

FORENSIC ANALYSIS
of
THE MERCANTILE SELF INSURANCE TRUST
for
THE NEW YORK STATE WORKERS' COMPENSATION BOARD
by
SaxBST LLP

February 18, 2016

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CONTENTS

	Page
EXECUTIVE SUMMARY	1
I. INTRODUCTION	6
A. Background	6
B. Methodology	8
C. Chronology of Key Events	9
II. OBSERVATIONS	18
A. Trust Formation	18
B. Board of Trustees	21
C. Program Administrator	33
D. Actuary	47
E. Certified Public Accountant	49
F. Marketing	51
G. Underwriting	55
H. Discounts/Dividends	59
I. Payroll Audits	62
J. Safety Programs	63
K. Renewal Process	66
L. Member Deficit	68
M. Claims Handling Procedures/Practices	77

EXHIBITS

EXECUTIVE SUMMARY

The New York State Workers' Compensation Board ("WCB") regulates and monitors programs that offer workers' compensation insurance to employers in New York State, including group self-insurance trusts. WCB regulations require the WCB to ensure that the group self-insured trusts are financially viable and have remediation plans in the event a trust's financial stability needs to be restored. Primarily as a result of financial concerns regarding several group self-insured trusts, the WCB began a process of seeking an independent assessment of the financial and operational aspects of certain group self-insured trusts, and the persons and entities responsible for the administration and management of these trusts.

The WCB retained Bollam, Sheedy, Torani & Co. LLP, CPAs (now "SaxBST LLP") through a competitive procurement process in June 2008 to provide an independent assessment of several group self-insured trusts.¹ SaxBST LLP was engaged on February 28, 2012, to perform a review of the Mercantile Self Insurance Trust ("MERC" or "Trust") and its predecessor entity, The Supermarket & Grocers Insurance Trust ("MERC" or "Trust").

The Trust was created effective October 1, 1994 and served 575 members during its term. It was governed by a Board of Trustees and managed by New York Compensation Managers, Inc. ("NYCM") and a successor firm, USA-TPA, Inc. (collectively, "NYCM") - the Trust's Group and Claims Administrator whose duties were overseen by a Board of Trustees. The Trust's Trustees voted to dissolve the Trust, effective February 29, 2008, and the WCB began working with the Trustees and NYCM to administer the Trust's affairs, and to liquidate the Trust's assets. Effective June 1, 2012, the WCB appointed a new Group Administrator, NCAComp, to manage the Trust's run-off in liquidation. This report addresses the issues and circumstances surrounding the formation and operation of MERC and its \$22,182,504 gross deficit assessment as of December 31, 2014.

Similar to other group self-insured trusts, MERC's participating employers, as a condition of participation, must understand, acknowledge and agree that they are jointly and severally liable for all workers' compensation obligations of all participating employers in the Trust during the period the individual employer is a Trust participant, and may be required to pay additional amounts of contributions or assessments to meet their obligations of joint and several liability.

Our independent assessment of MERC's operation began with a review of documents provided by the WCB, NYCM and NCAComp, including documents relating to the Trust's formation, e.g., Trust Agreement, Administration Agreement, and By-Laws. We subsequently read and analyzed thousands of documents.

We reviewed the 2006 through 2010 audit work papers relating to the audited financial statements provided by MERC's financial statement auditor, Kruth, Stein, Squadrito, &

¹ The services provided by SaxBST LLP were essentially an independent assessment of the duties, responsibilities, and actions of the Trust Administrator, Claims Administrator and the Trustees, and a financial analysis of the Trust's assets and liabilities. We did not provide any attestation services with regard to the Trust and/or the WCB.

Liberman, LLP. We also engaged an actuarial consultant to provide an independent assessment of the Trust's claim liabilities, and a claims consultant to provide an independent evaluation of the NYCM's claims handling practices.

We interviewed, by phone, Lance Vella, one of the Trust's founding Trustees. All other Trustees contacted either did not respond to us, or declined to be interviewed.² This included the longest-tenured, and arguably the most knowledgeable Trustee, John Nelson who served as the sole active, voting Trustee for a period of over two (2) years.

Former and current officials of New York Compensation Managers/USA-TPA responded in writing to questions prepared by SaxBST LLP. NYCM also provided assistance in providing certain missing payroll audit information and other Trust documents.

We also interviewed by phone, or received written responses from, eleven (11) Trust Members, and two (2) insurance brokers.

Additional information may become available and, accordingly, we reserve the right to modify our report.

