STATE OF ALABAMA
DEPARTMENT OF INSURANCE
MONTGOMERY, ALABAMA

Report of Examination

of

PRIMEHEALTH OF ALABAMA, INC.

Mobile, Alabama

as of

December 31, 2001
# TABLE OF CONTENTS

<table>
<thead>
<tr>
<th>Section</th>
<th>Page</th>
</tr>
</thead>
<tbody>
<tr>
<td>EXAMINER AFFIDAVIT</td>
<td>iii</td>
</tr>
<tr>
<td>SALUTATION</td>
<td>1</td>
</tr>
<tr>
<td>SCOPE OF EXAMINATION</td>
<td>2</td>
</tr>
<tr>
<td>ORGANIZATION AND HISTORY</td>
<td>3</td>
</tr>
<tr>
<td>MANAGEMENT AND CONTROL:</td>
<td></td>
</tr>
<tr>
<td>Stockholders</td>
<td>3</td>
</tr>
<tr>
<td>Board of Directors</td>
<td>4</td>
</tr>
<tr>
<td>Officers</td>
<td>4</td>
</tr>
<tr>
<td>Committees</td>
<td>5</td>
</tr>
<tr>
<td>Conflict of Interest</td>
<td>5</td>
</tr>
<tr>
<td>CORPORATE RECORDS</td>
<td>6</td>
</tr>
<tr>
<td>HOLDING COMPANY AND AFFILIATE MATTERS:</td>
<td></td>
</tr>
<tr>
<td>Holding Company Registration</td>
<td>6</td>
</tr>
<tr>
<td>Organizational Chart</td>
<td>6</td>
</tr>
<tr>
<td>Transactions and Agreements with Affiliates</td>
<td>8</td>
</tr>
<tr>
<td>Dividends to stockholders</td>
<td>9</td>
</tr>
<tr>
<td>FIDELITY BONDS AND OTHER INSURANCES</td>
<td>10</td>
</tr>
<tr>
<td>EMPLOYEE AND AGENTS WELFARE</td>
<td>11</td>
</tr>
<tr>
<td>SPECIAL DEPOSITS</td>
<td>11</td>
</tr>
<tr>
<td>FINANCIAL CONDITION/GROWTH OF THE COMPANY</td>
<td>12</td>
</tr>
<tr>
<td>MARKET CONDUCT ACTIVITIES:</td>
<td></td>
</tr>
<tr>
<td>Territory</td>
<td>12</td>
</tr>
<tr>
<td>Plan of Operation</td>
<td>13</td>
</tr>
<tr>
<td>Provider Contracts</td>
<td>13</td>
</tr>
<tr>
<td>Policy Forms and Underwriting Practices</td>
<td>14</td>
</tr>
<tr>
<td>Advertising and Marketing</td>
<td>14</td>
</tr>
<tr>
<td>Claims Payment Practices</td>
<td>14</td>
</tr>
</tbody>
</table>
STATE OF ALABAMA
COUNTY OF MOBILE

Anne L. Ward, being first duly sworn, upon her oath deposes and says:

THAT she is an examiner appointed by the Commissioner of Insurance for the State of Alabama;

THAT an examination was made of the affairs and financial condition of PRIMEHEALTH OF ALABAMA, INC., for the period from April 1, 1999 through December 31, 2001;

THAT the following 48 pages constitute the report to the Commissioner of Insurance of the State of Alabama; and

THAT the statements, exhibits and data therein contained are true and correct to the best of her knowledge and belief.

Anne L. Ward, AFE
(Examiner-in-Charge)

Subscribed and sworn to before the undersigned authority this 14th day of February, 2003.

Rhonda C. Milligan, Notary Public
(Print Name)
in and for the State of Alabama

My commission expires 11/1/2006
Honorable Walter A. Bell
Commissioner of Insurance
State of Alabama, Department of Insurance
201 Monroe Street, Suite 1700
Montgomery, Alabama 36130-3351

Dear Commissioner:

Pursuant to your instructions and in compliance with the statutory requirements of the State of Alabama and the resolutions of the National Association of Insurance Commissioners, an examination as of December 31, 2001, has been made of the affairs and financial condition of

PRIMEHEALTH OF ALABAMA, INC.

at its home office located at 1400 S. University Boulevard, Mobile, Alabama 36609. The report of examination is submitted herewith.

Where the description "Company" or "PHAL," appears herein, without qualification, it will be understood to indicate PrimeHealth of Alabama, Inc.
SCOPE OF EXAMINATION

The Company was last examined for the period between January 1, 1997 and March 31, 1999. The current examination covers the intervening period from the date of the last examination through December 31, 2001, and was conducted by examiners representing the State of Alabama, Department of Insurance. Where deemed appropriate, transactions subsequent to December 31, 2001, were reviewed.

The Company has been examined in accordance with the statutory requirements of the Alabama Insurance Code and the regulations and bulletins of the Alabama Department of Insurance (ALDOI); in accordance with the applicable guidelines and procedures promulgated by the National Association of Insurance Commissioners (NAIC); and in accordance with generally accepted examination standards.

The examination included a general review of the Company’s operations, administrative practices, and compliance with statutes and regulations. Corporate records were inspected. Income and disbursement items for selected periods were tested. Assets were verified and valued, and all known liabilities were established or estimated as of December 31, 2001, as shown in the financial statements contained herein. However, the discussion of assets and liabilities contained in this report has been confined to those items which resulted in a change to the financial statements, or which indicated a violation of the Alabama Insurance Code and the Insurance Department’s rules and regulations or other insurance laws or rules, or which were deemed to require comments and/or recommendations.

A signed certificate of representation was obtained during the course of the examination. In this certificate, management attests to have valid title to all assets and to the nonexistence of unrecorded liabilities as of December 31, 2001. A signed letter of representation was also obtained at the conclusion of the examination whereby management represented that, through the date of this examination report, complete disclosure was made to the examiners regarding asset and liability valuation, financial position of the Company, and contingent liabilities.

The market conduct phase of the examination consisted of a limited review of the Company’s territory; plan of operation; provider contracts; policy forms, rates and underwriting practices; advertising and marketing; treatment of policyholders and claimants; compliance with agents’ licensing requirements; prescription drug information; and privacy policies and practices.
ORGANIZATION AND HISTORY


The Company was originally incorporated as “Mobile Health Plan, Inc.”; however, its Articles of Incorporation were amended on August 22, 1991, to change its name to “Mobile Health Plan of Alabama, Inc.,” and again on August 6, 1996, to the current “PrimeHealth of Alabama, Inc.”

The Company is a wholly-owned subsidiary of PHA Administrative Services, Inc. (PHA Services), and is under the jurisdiction of the ALDOI and the Alabama Department of Public Health (ADPH). PHA Services is a wholly-owned subsidiary of the University of South Alabama Foundation (USA Foundation). Other facts concerning details of the Company’s organization and history are contained in reports of previous examinations on file with the ALDOI.

At December 31, 2001, the Company’s amended Annual Statement reflected outstanding capital stock totaling $100,000, which consisted of 1,000 shares of Common capital stock of $100 par value; Gross paid in and contributed surplus of $19,775,000; Surplus notes of $10,483,000; and $(-28,693,020) in Unassigned funds (surplus), thereby aggregating to $1,664,980 in Total capital and surplus. Adjustments in certain of these items are discussed in the NOTES TO FINANCIAL STATEMENTS section under “Note 15 – Surplus notes,” and “Note 16 – Unassigned funds,” later in this report. As a result of particular examination findings, the Company was statutorily impaired at the examination date.

MANAGEMENT AND CONTROL

Stockholders

As of December 31, 2001, PHA Services owned 1,000 shares of the common voting stock of the Company, representing 100% of the total issued and outstanding common shares.

It was noted that there were no minutes of any meetings of the stockholder available for review. Management indicated that since there was only one shareholder, PHA Services had deemed it unnecessary to conduct shareholder meetings. Item 2.01 of
Article II of the By-Laws requires an annual meeting of the shareholders, and Article Nine, item 9.03 stipulates that the Company must keep “minutes of the proceedings of its shareholders, board of directors, and any committee…”

**Board of Directors**

The By-Laws of the Company provided that the business and affairs of the Corporation shall be managed by the Board of Directors. Article Three, Section 3.02 of the *By-Laws*, adopted on the August 8, 1991, set the number of directors at five (5) of which three (3) shall have no affiliation with the University of South Alabama either through employment or governance. It was noted that one director, Ms. Maxey Roberts, was General Counsel for the USA Foundation.

As noted above, there were no shareholders meetings during the examination period, and consequently, no election of board members. The 2001 Annual Statement reported the following three directors were serving at the examination date:

<table>
<thead>
<tr>
<th>Name/Residence</th>
<th>Principal Occupation</th>
</tr>
</thead>
<tbody>
<tr>
<td>Stephen Albert McMillan</td>
<td>McMillan &amp; Associates</td>
</tr>
<tr>
<td>Mobile, Alabama</td>
<td>State Legislator</td>
</tr>
<tr>
<td>John Malcolm Tyson</td>
<td>Attorney</td>
</tr>
<tr>
<td>Mobile, Alabama</td>
<td></td>
</tr>
<tr>
<td>Maxey Jerome Roberts</td>
<td>General Counsel,</td>
</tr>
<tr>
<td>Mobile, Alabama</td>
<td>USA Foundation</td>
</tr>
</tbody>
</table>

There were two vacant positions on the Board of Directors at December 31, 2001. Subsequently, on November 6, 2002, all three of the directors resigned when the Company was sold. [See the *Sale of PrimeHealth of Alabama, Inc.* caption in the SUBSEQUENT EVENTS section, beginning on page 46 of this report.]

**Officers**

Article Six of the By-Laws requires that the Company’s “board of directors…elect a chief operating officer, a president, and a secretary, in addition to such other agents and officers as the board of directors shall deem desirable…” Officers serving at the examination date, as reported on the 2001 Annual Statement, were as follows:
Name                                      Title

Kathryn J. Parks*                         President and CEO
Controller                                Linda B. Helton

* Resigned when the Company was sold, subsequent to the examination period.

There was no evidence in the corporate minutes that officers were elected during the examination period. No chief operating officer or secretary were reported on the Jurat page of the 2001 Annual Statement.

It was noted that the Company did provide documentation concerning notification to the Commissioner, in writing within thirty days, of the election or naming of officers in accordance with ALA. CODE § 27-27-23 (1975), and Section 13 of ALA. ADMIN. CODE 79 (1987).

Committees

Article Four of the By-Laws states that a majority of the board of directors may, by adopted resolution, designate executive and other committees. Management indicated that no committees had been designated during the examination period, but the board of directors did act in the capacity of an executive committee, as required.

ALA. CODE § 10-2B-8.25 (1975), requires the board of directors to appoint only members of the board to serve on its committees.

