of insureds that have not cooperated with Beacon's loss prevention programs. A consensus decision on the plan of action with respect to cancellation, renewal, surcharges, etc. allowable in accordance with applicable statutes and regulations should be presented to the CEO for approval.
  - The listing of insureds to be discussed and the resolutions should be clearly documented and provided to internal audit.
- This individual should also be responsible for analysis and evaluation of loss prevention programs and techniques to ensure the effectiveness of each program and/or technique in preventing injuries and losses. Programs that do not enhance workplace safety and/or contribute to loss prevention should be discontinued and no longer considered as appropriate criteria to be utilized in underwriting and pricing.

Information Systems

- The Information Systems area should be required to regularly test reports from PowerComp and the data warehouse for accuracy.
- All out-of-state policy data should be integrated with PowerComp through an interface with companies writing business through a fronting arrangement with Beacon.

- The following fields within PowerComp should not be changeable, or if allowed to be changed, a listing of these exceptions and the effect on premium or commission should be generated:
  - Base Commission rates
    - Should be calculated in the same manner for every policy written, the only difference being the higher commission paid during the first year of coverage.
  - NCCI Classification Code rates
  - NCCI EMods
- We found that some of the calculations for premium were based on a factor that is different from both earned premium and written premium. The calculation should be based on earned premium in order to compute the proper commissions.
- The shared earnings and contingent commissions calculations should be integrated to the PowerComp system, thereby generating payments automatically based on the insurance data within PowerComp. This practice will eliminate subjectivity and errors in the contingent commissions area.

CompAlliance

- Beacon should perform an actuarial analysis of the CompAlliance program to determine whether the discounts provided under the plan are justified. Documentation created at the time of the implementation of the program in 1996 indicated that the cost savings would be realized through changes in the premium calculation components within three to five years, after which the credit might not be warranted. Eliminate the program if it is not actuarially justifiable.
- Beacon should require independent confirmation from BCBSRI, or include BCBSRI number, with application each year.
- Beacon should require insured to provide name/personnel number of each employee in BCBSRI program, along with individual's payroll amount, to properly calculate CompAlliance percentage.

Safety Groups

- All safety groups must be filed with and approved by DBR before premium discounts can be provided by Beacon. Actuarial justification for each of the Safety Group programs should be prepared, and if not actuarially justified, the safety group discount will not be allowed. Any subsequent change to a safety group program must be filed and approved and, in general, safety group filings should be updated whenever Beacon adopts approved NCCI advisory loss costs, files and obtains approval for an alternate rating system or files and obtains approval for a loss cost multiplier ("LCM").

- Signed contracts between Beacon and each safety group should be obtained each year. These agreements should be approved by the legal and finance departments and include the following:
    - A representation from the safety group regarding the qualification of all of its members including the qualitative characteristics that Beacon cannot easily measure such as safety training attendance, etc.
    - A complete description of amounts to be paid by Beacon for marketing or any other purpose including performance expectations resulting from such payments.
    - These agreements should incorporate a "right to audit" clause whereby Beacon can, from time to time, review the amounts spent by safety groups for these activities.
- Beacon should require formal documentation that each insured meets the criteria to belong to a specific safety group; and update the documentation yearly at renewal, maintaining such documentation in insured's underwriting file.
- Ongoing actuarial analysis should be undertaken for each safety program, and any criteria established for membership that does not show a causal connection should be discontinued.

SIC Code

- Apply the correct SIC code for every insured, currently a default SIC code is used for many insureds.
- Use a weighted average classification code rate or similar benchmark to identify potential misclassifications and outliers within industries.

Agents

- Accommodations should not be made for preferred or other agents. Agents should have no influence over the pricing of accounts, outside of providing information showing that a particular insured qualifies for a filed program or credit. The underwriting department should price accounts according to the schedule rating and experience rating plans, as modified by other filed and approved programs only, without exceptions.
- Beacon should discontinue the practice of paying for golf outings, out of state travel and other gifts to agents, other than gifts of nominal or insignificant value.

Write-Offs / Account Receivable

- It is our understanding that the underwriting department currently maintains control over collections until a policy is cancelled for non-payment. This allowed underwriting to delay collections for favored accounts.
    - All receivables greater than 30 days past due should be transferred to the finance department to pursue collections. This will allow for a consistent collections policy (i.e. no favoritism), improve collections results because finance will have the opportunity to pursue collections earlier, and allow finance to better estimate the allowance for bad debt.