During the past seven years, SaxBST LLP has conducted a forensic analysis of fourteen group self-insured trusts on behalf of the New York State Workers' Compensation Board. The trusts analyzed by SaxBST LLP were eventually taken over by the WCB because of the trusts' deficit conditions. Over the course of their existence, these trusts sustained significant losses and moved into a deficit position primarily due to six factors:

- The members continued to enjoy the benefits of the coverage without having to pay onerous premiums;
- The brokers did not discourage their clients (the members) from renewing their premium despite the fact that the trust was experiencing losses and had a large member deficit;
- The premiums were general insufficient and/or the discounts provided were inappropriate given the losses sustained;
- Claim reserves were suppressed and/or unrealistic;
- Questionable actuarial estimates (on certain occasions), and
- Conflicts of interests by a trust administrator serving concurrently as claims administrator.

The trusts many times failed due to limited oversight by the Trustees. In most instances, the impetus to form and operate a trust did not come from the members, but came from a trust administrator (some of whom lacked even the basic credentials) - who received a fee for their services, and as such, the best interest of the members was not always foremost. The Trustees often had little, if any, role in preparing the complex legal documents which established and governed the trust. They generally did not have these documents vetted by independent legal

² A number of former Trustees could not be located.

counsel, and on some occasions, Trustees stated that they never even saw or reviewed the documents.

For both members and trust administrators, the underlying theme about whether to get involved in the trust essentially concerned money: how much can I make (trust administrator and marketing agents), and how little can I pay to get workers' compensation insurance coverage (trust members). The monetary factor greatly contributed to the trusts' financial problems as the business objectives of the related parties (administrators v. members) were often diametrically opposed.

Specifically, the trust administrators and marketing agents had a financial incentive to recruit and keep as many members as possible in the trust - regardless of the members' loss history and/or the trust's financial condition; and the members tended to join the trust simply because it was the cheapest workers' compensation insurance they could procure. It does appear that some Members were never advised by their brokers to leave the Trust due to its declining financial condition, ostensibly because the brokers received a commission for every Member that joined the Trust or remained in the Trust. Consequently, the Members' best interest may not have been considered by all the agents who recruited Trust Members.

The evidence examined strongly suggests that Members with good loss histories were generally not aware of the premiums paid by other Members and/or their losses, and therefore were not in a position to question these Members' continued participation in the Trust.³ As such, there was always financial pressure for the trust administrators to at least create the perception that the trust was a financially viable entity (so they would not have to increase premium rates), otherwise new members, who are jointly and severally liable for the trust deficits, would not join the trust, or existing members would leave the trust - thereby reducing the trust administrators' revenues.

In certain respects, and as detailed below, the MERC was not dissimilar to the other trusts analyzed by SaxBST LLP, i.e., many of the factors noted above contributed to the dissolution of this trust.

In summary, our review found that MERC operated for extended periods without benefit of substantive Member or Trustee participation, resulting in inadequate oversight of NYCM's activities as group administrator. Communications from the Trust to the Members was inconsistent, and did not sufficiently convey to the Members the Trust's chronic deficit position. The Trust operated without the required minimum number of Trustees for extended periods, and functioned for over 2 years with only one voting Trustee, this during a time when the Trust was experiencing severe financial difficulties. Trustee meetings were infrequent, and in some instances, meetings were not held for over one year. As a result, the Members' interests were not adequately represented in the Trust's decision-making process. Rates were kept artificially low and discounts were continued to be offered to attract new and retain existing Members, though

³ Sales marketing agents often played a crucial role in the formation of a trust with the trust administrator and oftentimes steered their clients to the trust ostensibly because of the cheaper premiums. The agents did not always have prior experience with self-insurance trusts, which may have explained why they renewed their clients' contracts with the trusts even when the trusts were experiencing multi-million dollar member deficits.

these actions exacerbated the Trust's financial woes. NYCM also engaged in a number of less-than arms' length transactions without disclosure to the Trustees, including the inappropriate charging of \$1.3 million in claims handling fees. Lastly, it appears that some of the Members' brokers may not have discouraged them from joining the Trust or renewing their premium despite the Trusts' declining financial condition.

