



STATE OF OREGON

DEPARTMENT OF CONSUMER AND BUSINESS SERVICES

INSURANCE DIVISION

REPORT OF A LIMITED SCOPE FINANCIAL EXAMINATION

OF

**PHP HEALTH PLAN, INC.
KLAMATH FALLS, OREGON**

NAIC COMPANY CODE 11161

AS OF

March 31, 2004

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September 20, 2004

Honorable Cory Streisinger, Director
Department of Consumer and Business Services
State of Oregon
350 Winter Street NE, Room 440
Salem, Oregon 97301-3883

Dear Director:

In accordance with your instructions and pursuant to ORS 731.300, I examined the business affairs and financial condition of

**PHP HEALTH PLAN, INC.
2605 CROSBY AVENUE
KLAMATH FALLS, OREGON 97603**

NAIC COMPANY CODE 11161

hereinafter referred to as "PHP." This report of examination is respectfully submitted.

SCOPE OF EXAMINATION

This examination is limited in scope to the verification of assets, liabilities and surplus as of March 31, 2004. It was conducted because of the Insurance Division's concern over PHP's precarious capital and surplus position.

The examination was conducted in accordance with procedures and guidelines prescribed by the National Association of Insurance Commissioners (NAIC). It included a discussion with PHP's certified public accountants concerning their annual audit as of December 31, 2003.

The Oregon Insurance Division conducted a full-scope examination as of December 31, 2002. PHP's compliance with the recommendations in the report of that examination is discussed below.

CAPITALIZATION

The original articles of incorporation authorized 10,000 shares of common stock. Merle West Medical Center (Merle West) of Klamath Falls, Oregon, provided initial capitalization of \$1,300,000 through the purchase of 1,000 shares. The articles were amended in September 2002, to authorize 5,000,000 shares of common stock and, at the same time, a 130 to 1 stock split provided an additional 129,000 shares to Merle West. The Medical Center acquired 49,279 more shares during 2003, for an investment of \$590,000.

PHP issued an additional 32,411 shares during 2003 in response to a June 2003, stock offering of 179,167 shares at \$12 a share. The offering was restricted to members of the board of directors, officers, medical providers and the local community. PHP received \$388,932 from the offering.

Merle West provided \$1,315,000 during the last quarter of 2003 in return for four subordinated surplus notes. These notes were issued with the prior approval of the Insurance Division and cannot be repaid without the approval of the director of the Oregon Department of Consumer and Business Services (director).

Merle West committed, in March 2004, to purchase an additional 100,000 shares of common stock for \$600,000. The first quarter 2004 financial statements reflect this as an asset, receivable from parent, and as capital stock to be issued.

Merle West paid \$526,569 of PHP start-up costs, prior to 2003. These contributions were incorrectly recorded as capital stock issued. The error was identified during this examination and the payments have been reclassified to gross paid in and contributed surplus.

COMPLIANCE WITH PRIOR EXAMINATION RECOMMENDATIONS

All three recommendations in the report of examination as of December 31, 2002, have been resolved.

1. I recommend the Company comply with the provisions of ORS 731.504 by reducing its retention per individual risk.

ORS 731.504 provides that an insurer shall not retain any risk in an amount exceeding 10% of its surplus to policyholders. That limit was exceeded as of December 31, 2002 because the \$100,000 retention under PHP's reinsurance agreement was greater than 10% of surplus to policyholders which totaled \$787,777. Surplus as of December 31, 2003 was \$1,556,069 and resolved the issue as of that date. Surplus as of March 31, 2004 was \$980,129 and PHP, again, was not in compliance with ORS 731.504. Capital and surplus exceeded \$2 million as of August 31, 2004, as discussed in the conclusion of this report. Risk retention under reinsurance agreements is now comfortably under 10% of capital and surplus.

2. I recommend the Company comply with the provisions of ORS 731.302 and the NAIC Examiners Handbook Part 1 General, Section IV, by holding all securities with a qualified bank or trust company.

The examiners learned that some securities held by PHP's investment manager were not held under a custody agreement with a qualified bank or trust company. This has been corrected and all securities, with the exception of a special deposit required by Oregon statute, are now held under a custody agreement with South Valley Bank and Trust, Klamath Falls. The special deposit is in the custody of US Bank, Portland, Oregon.

3. I recommend the Company disclose its contract with SBPI and its employment contracts with certain officers as a contingent liability in accordance with the requirements of the NAIC Annual Statement Instructions and SSAP No. 5.

The appropriate disclosure was made in note 14 to the financial statements of the 2003 annual statement.