Conflict of Interest

In its Annual Statements’ General Interrogatories, the Company reported that it had an established procedure for the disclosure “of any material interest or affiliation on the part of any of its officers, directors, trustees or responsible employees which is in or likely to conflict with the official duties of such a person.” For the period covered by the examination, conflict of interest statements were not signed by any of the Company’s key personnel.

During the course of this examination, the directors and officers signed conflict of interest statements. A review of these statements disclosed no material conflicts.

It was noted that conflict of interest statements were not signed by any of the Company’s “responsible employees.”
CORPORATE RECORDS

The Company's Articles of Incorporation, By-Laws and related amendments were inspected and found to provide for the operation of the Company in accordance with usual corporate practices.

Records of the meetings and actions of the Board of Directors since March 31, 1999, were reviewed. Other than the inconsistencies noted previously in this report, the records appeared to be complete and accurately reflect the actions of the respective corporate bodies.

There were no changes to the Company's corporate documents during the examination period.

HOLDING COMPANY AND AFFILIATE MATTERS

Holding Company Registration

The Company was not subject to the Alabama Insurance Holding Company Regulatory Act, as defined in ALA. CODE § 27-29-1 (1975), except as expressly required by other statutes and regulations. In accordance with ALA. CODE § 27-21A-27 (1975), the Company must report any possible acquisition of control to the Alabama Department of Insurance in accordance with ALA. CODE § 27-29-3 (1975), before any such change of control is consummated. Generally, HMOs are subject to regulation in regard to changes in control, but are not subject to the continuing holding company reporting requirements that apply to insurance companies.

The Company has been a member of a holding company system since 1991. At the December 31, 2001 examination date, the sole stockholder was PHA Services, which was owned by the USA Foundation. A detailed description of the various corporate changes since the Company's inception may be found under the heading ORGANIZATION AND HISTORY, previously in this report.

Organizational Chart

The following chart presents the identities of and interrelationships among all affiliated persons within the Insurance Holding Company System at December 31, 2001:
PrimeHealth
Organization and Governance

USA
Foundation

PHA Administrative Services, Inc. (TPA)
*for profit
*taxable corporation
Board of Directors - 5 Members Appointed by USA Foundation

PrimeHealth of Alabama, Inc. (State Qualified HMO)
*for profit
*taxable corporation
Board of Directors - 5 Members Appointed by PHA Administrative Services, Inc
Transactions and Agreements with Affiliates

Management Agreement:

The Company had no employees during the examination period. It operated under a management agreement entitled Cost Allocation Contract for the Prime Health Companies. The contract was executed on March 24, 1994, by and between the Company and the affiliated PrimeHealth, Inc., and PHA Services, collectively referred to as the "Prime Health Companies." The parties agreed to the following:

- All management, administrative and other personnel will be employed by PrimeHealth, Inc.
- All salaries, overhead costs, administrative expenses and other expenditures related to the operations of all companies will be reflected on the books and records of PrimeHealth, Inc., and allocated among all participating companies.
- All provider services shall be furnished to all companies on a capitated basis or on a fee for services basis, and reimbursed to PrimeHealth, Inc., in accordance with the current fee and capitation schedules.
- All costs and expenses incurred in operating the respective programs shall be allocated on a reasonable and consistent basis from year to year, and PrimeHealth, Inc., shall be reimbursed by the participating companies for their respective shares of such costs.
- All personnel costs shall be allocated on the basis of a time study performed by PrimeHealth, Inc., and such costs shall be reviewed and adjusted from time to time as may be necessary to accurately allocate such costs to the appropriate entity.
- The allocation of overhead and administration costs and expenses, personnel costs, and provider service costs shall be reviewed on an annual basis and adjusted as may be necessary in order to accurately reflect the true portion of such costs to be borne by each entity.
- The agreement shall be for an initial term of one (1) year and shall be automatically renewed annually unless sooner terminated.
- The agreement may be terminated by unanimous consent of the parties to this agreement.
- The agreement may be amended at any time by agreement in writing by all of the parties hereto.
- The agreement will not be assigned or transferred without the prior written consent of all the parties to this agreement.
As of March 31, 1999, the previous examination date, the Company was operating under the aforementioned arrangement with the affiliated PrimeHealth, Inc. The examination report as of December 31, 1996, noted that the contract had been sent to the ALDOI for approval, and since there was no objection or response from the ALDOI within thirty days, the contract was deemed approved per Section 13 of ALA. ADMIN. CODE 79 (1987). The ALDOI had no records concerning this matter, and the Company was unable to provide evidence to corroborate that any documentation had been sent to the ALDOI.

PrimeHealth, Inc., was dissolved in 2001, and its year-end transactions were merged with the Company with the approval of the Commissioner of the ALDOI. As a result of the dissolution, the Company had no effective management agreement in place at December 31, 2001. Additional discussion on this matter may be found in the SUBSEQUENT EVENTS section, later in this report.

**Consolidated Tax Filing Agreement:**

The Annual Statements filed during the examination period reported that the Company filed its federal income taxes on a consolidated basis with its parent, PHA Services. Item 2 of the 2001 Annual Statement Notes to Financial Statements stated that:

“For financial statement purposes, current income taxes (benefits) are provided as if the Plan filed a separate federal income tax return. The Plan has net operating loss carryforwards on a stand-alone basis for income tax purposes.”

It was noted that the Company was unable to provide a written agreement evidencing the terms and conditions of its tax filing arrangement. ALA. CODE § 27-21A-2 (1975) requires that any contract made or to be made between any affiliated party and the Company to be provided to the Commissioner. Section (d)(1) of this statute stipulates that the Company must file a notice with the Commissioner and the state health officer when a material modification is made to the Company’s operation. Section 15 of ALA. ADMIN. CODE 79 (1987) states that an HMO shall keep all necessary records “required for the efficient examination of its financial condition and health care delivery system…”

**Dividends to stockholders**

No dividends were paid to stockholders during the three-year examination period.
FIDELITY BONDS AND OTHER INSURANCES

At December 31, 2001, the Company was an additional named insured on a fidelity bond issued to an affiliate through St. Paul Fire and Marine Insurance Company. The policy provided coverage of $500,000 per occurrence, with a deductible of $5,000 per occurrence, against losses resulting from employee dishonesty. This examination concluded that the bond amount exceeded the minimum requirements for fidelity coverage as defined by NAIC guidelines, and ALA CODE § 27-21A-6(b) (1975). Said section states, in pertinent part:

“All such bonds shall be written with at least a one-year discovery period and if written with less than a three-year discovery period shall contain a provision that no cancellation or termination of the bond, whether by or at the request of the insured or by the underwriter, shall take effect prior to the expiration of 90 days after written notice of such cancellation of termination has been filed with the commissioner...”

The policy contained a one-year discovery period; there was no termination clause. Accordingly, the policy should include the provisions mentioned under the above referenced section of the Alabama Insurance Code.

In addition to the aforesaid fidelity bond, the Company was named insured on several PrimeHealth, Inc., policies. The following coverages were maintained to protect the Company against hazards to which it may be exposed:

- Professional Office Package Coverage
  - Commercial General Liability Protection
  - Liability Protection for Autos not owned by the Company
  - Commercial Blanket Employee Dishonesty
  - Business Personal Property
  - Valuable Records Research
  - Computer Coverage
    - Hardware
    - Data, Media, and Software
- Umbrella Excess Liability Protection Coverage
  - Commercial General Liability
  - Automobile Liability not owned by the Company
  - Employer’s liability
- Managed Care Organization Professional Liability
- Directors and Officers Liability Insurance policy
• Physicians Professional Liability Protection policy

The coverages and limits carried by the Company were reviewed during the course of the examination and appeared to adequately protect the Company’s interests at the examination date.

EMPLOYEE AND AGENTS WELFARE

Throughout the examination period, all personnel were employees of the affiliated PrimeHealth, Inc., which provided services to the Company under the terms of a cost allocation agreement. The contract was discussed previously in the HOLDING COMPANY AND AFFILIATE MATTERS section of this report, under the “Transactions and Agreements with Affiliates” caption. As a result of this agreement, the Company did not participate in a retirement plan, deferred compensation and/or other benefit plan.

SPECIAL DEPOSITS

In order to comply with the statutory requirements for doing business in the State of Alabama, the Company had the following securities on deposit with state authorities at December 31, 2001:

<table>
<thead>
<tr>
<th>Description</th>
<th>Par or Book Value</th>
<th>Statement Value</th>
<th>Market Value</th>
</tr>
</thead>
<tbody>
<tr>
<td>Certificate of Deposit, 5.85%,</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Compass Bank, Mobile, Alabama, autorenewing.</td>
<td>$100,000</td>
<td>$100,000</td>
<td>$100,000</td>
</tr>
<tr>
<td>FHLMC Medium Term Note, *</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>5.05%; Due 04/02/2002.</td>
<td>$400,000</td>
<td>$400,000</td>
<td>$400,000</td>
</tr>
<tr>
<td>Totals</td>
<td>$500,000</td>
<td>$500,000</td>
<td>$500,000</td>
</tr>
</tbody>
</table>

* The FHLMC is pledged to the Alabama Department of Insurance, and is on deposit with Compass Bank.

Confirmation of the above deposits was obtained directly from the ALDOI.
FINANCIAL CONDITION/GROWTH OF THE COMPANY

The following table sets forth the significant items indicating growth and financial condition of the Company for the period under review:

<table>
<thead>
<tr>
<th>Year</th>
<th>Admitted Assets</th>
<th>Liabilities</th>
<th>Capital And Surplus</th>
<th>Net Premium Income</th>
</tr>
</thead>
<tbody>
<tr>
<td>December 31, 2001*</td>
<td>$1,242,876</td>
<td>$9,292,592</td>
<td>$(8,049,716)</td>
<td>$16,332,836</td>
</tr>
<tr>
<td>December 31, 2000</td>
<td>7,247,023</td>
<td>6,045,719</td>
<td>1,201,304</td>
<td>19,217,136</td>
</tr>
<tr>
<td>December 31, 1999</td>
<td>10,282,070</td>
<td>9,264,141</td>
<td>1,017,931</td>
<td>26,475,491</td>
</tr>
<tr>
<td>March 31, 1999*</td>
<td>6,867,725</td>
<td>9,481,264</td>
<td>(2,613,540)</td>
<td>7,056,086</td>
</tr>
</tbody>
</table>

* Per examination. Amounts for the remaining years were obtained from Company copies of filed Annual Statements.

MARKET CONDUCT ACTIVITIES

For most aspects of consumer relations, the Company is regulated by the Alabama Department of Health (ADPH). During the examination period, ADPH conducted one two-year survey, dated March 13 – 17, 2000. The HMO On-Site Deficiency Report issued by ADPH identified several compliance issues, none of which was determined to indicate misstatement of any financial account balances or significant non-compliance with ALDOI statutes or regulations.

Due to the Company’s regulation by ADPH, claims payment practices, claimant grievance procedures, and portions of other market conduct items, generally reviewed by the examiners during financial statutory examinations, were not covered in this examination.