Major Observations:

1. The Trust operated on a fragile financial footing throughout most of its existence, being deemed "not adequately funded" or "underfunded" by the WCB continuously from 1998 through 2007.
2. Some brokers continued to encourage the members to renew their premiums despite the fact that the trust was either "not adequately funded" or "underfunded".
3. NYCM played a prominent role in the establishment of MERC in 1994, including the preparation of key Trust formation documents, such as the Trust Agreement. The founding Trustees executed these documents without independent legal review to ensure the documents adequately protected the interests of the Trustees and the Members.
4. The Trust operated as a group administrator-controlled, limited-participatory entity with Trustees and Members having minimal involvement in the decision-making process. The Trustees delegated to NYCM the complete range of management, administrative, and claims handling duties that is not atypical for self-insured groups. However, NYCM exercised an unusually high degree of control over the Trust's activities due to the absence of active Trustee participation, or strong Trustee leadership and oversight.
5. The Trustees and NYCM failed to effectively recruit and retain a full complement of Trustees, resulting in the Trust functioning for extended, critical periods without the required minimum of three (3) Trustees. Their collective failure to attract and retain a suitable number of Trustees denied the membership of meaningful representation, and an effective check and balance over NYCM's activities.
6. The Trustees and NYCM did not comply with Article V, Section 5.3 of the Trust's 2001 Bylaws by failing to conduct an annual meeting of the Trustees each and every year. In light of the Trust's ongoing financial difficulties, frequent Trustee meetings would have been prudent.
7. The Trustees and NYCM did not comply with Article IV, Section 4.1 of the 2001 Bylaws by failing to conduct annual Member meetings each and every year "to transact any business that may come before the (Members), and to discuss those issues which are of general concern to the (Members)." Communications from the Trust to the Members was often channeled through the individual Member's insurance broker/agent, some of whom appear to have been less than diligent in this regard.

8. The Trustees failed to meet their fiduciary duties by engaging and continuing the services of NYCM from October 1995 through April 14, 2001 based on an “informal agreement” without a written, specified scope of services or fee structure, thereby restricting their ability to adequately monitor and supervise NYCM’s activities and safeguard the Members’ interest. It also exposed the trust to unnecessary and potential litigation in the event the services or costs were ever questioned.
9. NYCM improperly executed Trust payments between \$1.1 and \$1.3 million to an affiliated entity, Lake Effect Claims Service, for claims administration functions for which NYCM was already being compensated pursuant to its Administration Agreement with the Trust. These duplicate expenses significantly contributed to the Trust’s deficit position. NYCM failed to affirmatively disclose to the Trustees, or the Members in a timely manner its relationship with, or payments to Lake Effect.
10. The claims services ostensibly provided by Lake Effect were of inconsistent and marginal quality including overpayments and under billings to vendors, and the incurring of unnecessary expenses. The Trustees and NYCM failed to implement recommended periodic independent assessments of claims administration that could have mitigated these qualitative shortcomings.
11. NYCM (through Lake Effect) served concurrently as the Trust’s Group Administrator and Claims Administrator creating the potential for a conflict of interest whereby individual claims reserves could be established for the financial benefit of NYCM, and not the Trust.
12. NYCM failed to inform the WCB of changes to excess insurance coverage in violation of Section 317.2(b) NYCRR. While purchase of a corridor plan appears to have been a cost-saving measure, the Trust was exposed to increased retention liability without the knowledge of the WCB, the Trustees or the Members.
13. NYCM entered into a less-than arm’s-length business relationship with an insurance agency that was owned and operated by a senior NYCM official who was a non-voting Trustee. NYCM failed to disclose this relationship to the Trustees.
14. The Trustees did not participate in rate setting or the awarding of premium discounts throughout the life of the Trust, this process being handled exclusively by NYCM. The Trustees and NYCM failed to sufficiently adjust contribution rates and discounts to reflect the Trust’s continuing underfunded status contributing to the Member deficit.
15. Trustee minutes and audited financial statements were not sent to Members as a matter of routine, denying the Members of ongoing communication concerning the Trust’s performance and financial condition necessary for Members to assess their continued participation in the Trust, particularly in light of the Trust’s ongoing deficit position.

