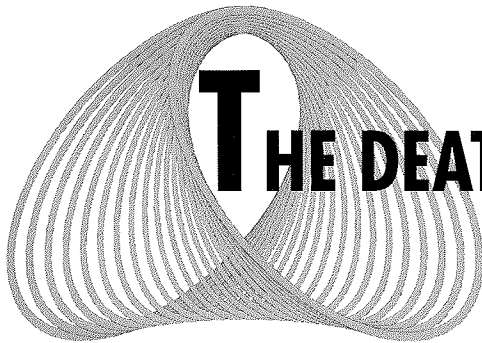


# THE RHA REVIEW

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## THE DEATH SPIRAL: IT'S TIME TO KILL IT

by Tim Ryles, Ph.D.

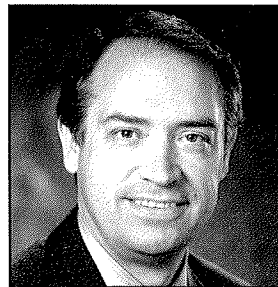
The death spiral is a practice under which health insurers open a book of business (a pool), sell a certain number of policies, then close the book of business. In insurance trade talk, insurers let the book of business "run off."

As insureds age, claims experience and premiums rise accordingly. Eventually, premiums reach a level few consumers can afford; consequently, consumers terminate their policies and seek new coverage elsewhere. If they are among the lucky ones with few claims, new insurance is probably available, perhaps from the same company under another policy number; however, chances are that policyholders who filed significant numbers of claims or who received treatment for certain diseases or disorders are uninsurable.

From an insurance accounting standpoint, when policies are canceled, all premiums paid to the date of cancellation remain with the insurance company and are moved from the liability reserve to the asset side of the ledger. This fact remains an important incentive for insurers to continue the cycle of opening and closing books of business. And, as I have learned, it is also an incentive for some companies to specialize in purchasing books of health insurance business from other companies for the purpose of deliberately letting the

policies "run out" in death-spiral fashion.

Predictably, consumer advocates criticize the death spiral as unfair, but in the absence of regulatory protections, they find that traditional breach-of-contract remedies present the most feasible line of attack. Increasingly, however, changing views about the nature of the



Tim Ryles, Ph.D.

insurance contract may offer a stronger basis for attacking death-spiral practices. One such development is the notion that insurance really is a "good" just like cars, refrigerators, or lawn mowers and should be governed under the Uniform Commercial Code. Viewing insurance as a good or product under the UCC could have two important consequences: (1) it could make it possible to challenge insurance policies under implied warranty doctrine and (2) assuming that we can establish product standards, certain insurance products, such as the death-spiral policies, could be attacked as nonconforming products.

Yet in many respects the death spiral is a perversion of certain legal principles governing insurance; it is a significant departure from commonly accepted insurance industry standards; and, given new concepts of what constitutes "insurance," the practice is highly vulnerable to successful attack by plaintiffs.

### INSURANCE AS A GOOD

Insurers and regulators are already establishing that insurance is a good by characterizing insurance as a "product" and insurance sales personnel as "producers." Likewise, mass merchandising of insurance identifies protection, reliability, solidity and related traits as what insurers really want consumers to believe about their products. Insurance, then, is being packaged in much the same way as other consumer products.

An early judicial expression of insurance as a good occurs in the minority opinion in *C&J Fertilizer Inc. v. Allied*

(Death Spiral, continued inside)

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**(Death Spiral, continued from cover)**

*Mutual Insurance Company* (227 N.W. 2d 169, Supreme Court of Iowa, 1975), wherein Justice Reynoldson wrote:

*Effective imposition of an implied warranty would encourage insurers to*

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***"Insurers and regulators are already establishing that insurance is a good by characterizing insurance as a 'product' and insurance sales personnel as 'producers.'"***

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*make known to insurance buyers those provisions which would limit the implied warranty inherent in the situation, these exclusions would then become part of the initial bargaining. Such provisions, mandated by the Uniform Commercial Code to be "conspicuous" in the sale of goods . . . should be conspicuously presented by the insurer in the sale of protection, this would be no more difficult than the manner in which they advertise their product's desirable features. . . . From a public policy viewpoint, such a requirement (in order to enforce what is essentially an exclusion) might promote meaningful competition among insurers in eliminating technical policy provisions which drain away bargained-for protection.*

More recently, The United States Court of Appeals, 6th Circuit, resurrected the C&J Fertilizer concept in a case brought under the Americans With Disabilities Act. *"Insurance products clearly fall within the common and ordinary meaning of the term 'goods' and the provision of insurance coverage clearly falls within the common and ordinary*

*meaning of the term 'service',"* wrote the court. (See *Parker v. Metropolitan Life Insurance Company, Schering-Plough Corporation and Schering-Plough Health Care Products*, Electronic Citation: 1996 FED App. 0338P, 6th Cir., October 25, 1996.)

Although the court vacated this decision and later ruled *en banc* on the case, nothing in the second opinion suggests that the court changed its mind about whether insurance may be viewed as a good. (See Electronic Citation 1997 FED App. 0230P, 6th Cir., August 1, 1997.)

#### **IMPLIED WARRANTIES AND DOMINANT PURPOSES**

Insurance experts will recognize the dominant purpose test as one standard applied in insurance contract interpretation to determine intent of the parties in a given situation. Indeed, any inquiry into intent of the parties asks what buyer and seller expected the contract to do following consummation. Thus, determining the dominant purpose of any contractual arrangement suggests a need

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***"Over time, death spirals undermine the insurance contract's implied warranty of fitness for the purposes for which it is sold: paying medical bills."***

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to inquire not only into the express language of the document, but also into what is implied.