Commissions

- The board of directors should approve the contingent commissions formulas, and there should be no deviation from the approved formulas.
- The finance department should perform, or at a minimum verify, the contingent commissions calculations, and they should be subject to internal audit review.

Accounts Payable Disbursements

- Beacon should add a system control that does not allow a user to add a vendor ID that already exists in the vendor master file.
- Beacon should centralize the purchasing function to the finance department and extend the functionality of the purchase order system to cover ALL purchases as follows:
    - Enact a three-way match for tangible items (purchase order – invoice – receiving report).
    - The finance department should monitor all purchases and ensure that the goods and services being ordered:
        - Have been approved by the appropriate level of management, or the board of directors, if required,
        - Are "necessary, appropriate, and convenient to administer" Beacon's operations in accordance with 2003 P.L. ch.410 § 6, § 10, and § 13.
        - Are in accordance with the budgets approved by the board of directors,
        - Are in accordance with Beacon's expense reimbursement policies.

- Beacon should perform a complete review and maintenance of the vendor master file including:
    - Eliminating dormant vendors,
    - Correcting missing address information,
    - Eliminating duplicate vendor names.
- Write-access to vendor master file including adding, editing or deleting vendors should be limited to a subset of personnel in the finance department.
- Additions to the vendor master file should be subject to the approval of the CFO and a report of new additions should be provided to the finance manager, director and internal audit for review.
- An exception report of edits and deletions from the vendor master file should be provided to finance department management.
- Internal audit should regularly perform a look-back analysis on cash disbursement activity related to new vendors added within the prior year for reasonableness.
- Add system control that does not allow a user to add a vendor name that already exists in the vendor master file.
- All disbursements should be mailed to the address in the vendor master file with very few exceptions. Commission checks may be one of these exceptions, if senior managemtent believes it is necessary and appropriate, on a very limited basis, to hand-deliver checks to agents.
- Add a system control that prevents the issuance of a payment to a vendor whose vendor ID does not exist in the vendor master file.
- Implement a standalone employee expense reimbursement system and regularly reconcile this system to the actual payments generated from AP data.
    - If possible, remove employees as vendors from the AP system and process the reimbursements through the new system.
- Formalize, in writing, the check signing limits and procedures. Make it known that second-signers on checks are vouching for the reasonableness of the payments.
- Under the current process, checks of $5,000 and below are printed with two automatic signatures and no handwritten signatures are required. Given the fact that there is no independent review of the reasonableness of these checks outside of the originating department, this is a disbursement risk. Beacon should require either:
    - An independent review of these expenses for reasonableness and compliance with policy and budgets, and/or

    - A manual signature from someone outside of the originating department.

- Beacon has weekly check runs, which should be sufficient enough to process all payments by their due dates. Do not allow for checks to be cut outside of the weekly check runs.
- Eliminate the ability to generate checks directly from the PayBase system. All checks cut from the PayBase check writing system should be sourced directly from MAS200, Payroll or PowerComp without exception.
- The board of directors should be provided a listing of the 100 largest vendors on an annual basis along with the descriptions of the services provided or goods received from each source.
- Guidelines for charitable contributions should be revised and followed and should be evaluated based upon the needs of the community, and not the association that a charity may have with board members, management or agents.
- The board of directors, or finance committee should be provided with a detailed breakdown of the expenses charged to the "Allowances to Agents" general ledger account. The budget for this account should be limited to those expenses "necessary, appropriate, and convenient to administer" Beacon.
- Beacon should amend its travel policy for employees, and only allow travel expenses for trips with a clearly documented true business purpose. Beacon should also discontinue the practice of paying for spouses of executives to travel out of state with their spouse on Beacon business.

Other

- Beacon should ensure that in all situations where they are required to report the taxable nature of an arrangement, such as the agreement with Cornerstone to provide free rent, that this information is provided to both the IRS and the person who has received the taxable benefit using the appropriate tax form. In general, arrangements, such as the free rent for Cornerstone are not a good or common business practice, and should be avoided in the future.
- Beacon should discontinue the practice of paying for corporate memberships to country clubs in order to entertain agents and others, and they should also discontinue the practice of paying for private memberships to country clubs for the benefit of its senior management staff. Paying for and sponsoring golf outings are in general an extravagance that is not necessary for the conduct of business at Beacon.