16. NYCM used a network of brokers/agents and professional associations to rapidly grow the Trust from 2001-2004. NYCM's promise and offering of low rates and premium discounts to entice membership, however, became unsustainable over time as losses mounted and revenues dropped.
17. The Trust adopted standard underwriting criteria to assess the suitability of applicants to join the Trust; however, NYCM applied these criteria inconsistently. For example, applicants with less than the requisite years of business experience were granted membership; and Members with experience modification rates greater than the underwriting threshold were allowed to remain in the Trust, and receive premium discounts.
18. Approximately one-third of total Trust Members for whom records were available retained the same experience modification rate for at least three (3) consecutive years, raising a serious question as to the efficacy of NYCM's underwriting and renewal processes.
19. Annual Member audits were not conducted for all Members each year denying the Trust of possible additional revenue due, and Members of a premium credit or refund to which they may have been entitled.
20. The Trustees were not sufficiently involved in the development and ongoing oversight of the Trust's safety and loss control program. NYCM's safety and loss control activities appear to be of acceptable quality, but were not applied equally to all Members, resulting in unnecessary risk exposure to certain Members and consequently, the Trust in general.

INTRODUCTION

A. Background

Every employer in New York State is required by the Laws of the State of New York to secure workers' compensation coverage for its employees. Employers essentially have four options - joining a group self-insured trust, obtaining insurance from the New York State Insurance Fund, individually self-insuring, or obtaining insurance from a private insurance carrier.

With regard to the formation of group self-insured trusts, each group of employers must establish a trust fund that is financed by contributions from and assessments of its members. Title 12, Chapter 5, Subchapter B of the New York Codes, Rules and Regulations ("NYCRR") establishes the procedures, qualifications, and responsibilities for any group of employers that wishes to become, or which has been approved by the WCB to operate as a group self-insurer.⁴ Every

⁴ The rules applying to the group self-insured trusts were originally covered under NYCRR Title 12, Chapter 5, Subchapter B, Section 316. Beginning January 31, 2001, the rules were modified and expanded.

group self-insurer must also have a set of documents that govern all aspects of the group's existence, which may include a trust agreement and by-laws.

Interviews and documents indicate that MERC was formed through the joint efforts of a group of upstate New York retail food grocers and NYCM. On June 6, 1994, grocer representatives George Gelsomin (Sweetheart Corner, Inc.) and Lance Vella (Vella's Enterprises), acting in the capacity as Trustees signed an Agreement and Declaration of the Trust Establishing the Supermarket & Grocers Insurance Trust Fund ("Trust Agreement"). In a letter to the WCB also dated June 6, 1994, Trustees Gelsomin and Vella appointed NYCM "to represent our interest in filing for group self insurance privileges and to further represent us as administrators if our application to operate as a group self insurer is approved." NYCM submitted to the WCB an application package to establish the Supermarket & Grocers Insurance Trust,⁵ with a proposed effective date of October 1, 1994. On October 7, 1994, the WCB Chair approved the Supermarket & Grocers Insurance Trust Fund as a group self-insurer, effective October 1, 1994.

The Trust was established to provide workers' compensation coverage through a self-insurance program to employers engaged in the "sale of groceries to the public on a retail basis." Membership criteria was later expanded to include retail and wholesale services in such business areas as building material and hardware, apparel and accessory stores, home furniture, automotive dealers, and gasoline service stations. From October 1, 1994 through February 29, 2008, 575 employers joined MERC. Membership rose to 430 (336 active and 94 inactive) by February 2004.⁶

MERC's financial statements reported net losses in eight of the thirteen years before it was in liquidation. The Trust has a \$22,182,504 gross deficit assessment as of December 31, 2014. Despite various remediation plans and actions by the WCB and efforts by the Trustees and NYCM, the Trustees' voted to dissolve the Trust, effective February 29, 2008. The WCB then began working with the Trustees and NYCM to administer the affairs of the Trust and to liquidate the Trust's assets. On February 17, 2012, the WCB notified the Trustees that the Trust demonstrated an inability to properly administer its liabilities and that WCB would transfer the Trust to a new WCB-contracted third-party administrator. This transfer occurred effective June 1, 2012.⁷

NYCM received from MERC approximately \$10.5 million in management fees during the period October 1, 1994 through February 29, 2008.⁸ This amounted to approximately 19% of MERC's Members' gross earned contributions of \$56.1 million during the same period. In addition, the Trust's financial statements note the Trust paid in excess of \$1 million in broker commissions

⁵ The Trust's name was changed to the Mercantile Self-Insurances Trust in February 2001.

⁶ During 2004, a number of Members left the Trust, many moving their workers' compensation insurance to NYCM's Automotive Service and Repair Self-Insurance Trust ("AUTO") that began operations, effective January 1, 2005.

⁷ The WCB's new administrator, NCAComp, Inc. assumed responsibility for the Trust's runoff effective June 1, 2012.