PHP HEALTH PLAN, INC.
BALANCE SHEET
As of March 31, 2004

<u>ASSETS</u>	<u>Quarterly Statement</u>	<u>Examination Adjustments</u>	<u>Examination</u>
Bonds	\$ 752,235	\$	\$ 752,235
Cash and short-term investments	2,686,334		2,686,334
Investment income due and accrued	5,332		5,332
Uncollected premiums	12,429		12,429
Amounts recoverable from reinsurers	150,000		150,000
Electronic data processing equipment	21,156		21,156
Receivables from parent	<u>600,000</u>	<u>0</u>	<u>600,000</u>
Total Assets	<u>\$4,227,486</u>	<u>\$ 0</u>	<u>\$4,227,486</u>
 <u>LIABILITIES</u>			
Claims	\$2,525,906	\$	\$2,525,906
Unpaid claims adjustment expenses (Note 1)	101,036		101,036
Premium received in advance	548,321		548,321
General expenses due and accrued	54,133		54,133
Amounts withheld or retained for others	<u>17,961</u>	<u>0</u>	<u>17,961</u>
Total Liabilities	<u>3,247,357</u>	<u>0</u>	<u>3,247,357</u>
 <u>CAPITAL AND SURPLUS</u>			
Common capital stock (Note 2)	2,805,541	(526,569)	2,278,972
Gross paid in and contributed surplus (Note 2)		526,569	526,569
Surplus notes	1,315,000		1,315,000
Common stock subscribed	600,000		600,000
Unassigned funds	<u>(3,740,412)</u>		<u>(3,740,412)</u>
TOTAL CAPITAL AND SURPLUS	<u>980,129</u>	<u>0</u>	<u>980,129</u>
TOTAL LIABILITIES, CAPITAL AND SURPLUS	<u>\$4,227,486</u>	<u>\$ 0</u>	<u>\$4,227,486</u>

PHP HEALTH PLAN, INC.
INCOME STATEMENT
For the Quarter Ended March 31, 2004

	<u>Annual Statement</u>	<u>Examination Adjustments</u>	<u>Examination</u>
Net Premium Income	\$ 4,795,990	\$ _____ 0	\$ 4,795,990
<u>Medical and hospital:</u>			
Hospital/medical benefits	5,029,700		5,029,700
Prescription drugs	618,291		618,291
Less net reinsurance recoveries	<u>217,855</u>		<u>217,855</u>
Total Medical and Hospital	5,430,136		5,430,136
Claims adjustment expenses	241,400		241,400
General administrative expenses	<u>329,730</u>		<u>329,730</u>
Total Underwriting Deductions	<u>6,001,266</u>		<u>6,001,266</u>
Net underwriting loss	(1,205,276)		(1,205,276)
Net invested income	<u>12,824</u>		<u>12,824</u>
Net loss before federal income taxes	(1,192,452)		(1,192,452)
Federal and foreign income taxes incurred	<u>_____ 0</u>	<u>_____ 0</u>	<u>_____ 0</u>
Net Loss	<u><u>\$(1,192,452)</u></u>	<u><u>\$ _____ 0</u></u>	<u><u>\$(1,192,452)</u></u>

CAPITAL AND SURPLUS ACCOUNT

Capital and surplus prior reporting year	<u>\$ 1,556,069</u>
Gains and losses to capital and surplus	
Net income	(1,192,452)
Change in nonadmitted assets	16,512
Change in surplus notes	0
Change in paid in capital	<u>600,000</u>
Net change in capital and surplus	<u>(575,940)</u>
Capital and surplus end of quarter	<u><u>\$ 980,129</u></u>

NOTES TO FINANCIAL STATEMENTS

Note 1 – Unpaid Claim Adjustment Expenses

PHP has included a \$25,260 increase determined by the Insurance Division's actuary.

Note 2 – Common Capital Stock and Gross Paid In and Contributed Surplus

Merle West Medical Center paid start-up costs of \$526,569 on behalf of PHP that were incorrectly recorded as capital stock. This adjustment reflects a reclassification to the correct category, gross paid in and contributed surplus.

EVENTS SUBSEQUENT TO MARCH 31, 2004

Order of Supervision and Order to Increase Capital and Surplus

The Insurance Division responded to the continuing decline in operating results during the first quarter of 2004 by issuing an IMMEDIATE ORDER OF SUPERVISION AND ORDER TO INCREASE CAPITAL AND SURPLUS, on April 9, 2004. The order was issued pursuant to ORS 734.043 and placed the following requirements upon PHP:

1. PHP must reduce, suspend or limit the volume of business being accepted or renewed by discontinuing policies or revising policy rates in order to create acceptable loss ratios. PHP must take the necessary steps to achieve a combined loss ratio not to exceed 100% by the expiration date of the order.
2. PHP must budget its operations for the next 60 days to eliminate unnecessary or excessive expenses.
3. PHP must obtain an infusion of capital sufficient to increase its aggregate capital and surplus to \$2,500,000 by the expiration date of the order.