With respect to death spirals, consumers believe — and insurers probably concur — that the dominant purpose of a health insurance policy is to pay claims for medical expenses. And though consum-

ers reasonably anticipate that health insurance costs will probably never go down, it is a reasonable assumption on their part that a company will not act so as to defeat the dominant purpose of the contract. Yet that is precisely how the death spiral operates: insurers make deliberate choices to defeat the dominant

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***"The question is, can we agree on a standard model, thereby establishing a basis for contending that certain insurance industry practices are nonconforming?"***

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purpose of the original bargain and do so with impunity. Over time, then, death spirals undermine the insurance contract's implied warranty of fitness for the purposes for which it is sold: paying medical bills.

One can readily see a parallel between arguing that a motor vehicle sale should be canceled because the vehicle is not suitable for the purpose for which it was sold (transportation) and insisting that an insurance product should be recalled because it is unfit for the dominant purpose for which it was sold, i.e., to pay expenses or losses in return for a reasonable price. Also, thinking in "goods" terms may encourage policy makers to recognize a "standard product" as defined by laws, industry custom, and regulators. This would enable comparisons of the policy or policies in dispute with the standard model. The question is, can we agree on a standard model, thereby establishing a basis for contending that certain insurance industry practices are nonconforming?

**(Death Spiral, cont'd on opposite page)**

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(Death Spiral, cont'd from previous page)

## STANDARD MODELS AND NON-CONFORMING PRODUCTS

Although there is no universally acceptable definition of insurance, policies

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***"Under this arrangement, arguably, the insurer becomes nothing more than a depository for consumer dollars that will be used for paying future claims, a function which banks and credit unions can perform at a better rate of return."***

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common to the consumer market have certain identifiable qualities. According to both legal and industry standards, insurance involves transfer of risk from the insured to another party (the insurer); individual risks are distributed or pooled among the group; there is indemnification or payment for losses; and the relationship is aleatory, meaning that the insured may get back more in

claims than paid into the pool as premiums or the company may earn more in premiums than it pays out in claims.

Insurance authorities also acknowledge that insurance operates on the law of large numbers. As the number of insureds in a pool increases, the closer the pool approximates the real world and the less likely it is that either a single claim or average claims experience will undermine the financial soundness of the group. As Rejda explains it, pooling is used "to spread the losses of the few over the entire group so that average loss is substituted for actual loss." (George Rejda, *Principles of Risk Management and Insurance*, 5th ed., New York: Harper Collins, 1995, p. 16.) From Rejda's perspective, pooling also enables insurers to realize another essential element of insurance product design: affordability of the policy.

In contrast to those commonly accepted standards for defining insurance, the death spiral turns these factors on their head. The pricing mechanism of ever-increasing premiums gradually transfers risk back to the insured; the law of large numbers becomes the law of decreasing numbers as the quantity of persons in a

given pool shrinks; indemnification becomes a sham because as the premium increases to extraordinary levels, the consumer is basically self-insured and will never have the opportunity of getting back more money through filing claims than is paid to the insurer in premiums. Under this arrangement, arguably, the insurer becomes nothing

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***"What we need, ultimately, is for someone to refuse a settlement offer and secure a sound judicial ruling on the matter."***

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more than a depository for consumer dollars that will be used for paying future claims, a function which banks and credit unions can perform at a better rate of return. In short, the death spiral converts insurance into a "nonconforming" product.

## CONCLUSION

A substantial body of opinion supports the notion that the death spiral subverts commonly accepted principles of insurance that it may undermine the dominant purpose for which the product is sold and that application of UCC principles is an appropriate remedy in today's insurance marketplace. Perhaps this is why insurers are increasingly unwilling to litigate death-spiral lawsuits, choosing instead to settle out of court. What we need, ultimately, is for someone to refuse a settlement offer and secure a sound judicial ruling on the matter. **RHA**

*Tim Ryles, Ph.D., is an associate consultant with Robert Hughes Associates, Inc. He is the former Georgia Commissioner of Insurance, Fire Safety, Industrial Loans and Comptroller General.*

## FROM NEAR & FAR



Dense smoke from a multitude of forest fires has been blamed for the loss of many lives in Southeast Asia. Notably, in Jakarta, Indonesia, the smoke was seen as the major factor behind a plane crash that killed 234 people and was thought also to be the cause of a collision between two cargo ships, which killed 29. Apparently there have been two other plane crashes in Indonesia this year which might also be attributed to the smoke.



A crash between a high-speed passenger train and a freight train just outside of London resulted in the deaths of at least six people and injuries to many more. According to *National Underwriter*, since the privatization of British Rail last year, the liability insurance of train operators is governed by a complex agreement known as the Claims Allocations and Handling Agreement.

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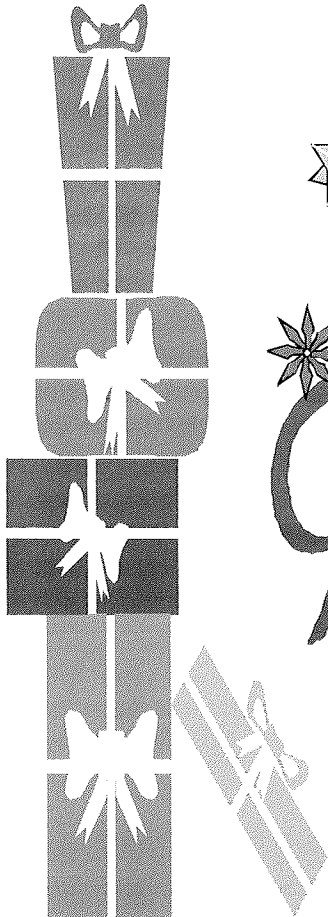
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# Seasons Greetings

*from all of us at*

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