Territory

As of December 31, 2001, the Company was licensed to transact business in the State of Alabama only. The Certificate of Authority was inspected and found to be in order.

The ALDOI and the ADPH authorized the Company to market business in the following Alabama service areas or counties at the examination date:
Autauga  Coosa  Lauderdale  Montgomery
Baldwin  Cullman  Lawrence  Morgan
Bibb  Dallas  Limestone  Shelby
Blount  Elmore  Lowndes  St. Clair
Bullock  Escambia  Macon  Tallapoosa
Chilton  Franklin  Madison  Walker
Clarke  Jackson  Marshall  Washington
Colbert  Jefferson  Mobile

The Company had not requested approval to expand to any other regions, and no applications were pending at year-end 2001.

Plan of Operation

Lines of business, as reported in the 2001 Annual Statement included:

- Comprehensive (hospital and medical);
- Medicare supplement; and
- Federal Employees Health Benefit Plan.

The Company is the oldest active HMO in Alabama, serving the community since 1985. PHAL offers health coverage to individuals, employers, and employees of the Federal Government in the previously mentioned Alabama counties, primarily surrounding the metro areas of Mobile and Montgomery.

The Company offers group coverage, and to a lesser extent, individual products in its areas of operation. The Company supports the University of South Alabama Hospitals, and the University of South Alabama College of Medicine faculty practices.

It was noted that the examiners repeatedly requested information concerning the Company’s budgets and plan of operation but through the date of this report, management was either unwilling or unable to provide responses.

Provider Contracts

The Company’s provider contracts were found to contain the required “Hold Harmless” clauses in accordance with Section 5, item B.3, of ALA. ADMIN. CODE 80 (1996).
Policy Forms and Underwriting Practices

The Company’s Underwriting Department was responsible for the development and implementation of underwriting and pricing policies. The underwriting manual outlined the different products available and the sales process for the different group sizes and products.

New plan designs, benefits, etc., during the examination period were added to rate cards, and changes were filed for approval with the Life and Health Division of the ALDOI.

Advertising and Marketing

The sales and advertising material provided by the Company was maintained in accordance with Section 6 of ALA. ADMIN. CODE 79 (1987).

During the examination period, a “Certificate of Compliance,” was not filed with the Annual Statement, in accordance with the aforementioned ALDOI regulation.

Marketing practices were regulated by ADPH.

Claims Payment Practices

A sample of claim files was reviewed in order to evaluate the Company’s compliance with policy provisions, timeliness of payment and adequacy of documentation. No problems were noted concerning the sampled claims documentation.

The Company’s claims payment practices were regulated by ADPH.

Treatment of Members and Claimants

An inspection of the Company’s Complaint Register was made by the examiners and compared with complaints recorded by the Consumer Division of the ALDOI. The examiners noted only minor differences in the number of complaints reported by the Company and those documented by the ALDOI. Most of the inquiries were related to policy coverage and benefits, and questions concerning claim handling and premium billing statements.

Complaint procedures were monitored by ADPH.
Compliance with Agents’ Licensing Requirements

The examiners made an inspection of the Company’s records to determine that agents representing the Company were duly licensed by the State of Alabama.

A review was made to determine that agents receiving commissions from the Company were properly licensed to represent the Company. A sample of individuals who received commission payments during 2001 was selected and verified to the register of licensed agents obtained from the ALDOI. The review disclosed no evidence that unlicensed agents were receiving commissions.

Rates

The Company’s rates were filed with and approved by the ALDOI in accordance with Section 5 of ALA. ADMIN. CODE 79 (1987). The rate filings were reviewed by the consulting actuarial firm of Taylor-Walker & Associates, Inc., Midvale, Utah. Filings submitted to the ALDOI explained how the rates were derived and provided documentation and support for the experience period, loss development, trend and expense assumptions included in the filings.

Based on observations of the Company’s increasing PMPMs (Per-Month-Per-Member) and knowledge of the trends in the market, the actuarial examiners determined that the increases in trend appeared reasonable. It appears that the Company is properly monitoring its rates. It is the opinion of the actuarial examiners that the Company should continue to monitor and file rate studies using PMPM cost estimates, trend estimates, and expense assumption based on reviews of recent experience.

Further information and discussion may be found under the Claims unpaid caption in the NOTES TO FINANCIAL STATEMENTS and COMMENTS AND RECOMMENDATIONS sections of this report.

Prescription drug information cards

Effective August 1, 2000, ALA. CODE § 27-1-22 (1975), was enacted [Acts 2000, No. 2000-392, §§ 1, 2], which requires, in pertinent part, that:

“(a) Every health benefit plan that provides coverage for prescription drugs or devices, or administers a plan...shall issue to its insureds a card or other technology containing prescription drug information. The uniform prescription drug information card
or technology shall be in the format approved by the National Council for Prescription Drug Programs (NCPDP) and shall include all of the required fields and conform to the most recent pharmacy ID card or technology implementation guide produced by NCPDP or conform to a national format acceptable to the Commissioner of Insurance.”

A review conducted during the course of this examination determined that the Company was in compliance with the aforementioned section of the Alabama Insurance Code.

**Privacy Policies and Practices**

[Compliance with ALA. ADMIN. CODE 482-1-122 (2002), formerly known as Alabama Department of Insurance Regulation No. 122.]

The Company does not disclose non-public information, whether financial or health, to outside sources without the approval of a senior level director. Even then, the Company requires consent forms; this applies to authorized representatives, including lawyers.

Article II, Section .05 A., ALA. ADMIN. CODE 482-1-122 (2002), states that a “…licensee shall provide a clear and conspicuous notice that accurately reflects its privacy policies and practices…”

Under Section .15 of said regulation:

“A…The requirement for initial notice in Section 5A(2), the opt out in Sections 8 and 11, and service providers and joint marketing in Section 14 do not apply if the licensee discloses nonpublic personal financial information as necessary to effect, administer or enforce a transaction that a consumer requests or authorizes…”

“B. ‘Necessary to effect, administer or enforce a transaction’ means that the disclosure is…(2) Required, or is a usual, appropriate or acceptable method…(c) To provide a confirmation, statement or other record of the transaction, or information on the status or value of the insurance product or service to the consumer or the consumer’s agent or broker…(e) To underwrite insurance at the consumer’s request or for any of the following purposes as they relate to a consumer’s insurance: account administration, reporting, investigating or preventing fraud or material representation, processing premium payments, processing
insurance claims, administering insurance benefits (including utilization review activities), participating in research projects or as otherwise required or specifically permitted by federal or state law.”

The Company was, however, required under Section .07 C.(5), of the aforementioned regulation to supply its customers with simplified notices stating that the Company engages in disclosing some of its information to a third party. The notices should state this, in addition to the requirements under Section .07, items A.(1), A.(8), A.(9), and B.

The Company stipulated that it does not collect personal financial information. ALA. ADMIN. CODE 482-1-122 (2002), provides for an exemption if a business is subject to the enforcement provisions and regulations of Health Insurance Portability and Accountability Act (HIPAA), as administered by Health and Human Services (HHS). Company management verified its exemption status with the ALDOI. A Company official stated that:

“...all employees of PrimeHealth [companies] have signed confidentiality statements that are strictly enforced and include the ultimate sanction of termination. Moreover, employees have received HIPAA privacy training and such training is on-going due to the changing nature of the regulations issued by HHS.”

Section 164.534 of Title 45, Code of Federal Regulations, was amended as follows:

“2. Section 164.534 of Subpart E of 45 Code of Federal Regulation Part 64 is revised to read as follows:

Sec. 164.534 Compliance dates for initial implementation of the privacy standards.

(b) Health plans. A health plan must comply with the applicable requirements of this subpart no later than the following as applicable:

(1) Health plans...April 14, 2003.”

The Company indicated that it had several draft versions of a privacy statement currently under administrative review. Because HHS recently modified its privacy regulations, those changes are now being incorporated into prior drafts. Accordingly, the Company is not required to send privacy notices until April 14, 2003.
REINSURANCE

Reinsurance Assumed

The Company did not assume any business as reinsurance during the three-year examination period, and no contracts for assumed reinsurance were in effect at December 31, 2001.

Reinsurance Ceded

The Company’s ceded reinsurance program was negotiated through Molton, Allen & Williams Corporation, Birmingham, Alabama, a reinsurance intermediary. All communications under the reinsurance agreement were transmitted to the Company or the reinsurer through the intermediary.

As of the examination date, the Company maintained one reinsurance contract with ReliaStar Life Insurance Company, Minneapolis, Minnesota. The contract was structured as a Specific Excess Risk reinsurance agreement whereby the Company retained a predetermined dollar amount of loss (retention) per person, per year, and was indemnified by the reinsurer for eligible services at the percentage of coinsurance over and above the retention up to the limit of the agreement.

The highlights of the agreement are shown below:


Service included in the contract: Eligible Inpatient Hospital Services.

Service included in the contract: Eligible Out of Area Emergency Services.

Annual Deductible: $100,000 per member per year.

Coinsurance: 90% of Eligible Services over the retention.

Limits on Coverages: The maximum reinsurance indemnity payable under the agreement during any agreement year for each member was $1,000,000, and the maximum lifetime reinsurance payable under the agreement for all agreement years was $2,000,000. The maximum average daily reinsurance for Eligible Hospital Services for In-Net-Work was limited to $1,500, and Out-of-Network was limited to $3,000.
**Per-Diem Rate Limit:** The maximum expense reimbursements which were incurred at the contracted hospitals range from $400 to $3,400 per day per member, which rate is determined by the type of service provided.

**Premium Rate:** Commercial Members: $1.09 per member per month. Point of Service Member: $1.25 per member per month.

**Termination Clause:** Terminated at the sole discretion of the reinsurer.

**Insolvency Clause:** The Company has a standard insolvency clause.

*Schedule S – Part 3 – Section 2* of the Company’s 2001 Annual Statement reported $104,168 in ceded premiums. No reserve credit was taken at year-end 2001 for ceded reinsurance.

**ACCOUNTS AND RECORDS**

**Accounting System**

The Company’s accounting records were maintained primarily on electronic data processing (EDP) equipment. Management, administrative and record-keeping functions were performed by personnel and facilities of the affiliated PrimeHealth, Inc., under the *Cost Allocation Contract*, as previously mentioned. A detailed discussion on the aforesaid agreement is included in the HOLDING COMPANY AND AFFILIATE MATTERS section, elsewhere in this report.