The Order prohibits PHP from taking any of the following actions without the approval of the supervisor appointed by the director:

1. Disposing of, conveying or encumbering any of PHP's assets or its business in force.
2. Withdrawing from any of PHP's bank accounts.
3. Lending any of PHP's funds.
4. Investing any of PHP's funds.
5. Transferring any of PHP's property.
6. Incurring any debt, obligation or liability on behalf of PHP.
7. Merging or consolidating PHP with any other insurer or person.
8. Entering into any new reinsurance contract or treaty on behalf of PHP.
9. Approving any new premium or renewing any policies of PHP.
10. Terminating, surrendering, forfeiting, converting or lapsing any insurance policy, certificate or contract, except for nonpayment of premium.
11. Releasing, paying or refunding premium deposits, unearned premiums, or other reserves on any insurance policy, certificate or contract.
12. Making any material change in management.
13. Increasing salaries and benefits of officers or directors.
14. Making or increasing preferential payment of bonuses, dividends or other payments determined by the supervisor to be preferential.
15. Any other action affecting the business or condition of PHP.

Subordinated Surplus Note

PHP was successful in securing additional surplus when it reached an agreement with RRW Investment Group, LLC (RRW), an Oregon Limited Liability Company and the Oregon

Insurance Division for the issuance of a \$2.1 million Subordinated Surplus Note to RRW at 6% interest. The funds were received on May 27, 2004, upon execution of the note.

The note is payable on demand by RRW, but not prior to January 1, 2007. All payments of principal and interest require the prior written approval of the director. The payment of principal and interest due under the note is fully subordinated and subject to the right of prior payment of all other obligations of PHP, irrespective of the time or order that such obligations were incurred.

RRW may convert, with the director's approval, the entire principal and accrued interest of the note into 211,581 shares of PHP common stock. The number of shares received in conversion will be adjusted if certain events occur:

1. If PHP pays its shareholders a dividend in common stock, the shares received in conversion will be proportionately increased.
2. If PHP subdivides or combines the number of its common shares into a larger or smaller number of shares than were outstanding when the note was issued, then the number of shares received in conversion will be proportionately increased or decreased.
3. If PHP recapitalizes, consolidates with or merges or combines with or into any other entity, or sells or conveys to any other entity all or substantially all of its property, the agreement will include a provision that allows RRW to receive the same kind and amount of securities or assets, and at the same conversion ratio with respect to PHP's common stock, as are distributed under the agreement, in lieu of the common shares otherwise issuable to it upon the conversion of the note.

4. If RRW does not exercise its conversion rights within 10 business days after PHP notifies RRW that it has permission from the director, and intends to prepay all or a portion of the note, the number of conversion shares shall be proportionally decreased by the percentage that is equal to the prepayment amount divided by the then current outstanding balance of the note.

5. If PHP converts the subordinated surplus notes issued to MWMC during 2003 into shares of PHP common stock, the number of conversion shares issuable upon the conversion of this note will be increased by the same number of shares issued by PHP to MWMC as a result of the conversion of the MWMC subordinated surplus notes.

Treasury Stock

Concurrent with negotiation of the Subordinated Surplus Note with RRW, PHP acquired the 100,000 shares of its common stock that had been subscribed to and sold in April 2004 to MWMC. The cost of this treasury stock was its original sale price of \$600,000.

Operating Results since March 31, 2004

PHP has increased premiums charged to renewing groups, when possible, based upon consultation with its actuaries and recommendations from the Insurance Division's actuary. This, combined with the discontinuance of several unprofitable insured groups has started to show positive results.

PHP continued to show a net operating loss in the first four months after its first quarter; however, losses declined in each of the four months. Net losses reported by PHP from April through July were \$90,511, \$68,711, \$55,862 and \$32,380, respectively. August through October results reflected a remarkable improvement with a net gain of \$303,814, \$208,446,

and \$220,205, respectively. The \$485,001 net gain from April to October compares very favorably with the \$1,192,452 net loss during the first three months of 2004. The year to date loss through October 31, 2004 is \$707,451.

CONCLUSION

Capital and surplus reported by the Company as of October 31, 2004, was \$3,018,290, above the \$2,500,000 requirement imposed by the Order of Supervision. The major contributor is, of course, the \$2.1 million Subordinated Surplus Note issued to RRW Investment Group, LLC, in May. A favorable trend in operating results since March is demonstrated by the declining net loss described above and the \$732,465 net income reported during the three months ending October 31, 2004.

Based on the Company's financial condition and positive operating results, the Company is no longer in supervision.

ACKNOWLEDGMENT

The cooperation and assistance extended by the officers and employees of PHP Health Plan, Inc., are gratefully acknowledged.

David Ball, FSA, MAAA, Life and Health Actuary for the Oregon Insurance Division, performed the actuarial analysis.

Respectfully submitted,

Thomas F. Farrelly, CFE
Senior Insurance Examiner
Insurance Division
Department of Consumer and Business Services
State of Oregon

AFFIDAVIT

STATE OF OREGON)
)
County of Marion) ss

Thomas F. Farrelly, being duly sworn, deposes and says that the preceding report of financial examination as of March 31, 2004, of PHP Health Plan, Inc., Klamath Falls, Oregon, subscribed by him is true and correct to the best of his knowledge and belief.

Thomas F. Farrelly, CFE
Senior Insurance Examiner
Insurance Division
Department of Consumer and Business Services
State of Oregon

Subscribed and sworn to before me this _____ day of _____, 2004.

Notary Public for the State of Oregon

My Commission Expires:_____