⁸ The Trust's audited financial statements for the years 1996-1999 noted that the fees paid to NYCM "are based on terms of an informal agreement."

during this period. NYCM earned an additional \$1.47 million in fees during the Trust's run-off, through December 31, 2010.

In addition, Lake Effect Claims Services, Inc., a firm having common ownership with NYCM, was paid by the Trust approximately \$1.3 million for "claims handling time and expenses" for the period July 18, 2002 to February 5, 2007.⁹ However, the 2001 Administrative Service Agreement specifies that NYCM itself was responsible for claims supervision and adjudication as part of its fee. Therefore, MERC may have made substantial duplicate payments for claims handling services for this period.

The WCB engaged Bollam, Sheedy, Torani & Co. LLP, CPAs (now "SaxBST LLP") on February 28, 2012 to perform an operational assessment of MERC, and to assist the WCB in the financial reconstruction of MERC's financial position as of December 31, 2014. Since then, SaxBST LLP and other parties have assisted the WCB in its efforts to identify the reason(s) for MERC's deficit financial condition, and to determine whether NYCM and MERC's Trustees prudently exercised their fiduciary and legal responsibilities, including actions to preserve the integrity of MERC's funds. Our methodology and observations are detailed on the following pages.

B. Methodology

SaxBST LLP staff began their in-depth analysis by speaking with WCB officials to gain an overview of MERC's financial condition and organizational history. We also spoke with representatives of NCAComp, the third-party administrator retained by the WCB when it assumed control of the Trust's assets and management of the Trust's liabilities in June 2012.

SaxBST LLP engaged an independent actuary, a legal consultant, and a claims auditor to assist in our analysis of the loss reserves, legal responsibilities, and claims handling processes, respectively. SaxBST LLP also reviewed the 2006-2010 audit work papers prepared by the Trust's financial statement audit firm.

SaxBST LLP subsequently reviewed thousands of hardcopy and electronic Trust documents, including but not limited to, individual Member files, Trust formation documents, financial statements, actuarial reports, WCB Level I and II Review reports, Trustee meeting minutes, and general correspondence. In addition, we have interviewed 19 individuals to date. It is noteworthy that a number of Trustees declined SaxBST LLP's request to be interviewed for the purposes of this report. Former NYCM President Lew E. Rumsmoke provided a written response to questions provided by SaxBST LLP. Other NYCM/USA-TPA officers provided a joint written response to the same questions.¹⁰

⁹ SaxBST LLP's claims consultant, KBM, found possible payments to Lake Effect of approximately \$1.14 million.

¹⁰ In NYCM's response transmittal, CFO Edward Coombs provided the following qualifier: "Attached is the response from the management of USA-TPA and NYCM. Many of the questions, especially surrounding formation, documentation and initial agreements were answered by David Francey, a principle of NYCM, the management of USA-TPA were not aware of the answers to those questions. Items left blank could not be answered by USA-TPA management team and were left unanswered by Mr. Francey. If you have questions or require further clarification please send those to my attention and we will do our best to address." Former NYCM Vice President Edwin L.

C. Chronology of Key Events

September 2, 1993 - New York Compensation Managers, Inc. (“NYCM”) formed as a New York Domestic Business Corporation.

June 6, 1994 - George Gelsomin (Sweetheart Corners, Inc.) and Lance Vella (Vella’s Enterprises) sign Trust Agreement as Trustees establishing the Supermarket & Grocers Insurance Trust to provide workers’ compensation insurance for employers engaged in the retail distribution and sale of food products. Trustees Gelsomin and Vella send letter to the WCB appointing NYCM to represent them in the formation of the Supermarket & Grocers Insurance Trust.

June 29, 1994 - NYCM sends application package to the WCB to form the Supermarket & Grocers Insurance Trust with proposed effective date of October 1, 1994.

October 1, 1994 - Trust begins operation.

October 7, 1994 - The WCB Chair approves formation of Trust, effective October 1, 1994.

October 25, 1994 - The WCB sends to NYCM *Notice of Qualification as a Group Self-Insurer* approving the Supermarket & Grocers Insurance Trust as a group self-surer.

August 15, 1995 - First documented Trustee meeting held.

March 12, 1996 - MERC’s independent auditors conclude that MERC’s financial statements for the period ending December 31, 1995 were presented fairly, in all material respects. Auditor reports a Members’ deficit of (\$21,674). Note F states: “The Trust utilizes New York Compensation Managers, Inc. for administrative and management purposes. Fees paid are based on terms of an informal agreement. Administration fees for 1995 fees aggregated \$84,727.”