**Accounting Records**

The Company was audited annually by the independent certified public accounting (CPA) firm of Deloitte & Touche, LLP, Atlanta, Georgia, which conducted all of the Company’s audits for the three-year period covered by this examination. Financial statements were prepared in conformity with statutory accounting practices prescribed or permitted by the ALDOI. Analysis of the CPA’s workpapers indicated most reviews were roll-forwards and reasonableness tests. No testing of internal controls was documented; no substantive testing was identified that could be utilized in the examination. The reports generated by the CPAs were made available to the examiners and were used where deemed appropriate. The examiners encountered difficulty in obtaining the CPA workpapers from the Company’s independent auditors. Information requested as early as March 26, 2002, was not received in its entirety until July 2002. In accordance with NAIC A/S Instructions, the CPAs are
required to make available for review by domiciliary department examiners all workpapers prepared in the conduct of their annual audits. In addition, ALA. ADMIN. CODE 118 (1999) requires insurers to provide a response to written information requests "within ten (10) working days."

The reserve calculations for the examination period were certified by Darin W. Dalton, FSA, MAAA, of the consulting actuarial firm of Tillinghast-Towers Perrin, Atlanta, Georgia.

The Company's books were maintained primarily on the basis of generally accepted accounting principles (GAAP), and then adjusted, as necessary or appropriate, in accordance with statutory requirements. The financial statements were prepared using the accrual basis of accounting.

It was noted that in 1999, the Company's fiscal year ended on September 30th, after which the Company's fiscal year was changed to coincide with the calendar year. There was a three month accounting period between October 1st and December 31st, 1999; the accounting years 2000 and 2001 ended on December 31st, and were for twelve-month periods.

This examination has determined that the Company did not maintain "all necessary records...required for the efficient examination of its financial condition and health care delivery system..." in accordance with Section 15 of ALA. ADMIN. CODE 79 (1987). Incomplete records included, but were not limited to, the following captions:

- Stockholders
- Board of Directors
- Conflict of Interest
- Transactions and Agreements with Affiliates
- Plan of Operation
- Advertising and Marketing
- Bonds
- Cash and short-term investments
- Accident and health premiums due and unpaid
- Amounts recoverable from reinsurers
- Investment income due and accrued
- Claims unpaid
- Aggregate policy reserves
- Amounts withheld or retained for the account of others
• D&U Premiums
• Gross paid in and contributed surplus
• Surplus notes.

Detailed discussions and additional commentary on all of these and other matters may be found in the NOTES TO FINANCIAL STATEMENTS and COMMENTS AND RECOMMENDATIONS sections of this examination report, under the specific captions to which they pertain.

Accounting Procedures

According to ALA. CODE § 27-21A-16(a) (1975), statutory examinations on health maintenance organizations shall be conducted at least once every three years. Statutory Accounting Principles are utilized; Generally Accepted Accounting Principles are not applicable to statutory examinations.

Accounting Policies

In March 1998, the NAIC adopted the Codification of Statutory Accounting Principles (Codification), which is intended to standardize regulatory accounting and reporting for the insurance industry. The State of Alabama required adoption of Codification for the preparation of statutory financial statements, effective January 1, 2001. As a result of these changes, the Company reported a change in accounting principle as an adjustment that decreased net worth by $141,000, as of January 1, 2001.

Amended 2001 Annual Statement

Differences between the Company’s 2001 Annual Statement and the CPA’s audited amounts resulted primarily from reclassifications with no material differences in statutory net worth. The Company amended the statements, which were subsequently refiled with the ALDOI. The following schedule reflects the details of the differences:

<table>
<thead>
<tr>
<th>Line Item Description</th>
<th>Per Unaudited Annual Statement</th>
<th>Per Audited Statements</th>
<th>Difference</th>
</tr>
</thead>
<tbody>
<tr>
<td>A/R-Springhill Hospital Dep.</td>
<td>$ 129,506</td>
<td>$ 29,506</td>
<td>$ 100,000</td>
</tr>
<tr>
<td>Claims unpaid (estimated)</td>
<td>2,585,014</td>
<td>2,535,014</td>
<td>(50,000)</td>
</tr>
</tbody>
</table>
FINANCIAL STATEMENTS INDEX

The Financial Statements included in this report were prepared on the basis of the Company’s records, and the valuations and determinations made during the examination for the year 2001. Amounts shown in the comparative statements for the years 1999 and 2000, were compiled from Company copies of filed Annual Statements. The statements are presented in the following order:

<table>
<thead>
<tr>
<th>Statement</th>
<th>Page</th>
</tr>
</thead>
<tbody>
<tr>
<td>Statement of Assets</td>
<td>23</td>
</tr>
<tr>
<td>Statement of Liabilities, Capital and Surplus</td>
<td>24</td>
</tr>
<tr>
<td>Statement of Revenue and Expenses</td>
<td>25</td>
</tr>
<tr>
<td>Statement in Changes in Capital and Surplus Account</td>
<td>27</td>
</tr>
</tbody>
</table>

Amounts included in columns captioned “03/31/1999,” or “March 31, 1999,” are reported as a result of the previous examination.

It is noted that during the examination period, the format of Annual Statement and Quarterly Statement convention blanks changed substantially. Certain lines and items evident during the previous examination no longer existed in that form at the current examination date. For disclosure and clarification purposes, those items have been included on the financial statements of this report, are annotated with (*) and italicized.

FAILURE OF FINANCIAL STATEMENTS TO BALANCE TO INDICATED TOTALS IS DUE TO ROUNCING.

THE NOTES IMMEDIATELY FOLLOWING THE FINANCIAL STATEMENTS IN THIS REPORT ARE AN INTEGRAL PART THEREOF.
# PRIMEHEALTH OF ALABAMA, INC.

## STATEMENT OF ASSETS

For the Year Ended December 31, 2001

<table>
<thead>
<tr>
<th>ASSETS</th>
<th>Non-admitted Assets</th>
<th>Net Admitted Assets</th>
<th>Prior Year Net Admitted Assets</th>
</tr>
</thead>
<tbody>
<tr>
<td>Bonds (Note 1)</td>
<td>$400,000</td>
<td>$</td>
<td>$400,000</td>
</tr>
<tr>
<td>Cash ($5,761,417, Schedule E-Part 1) and short-term investments (Schedule DA-Part 1) (Note 2)</td>
<td>5,761,417</td>
<td>5,214,696</td>
<td>546,721</td>
</tr>
<tr>
<td>Subtotals, cash and invested assets</td>
<td>$6,161,417</td>
<td>$5,214,696</td>
<td>$946,721</td>
</tr>
<tr>
<td>Accident and health premiums due and Unpaid (Note 3)</td>
<td>266,649</td>
<td>266,649</td>
<td>120,968</td>
</tr>
<tr>
<td>Health care receivables (Note 4)</td>
<td>141,000</td>
<td>141,000</td>
<td>56,700</td>
</tr>
<tr>
<td>Amounts recoverable from reinsurers (Note 5)</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Investment income due and accrued (Note 6)</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Amounts due from parent, subsidiaries and affiliates</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Aggregate write-ins for other than invested assets:</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Accounts Receivable – Other (Note 7)</td>
<td>29,506</td>
<td>29,506</td>
<td></td>
</tr>
<tr>
<td>Springhill Memorial Deposit</td>
<td>100,000</td>
<td>100,000</td>
<td>0</td>
</tr>
<tr>
<td><strong>Total assets</strong></td>
<td>$6,698,572</td>
<td>$5,455,696</td>
<td>$1,242,876</td>
</tr>
</tbody>
</table>

THE NOTES IMMEDIATELY FOLLOWING THE FINANCIAL STATEMENTS IN THIS REPORT ARE AN INTEGRAL PART THEREOF.
PRIMEHEALTH OF ALABAMA, INC.
STATEMENT OF LIABILITIES, CAPITAL AND SURPLUS
For the Year Ended December 31, 2001

<table>
<thead>
<tr>
<th>LIABILITIES</th>
<th>Current Year</th>
<th></th>
<th>Prior Year</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Claims unpaid (Note 8)</td>
<td>$ 2,187,209</td>
<td>$ 347,805</td>
<td>$ 2,535,014</td>
<td>$ 3,260,196</td>
</tr>
<tr>
<td>Unpaid claims adjustment expenses (Note 9)</td>
<td>133,674</td>
<td></td>
<td>133,674</td>
<td></td>
</tr>
<tr>
<td>Aggregate policy reserves (Note 10)</td>
<td>180,334</td>
<td></td>
<td>180,334</td>
<td>323,529</td>
</tr>
<tr>
<td>Premiums received in advance</td>
<td>170,201</td>
<td></td>
<td>170,201</td>
<td>373,773</td>
</tr>
<tr>
<td>General expenses due or accrued</td>
<td>3,645</td>
<td></td>
<td>3,645</td>
<td></td>
</tr>
<tr>
<td>Amounts withheld or retained for the account of others (Note 11)</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Borrowed money (Note 12)</td>
<td>4,500,000</td>
<td></td>
<td>4,500,000</td>
<td></td>
</tr>
<tr>
<td>Amounts due to parent, subsidiaries and affiliates</td>
<td>1,769,724</td>
<td></td>
<td>1,769,724</td>
<td>1,894,810</td>
</tr>
<tr>
<td>Aggregate write-ins for other liabilities:</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>D&amp;U Premiums (Notes 13)</td>
<td></td>
<td>0</td>
<td>0</td>
<td>193,411</td>
</tr>
<tr>
<td>Accrued Expenses</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Total liabilities</td>
<td>$ 8,944,787</td>
<td>$ 347,805</td>
<td>$ 9,292,592</td>
<td>$ 6,045,719</td>
</tr>
</tbody>
</table>

CAPITAL AND SURPLUS

| Common capital stock                            | XXX          | XXX      | $ 100,000   | $ 100,000  |
| Gross paid in and contributed surplus (Note 14) | XXX          | XXX      | 19,775,000  | 19,775,000 |
| Surplus notes (Note 15)                         | XXX          | XXX      | 5,983,000   | 9,283,000  |
| Unassigned funds (surplus) (Note 16)            | XXX          | XXX      | (33,907,716)| (27,956,696)|
| Total capital and surplus                       | XXX          | XXX      | $ (8,049,716)| $ 1,201,304|

| Total liabilities, capital and surplus          | $ 1,242,876  |          | $ 7,247,023 |          |
**PRIMEHEALTH OF ALABAMA, INC.**  
**STATEMENT OF REVENUE AND EXPENSES**  
For the Years Ended December 31, 2001, 2000, 1999, and March 31, 1999

<table>
<thead>
<tr>
<th>Current Year</th>
<th>Uncovered</th>
<th>Total</th>
<th>12/31/2000</th>
<th>12/31/1999</th>
<th>03/31/1999</th>
</tr>
</thead>
<tbody>
<tr>
<td>MEMBER MONTHS</td>
<td>XXX</td>
<td>97,269</td>
<td>147,231</td>
<td>257,257</td>
<td>75,400</td>
</tr>
</tbody>
</table>

**Revenues:**
Net premium income XXX $16,332,836 $19,217,136 $26,475,491 $7,056,086
Aggregate write-ins for other health care related revenues:
- *Net Investment Income* 444,728 89,837
- Pharmacy Rebate Revenue XXX 311,645
- Other Revenues XXX 258,157 82,585 2,163 580
- **Total revenues** XXX $16,902,638 $19,299,721 $26,922,382 $7,146,503

