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 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)

IN THIS ISSUE:

- The Death Spiral
- From Near and Far
- Season’s Greetings
meaning of the term 'service,'" wrote
the court. (See Parker v. Metropolitan
Life Insurance Company, Schering-
Plough Corporation and Schering-
Plough Health Care Products, Elec-
tronic 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 interpreta-
tion 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, deter-
mining the dominant purpose of any
contractual arrangement suggests a need

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

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

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

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

(Death Spiral, cont'd on opposite page)
STANDARD MODELS AND NON-CONFORMING PRODUCTS

Although there is no universally acceptable definition of insurance, policies

"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."

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 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. 

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.
Seasons Greetings

from all of us at

Robert Hughes Associates, Inc.