October 23, 1997 - MERC’s independent auditor concludes that MERC’s financial statements for the period ending December 31, 1996 were presented fairly, in all material respects. Auditor reports a Members’ equity of \$23,590. Note F states: “The Trust utilizes New York Compensation Managers, Inc. for administrative and management purposes. Fees paid are based on terms of an informal agreement.”

February 20, 1998 - MERC’s independent auditor concludes that MERC’s financial statements for the period ending December 31, 1997 were presented fairly, in all material respects. Auditor reports a Members’ deficit of (\$5,406.) Note F states: “The Trust utilizes New York Compensation Managers, Inc. for administrative and management purposes. Fees paid are based on terms of an informal agreement.” Management letter to Trust notes lack of Trustee bonding as per Trust Agreement, bank cash balances in excess of FDIC insurance limit, and lack of segregation of duties.

Olmstead, and a non-voting Trustee was contacted by SaxBST LLP and sent a questionnaire at his request. He has yet to furnish a written response.

April 22, 1999 - MERC's independent auditor concludes that MERC's financial statements for the period ending December 31, 1998 were presented fairly, in all material respects. Auditor reports a Members' deficit of (\$46,962). Note F states: "The Trust utilizes New York Compensation Managers, Inc. for administrative and management purposes. Fees paid are based on terms of an informal agreement." Management letter to Trust notes lack of Trustee bonding as per Trust agreement, bank cash balances in excess of FDIC insurance limit, and lack of segregation of duties.

March 6, 2000 - MERC's independent auditor concludes that MERC's financial statements for the period ending December 31, 1999 were presented fairly, in all material respects. Auditor reports a Members' deficit of (\$57,782). Note F states: "The Trust utilizes New York Compensation Managers, Inc. for administrative and management purposes. Fees paid are based on terms of an informal agreement."

June 16, 2000 - The WCB advises Trust it is not adequately funded for fiscal year ending December 31, 1998.

October-December 2000 - Various correspondences exchanged between NYCM and the WCB regarding proposed document changes. These changes include: approval of new trust name - Mercantile Self-Insurance Trust, addition of SIC Division F (Wholesale Trade) instead of just food products, and addition of SIC Code 2052 (Manufacturers of Cookies and Crackers).

January 30, 2001 - Trust submits revised Trust Agreement, Participation Agreement, and Bylaws.

February 16, 2001 - The WCB approves change of Trust name to Mercantile Self-Insurance Trust.

March 1, 2001 - Trust By-laws and revised Trust Agreement is executed by Trustees reflecting name change and other modifications.

March 5, 2001 - MERC's independent auditor concludes that MERC's financial statements for the period ending December 31, 2000 were presented fairly, in all material respects. Auditor reports a Members' deficit of (\$155,406).

April 15, 2001 - Trustees and NYCM execute first written Administration Agreement for a minimum period of ten years.

April 18, 2001 - The WCB conducts WCL Section 111 hearing with NYCM regarding marketing material.

May 10, 2001 - The WCB deems Trust underfunded and requires remediation plan, and report on member contributions. Group is frozen to new members, and additional security of \$600,000 required.

August 16, 2001 - The WCB sends letter to Trust indicating serious issues and concerns regarding the financial viability of the Trust.

March 11, 2002 - MERC's independent auditor concludes that MERC's financial statements for the period ending December 31, 2001 were presented fairly, in all material respects. Auditor reports a Members' equity of \$19,534.

March 31, 2002 - Founding Trustee Wiedenbeck's term ends.

June 5, 2002 - The WCB deems Trust underfunded and Trust frozen to new Members.

June 26, 2002 - The WCB assesses Trust penalty of \$4,500 due to late report filing. Trust's appeal of penalty is denied by WCB. Penalty amount applied toward the cost of independent actuarial audit and rate analysis.

July 2, 2002 - Founding Trustees Vella's and Gelsomin's terms end. Trust remains without a voting Trustee until October 8, 2002.

September 3, 2002 - Bylaws amended to include additional SIC Codes.

September 6, 2002 - Trustee meeting held to amend bylaws to include additional SIC Codes.

September 10, 2002 - Trustee meeting held to amend bylaws to include additional SIC Codes.

September 12, 2002 - NYCM submits amended bylaws to the WCB for additional SIC Codes.

September 18, 2002 - The WCB sends letter to Trust approving amendments and requests that an announcement be sent to all Members informing them of these changes.