**Medical and Hospital:**
Hospital/medical benefits $1,132,737 $14,091,155 $12,458,301 $  
Other professional services 19,693 137,902 4,539,344 21,385,015
Outside referrals 647,280 647,280
*Physician Services* 16,905,291 5,617,393
*Emergency room and out-of-area* 129,874 483,588 1,257,357 1,943,485 779,250
*Inpatient* 29,125,288 8,228,016
Aggregate write-ins for other medical and hospital:
- Provider Refunds 875 10,329 104,538 38,841 6,925,635
- *Other Medical & Ancillary Services* (917,634)
- *Recognition of Premium Deficiency* (100,536)
- Mississippi Run-Out 1,311
- Medicare Gold Run-Out
- Medical Claim Write Offs 0 (11,287) 363,856 405,449 12,824
Subtotal $1,929,584 $15,247,666 $18,629,187 $68,951,432 $21,601,959

**Less:**
- *Copayments* $  
- *COB and Subrogation* 39,437,265 12,738,505
- Net reinsurance recoveries incurred 0 221,373 0 0 0
**Total medical and hospital** $1,929,584 $15,026,293 $18,629,187 $28,385,171 $8,535,491

THE NOTES IMMEDIATELY FOLLOWING THE FINANCIAL STATEMENTS IN THIS REPORT ARE AN INTEGRAL PART THEREOF.
**PRIMEHEALTH OF ALABAMA, INC.**  
STATEMENT OF REVENUE AND EXPENSES (continued)  
For the Years Ended December 31, 2001, 2000, 1999, and March 31, 1999

<table>
<thead>
<tr>
<th>Current Year</th>
<th>Uncovered</th>
<th>Total</th>
<th>12/31/2000</th>
<th>12/31/1999</th>
<th>03/31/1999</th>
</tr>
</thead>
<tbody>
<tr>
<td>Claims adjustment expenses</td>
<td>$ \text{--}</td>
<td>$ 405,176</td>
<td>$ 531,469</td>
<td>$ \text{--}</td>
<td>$ \text{--}</td>
</tr>
<tr>
<td>General administration expenses</td>
<td>1,612,159</td>
<td>3,011,660</td>
<td>5,057,197</td>
<td>1,341,986</td>
<td></td>
</tr>
<tr>
<td>Increase in reserves for A&amp;H contracts</td>
<td>0</td>
<td>(143,195)</td>
<td>(485,814)</td>
<td>0</td>
<td>0</td>
</tr>
<tr>
<td><strong>Total underwriting deductions</strong></td>
<td>$ 1,929,584</td>
<td>$16,900,433</td>
<td>$21,686,502</td>
<td>$33,442,368</td>
<td>$9,877,477</td>
</tr>
<tr>
<td>Net underwriting gain or (loss)</td>
<td>XXX</td>
<td>2,205</td>
<td>(2,386,781)</td>
<td>0</td>
<td>0</td>
</tr>
<tr>
<td>Net investment income earned</td>
<td>(\text{--} (554,229))</td>
<td>$ 419,487</td>
<td>0</td>
<td>0</td>
<td>0</td>
</tr>
<tr>
<td>Net realized capital gains or (losses)</td>
<td>0</td>
<td>0</td>
<td>0</td>
<td>0</td>
<td>0</td>
</tr>
<tr>
<td>Net investment gains or (losses)</td>
<td>(\text{--} (554,229))</td>
<td>$ 419,487</td>
<td>0</td>
<td>0</td>
<td>0</td>
</tr>
<tr>
<td>Net income or (loss) before federal taxes</td>
<td>XXX</td>
<td>$ (552,024)</td>
<td>$1,967,294</td>
<td>$33,442,368</td>
<td>$9,877,477</td>
</tr>
<tr>
<td>Federal and foreign income taxes incur'd</td>
<td>XXX</td>
<td>0</td>
<td>0</td>
<td>0</td>
<td>0</td>
</tr>
<tr>
<td><strong>Total expenses</strong></td>
<td>(\text{--} (552,024))</td>
<td>$1,967,294</td>
<td>0</td>
<td>0</td>
<td>0</td>
</tr>
<tr>
<td><strong>Income (loss)</strong></td>
<td>XXX</td>
<td>(\text{--} (552,024))</td>
<td>$1,967,294</td>
<td>(\text{--} (6,519,986))</td>
<td>(\text{--} (2,730,974))</td>
</tr>
</tbody>
</table>

\* The notes immediately following the financial statements in this report are an integral part thereof.
**PRIMEHEALTH OF ALABAMA, INC.**  
**STATEMENT OF CHANGES IN CAPITAL AND SURPLUS ACCOUNT**  
For the Years Ended December 31, 2001, 2000, 1999, and March 31, 1999

<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Capital and Surplus Account:</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Capital and surplus prior reporting year</td>
<td>$1,201,302</td>
<td>$1,017,928</td>
<td>$1,898,925</td>
<td>$1,898,925</td>
</tr>
<tr>
<td><strong>Gains and Losses to Capital &amp; Surplus:</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Net income or (loss)</td>
<td>$(552,024)</td>
<td>$(1,967,294)</td>
<td>$(6,519,986)</td>
<td>$(2,730,974)</td>
</tr>
<tr>
<td>Change in valuation basis of aggregate policy and claim reserve</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Net unrealized capital gains and losses</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Change in net deferred income tax</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Change in nonadmitted assets</td>
<td>(5,398,996)</td>
<td>350,690</td>
<td>(80,834)</td>
<td>(618,316)</td>
</tr>
<tr>
<td>Change in borrowed money <em>(Notes 12 and 15)</em></td>
<td>(4,500,000)</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Change in surplus notes</td>
<td>1,200,000</td>
<td>1,800,000</td>
<td>6,883,000</td>
<td></td>
</tr>
<tr>
<td><strong>Cumulative effect of changes in accounting principles</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Capital changes:</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Paid in</td>
<td></td>
<td></td>
<td>(22)</td>
<td></td>
</tr>
<tr>
<td><strong>Aggregate write-ins for gains or (losses) in surplus:</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Rounding-up difference</td>
<td>2</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td><em>1998 Annual Stmt Changes (not yet amended)</em></td>
<td>0</td>
<td>0</td>
<td>(1,163,177)</td>
<td>(1,163,177)</td>
</tr>
<tr>
<td>Net change in capital &amp; surplus</td>
<td>$(9,251,018)</td>
<td>$183,374</td>
<td>$(880,997)</td>
<td>$(4,512,467)</td>
</tr>
<tr>
<td><strong>Capital and surplus end of reporting year</strong></td>
<td>$(8,049,716)</td>
<td>$1,201,302</td>
<td>$1,017,928</td>
<td>$(2,613,540)</td>
</tr>
</tbody>
</table>

---

THE NOTES IMMEDIATELY FOLLOWING THE FINANCIAL STATEMENTS IN THIS REPORT ARE AN INTEGRAL PART THEREOF.

27
NOTES TO FINANCIAL STATEMENTS

Note 1 - Bonds $400,000

The captioned amount is the same as reported in the Company’s Annual Statement as of December 31, 2001.

A review of the Company’s schedules associated with “Bonds” for the period covered by the examination determined that Schedule D – Part 1, Schedule D – Part 3, and Schedule D – Part 4, were not completed in accordance with the NAIC Annual Statement Instructions (A/S Instructions) and the NAIC Accounting Practices and Procedures Manual (AP&P Manual).

The following items were not completed in accordance with the A/S Instructions:

- Acquisition of security during 1999, was not reported on Schedule D – Part 3.
- Security disposal was not reported on Schedule D – Part 4.
- In 1999 and 2000, Schedule D – Part 1 inappropriately recorded the purchase price in the par value column.
- Interest accrual on the security was not recorded on Schedule D – Part 1. (See “Note 6 – Investment income due and accrued.”)

The following items were not completed in accordance with the AP&P Manual:

- FNMA was not amortized to its par value at redemption/call.
- Interest income was not adjusted as to interest collected, due and accrued and amortization.

During the examination period, Company management maintained no evidence to support the continued eligibility of Provisionally Exempt (PE) assets. The NAIC’s Security Valuation Office requires an insurer to maintain a record supporting its decision to list an asset as PE, including the terms of the security, documents verifying the security’s rating, and documents evidencing the continued monitoring of the position. In addition, Section 15 of ALA ADMIN. CODE 79 (1987) requires the maintenance of complete and accurate records. Prior to the conclusion of the examination, the Company assembled the various documents necessary to substantiate the PE listing of certain of its assets.
Note 2 - Cash and short-term investments

$546,721

The captioned asset is $5,214,696 less than the $5,761,417 amount reported in the Company’s Annual Statement as of December 31, 2001, and consisted of the following:

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Amount adjusted in accordance with ALA. CODE § 27-41-6(a) (1975)</td>
<td>$5,098,696</td>
</tr>
<tr>
<td>Amount adjusted in accordance with AP&amp;P Manual, SSAP No. 45</td>
<td>116,000</td>
</tr>
<tr>
<td>TOTAL</td>
<td>$5,214,696</td>
</tr>
</tbody>
</table>

The examination has determined that the Company’s short-term investment made under the repurchase agreement with Compass Bank was subjected to investment limitation of ALA. CODE § 27-41-6(a) (1975), which states that:

“...an insurer shall not have at any one time any single investment or combination of investments in or loans upon the security of the obligation, property or security of any one person aggregating in cost to the insurer in excess of the greater of 10 percent or such insurer’s assets or the total of its capital and surplus, as shown in the latest annual report of the insurer filed pursuant to subsection (a) of section 27-3-26 of the Alabama insurance code, less the minimum capital and surplus required of said insurer...”

Utilizing those guidelines, the examiners determined that the capital and surplus, less the minimum $500,000 surplus required, or $701,304, was the greater amount. The short-term investment in the Compass Bank account at December 31, 2001, was $5,800,000; therefore, $5,098,696 was not admitted in accordance with the previously mentioned section of the Alabama Insurance Code.

Item 4 of SSAP No. 45, of the AP&P Manual states that “Repurchase agreements shall be accounted for as collateralized lendings. The underlying securities shall not be accounted for as investments owned by the reporting entity.” Item 8 specifies collateral requirements for repurchase agreements, whereby

“The reporting entity shall receive as collateral transferred securities having a fair value at least equal to 102 percent of the purchase price paid by the reporting entity for the securities. If at any time the fair value of the collateral is less than 100 percent of the purchase price paid by the reporting entity, the counterparty shall be obliged to provide additional collateral, the fair value of which, together with fair value of all collateral then held in connection with the transaction, at least equals...”
102 percent of the purchase price.”

Fair value did not equal 102%, or $5,916,000, at the examination date; hence, an additional $116,000 [the difference between the 102% and the original purchase price ($5,916,000 − $5,800,000)] was not admitted for the purposes of the examination.

A review of Schedule E – Part 1, for the period covered by the examination determined that the Company had not complied with the A/S Instructions and the AP&P Manual as to the following:

- Short-term investments acquired under repurchase agreement were listed as cash.
- Interest accrued on a Certificate of Deposit (CD) and credited by the bank in January 2002, was not included in the schedule.

Item 13 of SSAP No. 45, of the AP&P Manual states, in pertinent part:

“For the purchaser in a dollar repurchase agreement, an asset is recorded for the amount of purchase. Since the term of the agreement is limited to twelve months, it is accounted for as short-term investment.”

In addition, item 10 in SSAP No. 2, defines “short-term investments” as follows:

“All investments with remaining maturities (or repurchase dates under repurchase agreements) of one year or less at the time of acquisition…shall be considered short-term investments. Short-term investments include, but are not limited to, bonds, commercial paper, money market instruments, repurchase agreements [emphasis added], and collateral and mortgage loans…”

According to the A/S Instructions, bond securities are reported in Schedule D – Part 1, and under Bonds in the balance sheet. The AP&P Manual requires short-term investments to be reported under Schedule DA – Part 1, as well.

**Note 3 – Accident and health premiums due and unpaid**  
$266,649

The Company appropriately reported Accident and health premiums due and unpaid (D&U) on page 2, line 10, of its 2001 Annual Statement. This examination has determined the captioned amount to be accurate. However, the actuarial examiner’s review
indicated that the Company did not report an offsetting liability for the commissions, cost of collection, taxes, and/or unpaid claims associated with the D&U premiums, in accordance with SSAP No. 5 of the AP&P Manual and relevant sections of ALA. CODE § 27-36-1 (1975).

In addition, item 12 of SSAP No. 54 of the AP&P Manual states, in pertinent part:

"If premiums due and unpaid are carried as an asset, such premiums must be treated as premiums in force, subject to unearned premium reserve determination (but never less than the expected claims). The value of unpaid commissions, premium taxes, and the cost of collection associated with due and unpaid premiums must be carried as an offsetting liability."

It is the actuarial examiner’s opinion that the Company’s reserving methods and results were reasonably conservative based on data available at year-end 2001; therefore, no adjustments were made to the reported amounts for the purposes of this examination. (Also see "Note 13 – D&U Premiums," later in this section.)

**Note 4 – Health care receivables**

The referenced amount is the same as reported by the Company in its 2001 Annual Statement.

The Annual Statement Notes to Financial Statements did not disclose the method utilized by the Company to estimate pharmaceutical rebate receivables as required by paragraph 24, of SSAP No. 84, of the AP&P Manual, which stipulates that:

"The financial statements shall disclose the method used by the reporting entity to estimate pharmaceutical rebate receivables. Furthermore, for the most recent three years and for each quarter therein, the reporting entity shall also disclose the following:

a. Estimated balance of pharmacy rebate receivable as reported on the financial statements.

b. Pharmacy rebates as invoiced or confirmed in writing; and

c. Pharmacy rebates collected."
Note 5 - Amounts recoverable from reinsurers

The captioned amount is the same as reported in the Company’s 2001 Annual Statement.

The examination has determined that the Company had not completed certain portions of Schedule S associated with reinsurance ceded in accordance with the A/S Instructions for the year 2001. A review of workpapers and supporting details determined that $221,373 was recovered from the reinsurer and reported by the Company in 2001 for claims settled in the year 2000.

SSAP No. 61, of the AP&P Manual, under the heading “Accounting and Reporting of Reinsurance,” required the Company to recognize reinsurance recoverable on paid claims in its balance sheet. By not recognizing the recoverables in the year the claims were paid, the Company understated its capital and surplus; consequently, capital and surplus was overstated in the year the reinsurance was recovered. Since there was no effect on the Company’s current Total capital and surplus, no changes were made to the financial statements in this report.

Sections of Schedule S related to reinsurance ceded should be completed in accordance with the A/S Instructions. The reinsurance recoverable is to be recognized in the year the claims are paid in accordance with SSAP No. 61, of the AP&P Manual.

Note 6 - Investment income due and accrued

The captioned amount is the same as reported in the Company’s 2001 Annual Statement. The examination has determined certain exceptions in the investment income due and accrued account, which are discussed below.

At the examination date, the Company recorded bond dividends and interest on certificate of deposits (CDs) when received. However, adjustments for due and accrued interest between the beginning and the end of the accounting period was not made in accordance with A/S Instructions and SSAP No. 34, of the AP&P Manual.

The examination determined that the Company had overstated the amount by an aggregate of $8,186; hence, the Statement of Revenue and Expenses for the year 2001, was overstated by that amount.

The Company did not complete Part 4 – Interest, Dividend and Real Estate Income in accordance with the A/S Instructions. Investment income should be recognized in
accordance with the AP&P Manual.

Due to the immateriality of the aforementioned difference, no changes were made to the financial statements in this report.

**Note 7 – Aggregate write-ins for other than invested assets**

**Accounts receivable – Other**

$29,506

The captioned amount is the same as reported by the Company in its 2001 Annual Statement but $12,142 more than the $17,364 amount determined by this examination.

The entirety of the $12,142 difference was determined to be overpayments of claims, which is a non-admitted asset according to the AP&P Manual. **SSAP No. 4**, requires that the Company not admit assets that are specifically identified as not admitted assets or not specifically identified as an admitted assets within the AP&P Manual.

Due to the immateriality of the amount, no change was made to the financial statements for the purposes of this examination.

It is noted that the previous examination recommended that the Company not admit all amounts recoverable that it believes is due for past overpayment of claims.

**Note 8 – Claims unpaid**

$2,535,014

The captioned liability is the same as was reported by the Company in its 2001 Annual Statement, but $959,073 more than the $1,575,941 amount determined by this examination. When compared to the actuarial examiners’ calculations, the Company’s **Claims unpaid** liability was overstated by $959,073, indicating that the Company experienced favorable development on year-end 2001 reserves. The actuarial examiners opine that the Company’s reserve methods and results were reasonably conservative based on the data available at the time of completing the 2001 Annual Statement. Consequently, for the purposes of the examination, no adjustment was made to the reported liability on the financial statements of this report.

The actuarial examiners asked the Company to reconcile paid claims reported in its general ledger accounts to paid claims shown in its lag studies; the Company was able to do so. The month/year of incurral and the month/year of payment data was reviewed by the examiners and determined to be accurate.
The following schedule outlines the components of the *Claims unpaid* liability, per the Company and our examination, which was based on claims run-off data through May 31, 2002. The actuarial examiners' figures also include estimates of claims incurred prior to January 1, 2002, that remained unpaid as of May 31, 2002, based on our independent claim payment lag analysis.

<table>
<thead>
<tr>
<th>Claims Unpaid</th>
<th>Per Company</th>
<th>Per Examination</th>
<th>Difference</th>
</tr>
</thead>
<tbody>
<tr>
<td>IBNR Claims</td>
<td>$1,830,106</td>
<td>$1,234,750</td>
<td>$(595,356)</td>
</tr>
<tr>
<td>Catastrophic Claims</td>
<td>587,717</td>
<td>224,000</td>
<td>(363,717)</td>
</tr>
<tr>
<td>Pharmacy Claims</td>
<td>117,191</td>
<td>117,191</td>
<td>0</td>
</tr>
<tr>
<td><strong>TOTALS</strong></td>
<td><strong>$2,535,014</strong></td>
<td><strong>$1,575,941</strong></td>
<td><strong>$(959,073)</strong></td>
</tr>
</tbody>
</table>

The Company’s calculation of Incurred-but-not-reported (IBNR) claims was based on a claims payment lag triangle analysis, and on the development of completion factors. This is a standard actuarial methodology. The Company included a 10% margin in its IBNR reserve for contingencies.

The Company established a separate reserve for specific catastrophic claims. Initially, the Company calculated and filed a $637,717 Catastrophic Claims reserve (labeled "Original"). Later, this reserve was reduced to $587,717, and the Company filed an amended 2001 Annual Statement.

The Company determined $117,191 in pharmacy claims through an audit of claims payable incurred in 2001, and to be paid in 2002.

It was noted that the Company did not report separate liabilities for deferred maternity reserves and organ transplant reserves. That information was included in the Company’s paid claims lag data. Since the Company accounted for these benefits in its *Claims unpaid* liability, the establishment of any other deferred maternity or organ transplant reserves was not required.

The actuarial examiners reviewed the Company’s recent rate filings submitted to the ALDOI. Through discussions with the Company regarding its rate filings, the actuarial examiners determined that the Company is monitoring and filing rate studies using the Per-Month-Per-Member (PMPM) cost estimates, trend estimates, and expense assumptions generally based on its experience for the year ending two quarters prior to making the filing. The experience was generally valued two months later than the quarter end. The actuarial examiners determined that this process was reasonable.
Note 9 – Unpaid claims adjustment expenses $133,674

The referenced amount is the same as was reported by the Company in its 2001 Annual Statement but $70,636 more than the $63,038 amount determined by this examination.

The Company’s calculations are described as follows:

- **Unpaid claims adjustment expenses** (UCAE) was estimated as 4.5% of the sum of the IBNR claims and the “Original” catastrophic claims reserves, including margins. The 4.5% UCAE ratio was an approximation based on the Company’s expenses and on industry norms. The resulting UCAE liability [($1,830,106 + $637,717) x .045] is $111,052.

- An additional liability, as determined through an internal audit, was added for accrued due and unpaid UCAE as of December 31, 2001, in the amount of $22,622.

- The reported $133,674 UCAE liability is the sum of $111,052, and $22,622.

It was noted that the resulting year-end 2001 ratio of UCAE to the reported amended **Claims unpaid** liability was 5.27%.

Based on the actuarial examiners’ examination of numerous similar companies, it was found that the UCAE liability was typically calculated as 3% to 5% of the **Claims unpaid** liability. For the purposes of this examination, we used a 4% ratio applied to our claims unpaid liability estimate ($1,575,941) as of December 31, 2001. [See “Per Examination” column in the schedule contained in “Note 8 – Claims unpaid,” previously in this section.]

Guidelines for determining those administrative expenses that should be included in the UCAE liability are established in **SSAP No. 55**, of the AP&P Manual. Item 6.c., states that:

“…expenses incurred in these activities are estimating the amounts of losses, disbursing loss payments, maintaining records, general clerical, secretarial, office maintenance, occupancy costs, utilities, computer maintenance, supervisory and executive duties, supplies and postage.”

35
When compared to our calculations, the Company’s UCAE liability of $133,674 was overstated by $70,636. For the purposes of our examination, however, no adjustments were made to the reported UCAE liability amount.