September 25, 2002 - Trust sends letter to Members announcing the addition of the new SIC Codes and provides copy of revised bylaws.

October 8, 2002 - Trustee Thaler's term begins and is the only active voting Trustee.

February 5, 2003 - Trustee Nelson's term begins as second voting Trustee.

February 26, 2003 - MERC's independent auditor concludes that MERC's financial statements for the period ending December 31, 2002 were presented fairly, in all material respects. Auditors report a Members' equity of \$174,285.

June 12, 2003 - Trust seeks approval to amend bylaws for additional SIC Codes to include Automotive Rental and Leasing, Without Drivers; Automobile Parking; Automotive Repair Shops; and Automotive Services, Except Repair.

August 4, 2003 - The WCB rejects new proposed SIC Codes.

August 8, 2003 - Trust asks the WCB to reconsider approving additional SIC Codes.

September 4, 2003 - The WCB disapproves Trust request to expand Trust's homogeneity standard automobile related employers.

September 16, 2003 - Trustee meeting held. NYCM introduces Christopher Mason, Esq. as Trust Counsel and Anthony D'Amato as Director of Trust Services. Last meeting attended by NYCM Vice-President and non-voting Trustee Edwin Olmstead.

September 18, 2003 – USA-TPA, Inc. formed as a New York State Domestic Business Corporation.

December 2, 2003 - NYCM executes Investment Management Agreement with City Capital Inc. to manage Trust's investments.

March 29, 2004 - WCB issues draft Level II Review conducted by PricewaterhouseCoopers ("PwC") for the period ended December 31, 2002 to NYCM for review and comment. Trust is deemed underfunded with a regulatory deficit of (\$484,000) and a trust equity ratio of 84.5%. Upward reserve adjustment of \$617,053 is considered necessary. Report also identifies governance, administrative, operational, and internal control deficiencies.

April 19, 2004 - MERC's independent auditor concludes that MERC's financial statements for the period ending December 31, 2003 were presented fairly, in all material respects. Auditor reports a Members' deficit of (\$1,434,398).

April 30, 2004 - NYCM submits to the WCB written comments regarding Level II Report. NYCM expresses concern about the consultant performing the analysis, particularly related to the NYCM's reserving practices. NYCM further expresses concern over the use of and comparison with NCCI reserving standards.

May 17, 2004 - The WCB sends letter to NYCM summarizing prior discussions regarding the Homogeneity Standards of the Trust. The WCB agrees to allow new Members, on a temporary basis, involved in the auto service and/or repair industry, with a termination date of December 31, 2004. NYCM must notify the WCB by September 1, 2004 of their intent to create a new group for Members involved in the auto service and/or repair industry no later than January 1, 2005.

July 22, 2004 - The WCB issues Level I report for the fiscal year ending December 31, 2003. The WCB deems Trust underfunded with a regulatory deficit of (\$1,569,358) and a regulatory trust equity ratio of 72.44%, and notes that the low and high estimates presented by the Trust's actuary appear to be broader than the more typical range. The WCB indicates that based on PwC's Level II report as of 12/31/02, it has adjusted the reserves presented by the Trust as of 12/31/02 by \$617,000 from \$2.3 million up to \$2.9 million.

August 13, 2004 - The WCB issues final Level II Review Report to Trustees and NYCM. Trust is frozen to new members.

August 19, 2004 - The WCB denies Trust's request to add new members given Trust's current underfunded status. Membership freeze also includes potential Members for NYCM's Automotive Trust.

September 30, 2004 - Trust submits action plan to address underfunded position.

December 31, 2004 - Trustee Thaler's term ends. Trustee Nelson remains as only voting Trustee until May 10, 2007.

January 1, 2005 - Automotive Service and Repair Self-Insurance Trust formed by NYCM begins operation. Approximately 100 MERC Members immediately join the new trust.

May 5, 2005 - The WCB receives check from Trust in the amount of \$1,500 as penalty payment for overdue annual financial and actuarial reports. Balance of \$500 remains due and was received by WCB on May 19, 2005.

May 11, 2005 - The WCB advises Trust that excess coverage's Self-Insurer Retention Level (SIR) requirement of \$500,000 will be reduced to \$400,000 effective May 1, 2005. The WCB recommends layered coverage to meet WCB requirements in the future and further requests clarification regarding the corridor deductible of \$1.2M for the 2004 policy identified in the Actuarial Report.