**Note 10 — Aggregate policy reserves**  
$180,334

The Company calculated a Premium Deficiency Reserve (PDR) in the referenced amount and reported it as captioned above on page 3, line 4 of its 2001 Annual Statement. The Company’s calculations were based on methods consistent with those as outlined in the NAIC’s Health Reserves Guidance Manual. The PDR is an estimate using realistic assumptions of current reserves and future premiums, claims payments, and expenses.

The actuarial examiners noted that unearned premiums [premiums reported as paid from the date of valuation to the next modal paid-to date (i.e., due date)], should have been included in Aggregate policy reserves in accordance with SSAP No. 54, of the AP&P Manual. Based on the actuarial examiners’ review of the Company’s methods and assumptions, and the immateriality of any unearned premium reserves that may not have been booked, the Aggregate policy reserves, in the reported amount of $180,334, have been accepted for the purposes of this examination.

**Note 11 — Amounts withheld or retained for the account of others**  
$ 0

The captioned amount is the same as was reported by the Company in its 2001 Annual Statement, and $3,268 less than was determined by this examination.

A review of the Company’s accounts and records determined that checks totaling $3,268, that were issued in the year 1996, had never been cashed, and were not reported as a liability in its 2001 Annual Statement. ALA. ADMIN. CODE 66 (1979) states that:

“All unclaimed funds in the procession, or under the control of an insurer shall, at all times, be maintained as a liability on the books of the insurer. This requirement shall remain in effect until the funds are claimed or transferred to the custody of the State of Alabama…”

The Company should have reported the above amount as a liability under Amounts withheld or retained for the account of others. Since the unclaimed checks were adjusted against the asset Cash and short-term investments, not reporting the escheatable property
as a liability would have no effect on the surplus of the Company. Hence, a change to the financial statement was not made.

ALA. CODE § 35-12-31(a) (1975) states, in pertinent part:

"Every person holding funds or other property, tangible or intangible, presumed abandoned under this article shall report to the Treasurer with respect to the property and deliver the property to the Treasurer as hereinafter provided."

The Company could not provide evidence of filing unclaimed property reports for the years 1999 and 2000, did not escheat unclaimed checks issued in 1996, and was, therefore, not in compliance with the referenced section of the Alabama Insurance Code.

According to ALA. ADMIN. CODE 66 (1979), the Company should create a liability for unclaimed property and then escheat the property to the treasury in accordance with ALA. CODE § 35-12-31(a) (1975).

**Note 12 – Borrowed money**  
$4,500,000

The captioned amount is $4,500,000 more than was reported by the Company in its 2001 Annual Statement. The entirety of the difference was the result of a reclassification from *Surplus notes*. A detailed discussion of this matter may be found later in this section under “Note 15 – Surplus notes.”

**Note 13 – D&U Premiums**  
$ -0-

This caption did not appear on the Company’s balance sheet as of December 31, 2001. The examination has determined that an offsetting liability should have been established to report commissions, cost of collection, taxes, and/or unpaid claims associated with the due and unpaid (D&U) premiums, in accordance with SSAP No. 5, and SSAP No. 54, of the AP&P Manual, and relevant sections of ALA. CODE § 27-36-1 (1975).

The Company’s D&U premiums are based on gross premiums. To calculate the offsetting liability, the actuarial examiners used an estimated expected claims ratio of 65%, and a ratio of 25% of claims for the Company’s estimated commissions, cost of collection, taxes, etc. Consequently, the offsetting liability should have been 90% of the gross D&U premiums, or $239,984, and reported with *Aggregate write-ins for other*
liabilities on page 3, line 17 of the Annual Statement. The review of actuarial liabilities determined that the Company’s reserving methods and results were reasonably conservative given the data available at year-end 2001; therefore, no changes were made to the financial statements in this report.

Additional discussion on this matter may be found previously in this section under “Note 3 – Accident and health premiums due and unpaid.”

**Note 14 – Gross paid in and contributed surplus** $19,775,000

The captioned amount is the same as was reported by the Company in its 2001 Annual Statement, and as determined during the previous examination. There were no changes during the three-year examination period.

Other than a listing of six individual contributions, the Company was unable to provide any information or documentation concerning these amounts.

**Note 15 – Surplus notes** $5,983,000

The referenced equity item is $4,500,000 less than the $10,483,000 amount reported by the Company in its 2001 Annual Statement. The Company listed eight surplus notes; the following table discloses the relevant information concerning each:

<table>
<thead>
<tr>
<th></th>
<th>AMOUNT OF NOTE</th>
<th>DATE ISSUED</th>
<th>DATE APPROVED</th>
<th>INTEREST RATE</th>
<th>ACCRUED INTEREST</th>
</tr>
</thead>
<tbody>
<tr>
<td>(1)</td>
<td>$600,000</td>
<td>05/05/1995</td>
<td>06/01/1995</td>
<td>8.5%</td>
<td>$153,139.55</td>
</tr>
<tr>
<td>(2)</td>
<td>$4,500,000</td>
<td>05/11/1999</td>
<td>07/18/2002</td>
<td>8.0%</td>
<td>955,726.02</td>
</tr>
<tr>
<td>(3)</td>
<td>$2,383,000</td>
<td>10/21/1999</td>
<td>10/22/1999</td>
<td>8.0%</td>
<td>441,866.91</td>
</tr>
<tr>
<td>(4)</td>
<td>$600,000</td>
<td>08/31/2000</td>
<td>09/05/2000</td>
<td>8.0%</td>
<td>62,465.75</td>
</tr>
<tr>
<td>(5)</td>
<td>$1,200,000</td>
<td>12/29/2000</td>
<td>01/20/2001</td>
<td>8.0%</td>
<td>95,999.96</td>
</tr>
<tr>
<td></td>
<td>$1,800,000</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>(6)</td>
<td>$500,000</td>
<td>03/23/2001</td>
<td>04/03/2001</td>
<td>8.0%</td>
<td>30,246.57</td>
</tr>
<tr>
<td>(7)</td>
<td>$515,000</td>
<td>06/28/2001</td>
<td>07/12/2001</td>
<td>8.0%</td>
<td>20,882.20</td>
</tr>
<tr>
<td>(8)</td>
<td>$185,000</td>
<td>09/27/2001</td>
<td>10/12/2001</td>
<td>8.0%</td>
<td>3,811.52</td>
</tr>
<tr>
<td></td>
<td>$1,200,000</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Totals</td>
<td>$10,483,000</td>
<td></td>
<td></td>
<td></td>
<td>$1,764,138.48</td>
</tr>
</tbody>
</table>
For each note, the Company promised to pay its ultimate parent, University of South Alabama Foundation (USA Foundation), in accordance with the terms and conditions specified in the agreement, and to pay interest quarterly at the stated rate per annum. The notes were issued to specifically conform with the requirements of ALA. CODE § 27-27-40 (1975), and ALA. ADMIN. CODE 80 (1996).

The principals of the notes are payable only out of the earned surplus of the Company in excess of $2,000,000; however, no payment of principal and/or interest shall be made unless approved in advance by the Alabama Insurance Commissioner in accordance with relevant sections of ALA ADMIN. CODE 94 (1993). There are no maturity dates.

All agreements since 1995 stipulate that if the Company fails to meet the conditions as described, the USA Foundation, at its option, may also, if permitted under applicable law, accelerate the interest rate of the notes to 10%.

With the exception of the $4.5 million note issued May 11, 1999, the Company maintained documentation evidencing that all notes were approved by the Alabama Insurance Commissioner in accordance with ALA. CODE § 27-27-40 (1975), and ALA. ADMIN. CODE 79 (1987), 80 (1996) and 94 (1993). During the course of this examination, the Company submitted the unapproved note to the ALDOI, where it was approved by the Commissioner on July 18, 2002. However, at year-end 2001, the ALDOI considered the $4.5 million to be Borrowed money, and that amount was reclassified as such for the purposes of this examination. Additional discussion on this matter may be found in this section under “Note 12 – Borrowed money.” As a result of this reclassification, the Company was determined to be capital impaired at December 31, 2001. Because the note was subsequently approved by the Commissioner, the $4.5 million will be classified as a component of net worth and accounted for in Surplus notes in all future quarterly and annual filings, thereby curing the impairment. It should be noted that the Company disclosed the surplus note in all of its filings during the examination period.

It was noted that no interest has ever been paid on any of the surplus notes in accordance with ALA. ADMIN. CODE 94 (1993).

Note 16 – Unassigned funds (surplus) $(33,907,716)

The Unassigned funds (surplus) of the Company, as determined by this examination, was $5,214,696 less than the $(28,693,020) reported by the Company in its Annual Statement as of December 31, 2001. The following presents a reconciliation of
unassigned funds per the Company’s filed Annual Statement to that developed by this examination:

<table>
<thead>
<tr>
<th>Unassigned funds (surplus) per Company</th>
<th>$(28,693,020)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Examination increase/(decrease) in assets:</td>
<td></td>
</tr>
<tr>
<td>• Cash and short-term investments (Note 2)</td>
<td>$(5,214,696)</td>
</tr>
<tr>
<td>Total decrease in assets</td>
<td>$(5,214,696)</td>
</tr>
<tr>
<td>Net Increase (Decrease)</td>
<td>(5,214,696)</td>
</tr>
<tr>
<td>Unassigned funds (surplus) per Examination</td>
<td>$(33,907,716)</td>
</tr>
</tbody>
</table>

**CONTINGENT LIABILITIES AND PENDING LITIGATION**

The review of contingent liabilities and pending litigation included an inspection of representations made by management, a review of a report to the independent CPAs on pending litigation made by Company counsel, and a general review of the Company’s records and files conducted during the examination, including a review of claims. This review did not disclose items that would have a material affect on the Company’s financial position in the event of an adverse outcome.

It was noted that the Company did not reserve any funds for legal actions brought against the Company. No reserve had been established for expenses of litigation on lawsuits known to exist at the Annual Statement reporting date. The actuarial examiners noted that if there are any litigation claims, the Company should recognize in the paid claims lag database that portion of litigation claims representing claims payments. **SSAP No. 5**, of the AP&P Manual defines and establishes statutory accounting principles for liabilities, contingencies and impairments of assets.

Recommendations concerning ongoing legal concerns is made in the **COMMENTS AND RECOMMENDATIONS** section of this report under the **Claims unpaid** caption.

**COMPLIANCE WITH PREVIOUS RECOMMENDATIONS**

A review was conducted during the current examination with regard to the Company’s compliance with recommendations made in the previous examination
report. This review indicated that the Company had satisfactorily complied with the prior recommendations with the exception of certain items listed below:

**Aggregate write-ins for Current Assets**
The *Report on Examination as of March 31, 1999*, recommended that the Company not admit all amounts recoverable that it believed was due to it for past overpayment of claims. The Company did not comply with that recommendation.

**COMMENTS AND RECOMMENDATIONS**

The following summary presents the comments and recommendations that are made in the current *Report of Examination*.

**Management and Control:**

**Stockholders** – Page 3

*It is recommended* that the Company hold annual meetings of its shareholders and maintain minutes thereof in accordance with items 2.01 and 9.03 of its By-Laws.

**Board of Directors** – Page 4

*It is recommended* that the Company comply with its By-Laws, which provides that five directors be appointed by the Board of Directors.

**Conflict of Interest** – Page 5

*It is recommended* that the Company’s officers, directors, trustees and/or responsible employees complete conflict of interest statements on an annual basis in accordance with NAIC Annual Statement guidelines and as part of good business practices.

**Holding Company and Affiliate Matters:**

**Management Agreement** – Page 8

*It is recommended* that the Company submit all management agreements, service contracts, and cost-sharing arrangements to the ALDOI for approval in accordance with Section 13 of ALA. ADMIN. CODE 79 (1987). *It is also recommended* that the Company maintain complete records of its management contracts as required by
Section 15 of that regulation.

It is recommended that the Company reduce its management and services arrangements with its parent to writing, and obtain approval of the agreement from the Commissioner in accordance with ALA. CODE § 27-21A-4, (1975), and Section 13 of the aforementioned ALDOI regulation.

Consolidated Tax Filing Agreement – Page 9

It is recommended that the Company’s arrangements for tax consolidation with its parent be reduced to writing and provided to the Alabama Commissioner of Insurance in accordance with ALA. CODE § 27-21A-2 (1975), and Section 15 of ALA. ADMIN. CODE 79 (1987).

Fidelity Bonds and Other Insurances - Page 10

It is recommended that the Company comply with the provisions of ALA. CODE § 27-21A-6(b) (1975), by including a termination clause in the language stated in the fidelity bond.

Market Conduct Activities:
Plan of Operation – Page 13

It is recommended that the Company provide all requested information to the examiners in accordance with ALA. ADMIN. CODE 118 (1999).

Advertising and Marketing – Page 14

It is recommended that the Company file an advertising “Certificate of Compliance” with its Annual Statement in accordance with Section 6 of ALA. ADMIN. CODE 79 (1987).

Accounts and Records – Page 19

It is recommended that the Company maintain complete and accurate records in its home office in accordance with Section 15 of ALA. ADMIN. CODE 79 (1987).

It is recommended that the Company comply with ALA. ADMIN. CODE 118 (1999), by providing responses within ten working days regarding information
requested by personnel representing the ALDOI.

**Bonds** – Page 28

**It is recommended** that the Company complete Schedule D in its entirety in accordance with A/S Instructions.

**It is recommended** that the Company amortize its bonds to par value in accordance with the AP&P Manual.

**It is recommended** that the Company maintain evidence, updated at least quarterly, supporting the continued eligibility for provisionally exempt status on all investments which have been so designated, in accordance with Section 15 of ALA. ADMIN. CODE 79 (1987), and guidelines established by the NAIC’s Security Valuation Office.

**Cash and short-term investments** – Page 29

**It is recommended** that the Company refrain from investing its cash in excess of the statutory limitation, as defined in ALA. CODE § 27-41-6(a) (1975). Any amount exceeding such guidelines should be not admitted from the balance sheet.

**It is recommended** that the Company comply with A/S Instructions, SSAP No. 2, and SSAP No. 45, of the AP&P Manual and report investments acquired under repurchase agreement as short-term investments.

**It is recommended** that the Company comply with the collateral requirements as stipulated by item 8 of SSAP No. 45, of the AP&P Manual.

**Accident and health premiums due and unpaid** – Page 30

**D&U Premiums** – Page 37

**It is recommended** that the Company establish a liability for commissions, cost of collection, taxes, and unpaid claims associated with Accident and health premiums due and unpaid. Said liability should be reported with Aggregate write-in for other liabilities on page 3, line 17, of the Company’s future annual and quarterly filings in accordance with the relevant sections of ALA. CODE § 27-36-1 (1975), and SSAP No. 5, and SSAP No. 54, of the AP&P Manual.
Health care receivables – Page 31

It is recommended that the Company disclose in the Notes to Financial Statements of its filed Quarterly and Annual Statements the method utilized to estimate pharmaceutical rebate receivables in accordance with paragraph 24, of SSAP No. 84, of the AP&P Manual.

Amounts recoverable from reinsurers – Page 32

It is recommended that the Company complete Schedule S in accordance with the A/S Instructions.

It is recommended that the Company recognize reinsurance recoverables in the balance sheet in the period claims are paid in accordance with SSAP No. 61, of the AP&P Manual.

Investment income due and accrued – Page 32

It is recommended that the Company complete Part 4 - Interest, Dividends and Real Estate Income in accordance with the A/S Instructions.

It is recommended that the Company make the necessary adjustment to investment income by recognizing income in the period in which it is incurred in accordance with SSAP No. 34, of the AP&P Manual.

Aggregate write-ins for other than invested assets – Page 33

It is recommended that the Company comply with SSAP No. 4, of the AP&P Manual and not admit all receivables on account of overpayments in all future statutory financial statements. It is noted that the previous examination recommended that the Company not admit all amounts recoverable that it believed was due it for past overpayment of claims.

Claims unpaid – Page 33

It is recommended that the Company continually review its lag studies and methodologies, and utilize those methods that will most closely imitate its Claims
unpaid liability.

If there are litigation claims, it is recommended that the Company recognize in the paid claims lag database that portion of litigation claims representing claims benefit payments. The Company should establish and report reserves for expenses of litigation on lawsuits, which are known to exist at the Annual Statement date. SSAP No. 5, of the AP&P Manual defines and establishes statutory accounting principles for liabilities, contingencies and impairments of assets.

It is recommended that the Company continue to monitor and file rate studies using PMPM cost estimates, trend estimates, and expense assumptions based on reviews of the Company’s recent experience. These studies should include sufficient documentation and support for another actuary to review the methods and assumptions.

Unpaid claims adjustment expenses – Page 35

It is recommended that the Company calculate an appropriate ratio of expenses to claims as of December 31st each year, and then utilize that ratio to calculate the liability for its Unpaid claims adjustment expenses.

It is recommended that the Company review SSAP, No. 55, of the AP&P Manual in order to determine those administrative expenses that should be selected in calculating the UCAE liability.

Aggregate policy reserves – Page 36

It is recommended that the Company establish an “Unearned Premium Reserve” for any premiums reported as paid from the date of valuation to the next modal paid-to date (i.e., due date), in accordance with SSAP No. 54, of the AP&P Manual.

Amounts withheld or retained for the account of others – Page 36

It is recommended that the Company established and maintain a liability for unclaimed property until the appropriate time frame has elapsed to remit said funds to the custody of the State of Alabama under the provisions of the Uniform Disposition of Unclaimed Property Act, in accordance with ALA. ADMIN. CODE 66 (1979).
It is recommended that the Company comply with ALA. CODE § 35-12-31 (1975), relating to the remittance of unclaimed funds to the Treasurer of the State of Alabama five years after the moneys become due and payable.

**Gross paid in and contributed surplus** – Page 38

It is recommended that the Company maintain complete records of its capital contributions in accordance with Section 15 of ALA. ADMIN. CODE 79 (1987).

**Surplus notes** – Page 38

It is recommended that the Company obtain approval of its surplus notes in accordance with ALA. CODE § 27-27-40 (1975), and ALA. ADMIN. CODE 80 (1996) and 94 (1993).

It is also recommended that the Company maintain complete records of its surplus notes in accordance with Section 15 of ALA. ADMIN. CODE 79 (1987).

**Compliance with ALA. ADMIN. CODE 60 (1977)**

It is recommended that the Company file future Annual Statements in accordance with the last filed Report of Examination, pursuant to ALA. ADMIN. CODE 60, and the ALDOI Bulletin, dated January 26, 2000 (Accounting Practices and Procedures Required for Authorized Insurers).

**SUBSEQUENT EVENTS**

**Other regulatory examinations**

**Alabama Department of Public Health (ADPH):**

The ADPH conducted the following reviews during its May 14 – 16, 2002, site visit to the Company:

- 2002 Off Year Claim Processing Audit; and
- 2002 Off Year Document Review.
The results of the ADPH evaluations identified no deficiencies in the claim processing examination, and compliance with the required document review.

Approval of Surplus Note

During the course of this examination, and subsequent to the examination date, the Company submitted a $4.5 million surplus note to the Alabama Department of Insurance, where it was approved by the Commissioner on July 18, 2002. The $4.5 million will be classified as a component of net worth and accounted for in Surplus notes in all future quarterly and annual filings, thereby curing the capital impairment determined as a result of examination reclassification of said funds.

Sale of PrimeHealth of Alabama, Inc.

On November 8, 2002, in accordance with ALA. CODE § 27-29-1 (1975) et seq., and ALA. CODE § 27-21A-27 (1975), the Alabama Insurance Commissioner “ORDERED that the...acquisition of control of or merger with PHA Administrative Services, Inc., the sole shareholder of PrimeHealth of Alabama, Inc., an Alabama health maintenance organization by PrimeHealth Holdings, Inc., a Florida corporation, be APPROVED...”

Mr. A. Paul Shapansky, Chief Executive Officer of PrimeHealth Holdings, Inc., announced that Mr. Robert Rubin, the Company’s Chief Financial Officer at the examination date, will assume the role of Interim Executive Director.

Management Agreement

As noted under this caption in the Transactions and Agreements with Affiliates section of the examination report, the Company did not have an effective management agreement in place at December 31, 2001. During the course of the examination, the examiners requested that the Company provide details of its replacement management and services arrangements with PHA Services, its parent. As of the date of this report, no evidence was furnished to indicate that an agreement had been reduced to writing, and that said agreement was submitted to the Commissioner in accordance with ALA. CODE § 27-21A-4 (1975), and Section 13 of ALA. ADMIN. CODE 79 (1987).

The Company is reminded without an approved management contract, payments for management fees, services and expenses cannot be reported as administrative expenses but should be classified as “Dividends to stockholders.”
CONCLUSION

Acknowledgement is hereby made of the courteous cooperation extended by all persons representing the Company during the course of this examination.

The customary insurance examination procedures, as recommended by the National Association of Insurance Commissioners, have been followed to the extent appropriate in connection with the verification and evaluation of assets and determination of liabilities set forth in this report.

As a result of findings determined by this examination, the Company was statutorily impaired at the December 31, 2001, examination date; the Company's total capital and surplus was $(8,049,716). Details of the noted problems may be found in the NOTES TO FINANCIAL STATEMENTS section of this report, under the various captions to which they relate. Certain subsequent events occurred, which restored a portion of the Company's statutory surplus.

In addition to the undersigned, F. Blase Abreo, Examiner; and Joseph J. Wallace, ASA, MAAA, Consulting Actuarial Examiner, both representing the Alabama Department of Insurance, participated in this examination of PrimeHealth of Alabama, Inc.

Respectfully submitted,

Anne L. Ward, AFE
Examiner-in-Charge
State of Alabama
Department of Insurance

February 14, 2003