May 16, 2005 - The WCB holds conference call held with NYCM and Trust's investment advisors to discuss investments that are over 25% allowable limit. The WCB will not allow retroactive adjustment, but will take this into consideration in terms of a remediation plan if Trust chooses to divest.

June 9, 2005 - Trust has 572 total members, 322 active and 250 inactive.

July 22, 2005 - The WCB issues Level I report for the fiscal year ending December 31, 2004 and deems Trust underfunded with a regulatory deficit of (\$3,099,319) and a regulatory trust equity ratio of 64.92%. The WCB excludes three foreign investments totaling \$104,436 from acceptable assets and increases the Trust's claim reserve liability by \$2,193,000. The WCB notes that the low and high estimates presented by the Trust's actuary appear to be broader than the more typical range. The WCB continues freeze on new members and requests an updated remediation plan that addresses the deficit.

August 22, 2005 - Trust submits to WCB Remediation Plan to address deficit.

September 9, 2005 (restated) - MERC's independent auditor concludes that MERC's financial statements for the period ending December 31, 2004 were presented fairly, in all material respects. Auditors report a members' deficit of (\$2,295,229). Note H notes that an increase in the claims reserve by \$2,193,000 as of December 31, 2004 was necessary based upon WCB's annual review and the resulting release of the personal guarantees issued by the stockholders of NYCM.

October 24, 2005 - Trust assigns investments from City Capital to Mellon Private Trust Company.

January 30, 2006 - The WCB meets with Trustee via conference call. Trust to remain frozen until December 31, 2005 reports are received by the WCB.

May 3, 2006 - The WCB sends letter to Trustees requesting breakeven rate analysis for the 2006 contribution year performed by the Trust's Actuary.

May 18, 2006 - NYCM transmits breakeven analysis to the WCB.

June 12, 2006 (restated) - MERC's independent auditor concludes that MERC's financial statements for the period ending December 31, 2005 were presented fairly, in all material respects. Auditors report a Members' deficit of (\$5,779,565). The auditors note that as the Trust may face the revocation of its self-insurance due to its deficit position, a substantial doubt is raised "about the ability of the Trust to continue as a going concern." Note H indicates Trust pays monthly fee to an affiliated entity to provide management and administrative services and the entities are considered related "based on the fact that the management company has significant control over the management and operating policies of the Trust."

July 13, 2006 - The WCB issues Level I report for the fiscal year ending December 31, 2005 and deems Trust underfunded with a regulatory deficit of (\$6,899,360) and a regulatory trust equity ratio of 51.15%. The WCB notes range of reserves presented by the Trust's actuary appears to be too broad for regulatory purposes and WCB expresses concern that "the estimates presented by the actuary, and used for financial statement purposes, are based on aggressive assumptions." The WCB also reports that NYCM had obtained a corridor deductible excess insurance policy for the Trust in 2004 without the WCB's required prior approval

August 1, 2006 - The WCB conducts conference call meeting with Trustees and NYCM where it is determined Trustee will develop plan to address the projected deficit for 2007 and the deficit assessment for prior years.

August 7, 2006 - The WCB conducts conference call meeting with Trust and NYCM. NYCM presents a plan to bring trust to a breakeven level for 2007 and to bill deficit over a five year period. NYCM is to contact Members to discuss plan and to obtain commitment to remain in Trust despite rate increases. Trust is to submit a report to the WCB detailing member renewal dates and a detailed projection of contributions.

September 7, 2006 - The WCB conducts conference call with Trustee representatives. Agreed by parties that effective January 1 2007, each Member would begin to be billed an increased rate (2005 CIRB manual rates +13%), and that the equivalent of CIRB manual rates plus 13 % would be collected by December 31, 2007. In addition, the WCB directs Trustees to develop and submit a plan to WCB by October 2, 2006 to address the accumulated deficit. The approved plan is to be memorialized in a Consent Agreement.

October 6, 2006 - NYCM submits 2007 breakeven plan of action to the WCB.

November 1, 2006 - NYCM sends letter updating the Members on the shortfall and remediation plan.

January 12, 2007 - Effective date of Consent Agreement and Order. Trust continues to remain closed to new members, and will bill a special assessment to Members, active and inactive, for

the program years 1996 - 2002, with the exception of 1998. Assessment to be apportioned among active and inactive members based upon a percentage of contribution.

April 25, 2007 - Trust executes Network Agreement with MedFocus of NY to provide radiology and other diagnostic services to Trust claimants.

April 27, 2007 - MERC's independent auditor concludes that MERC's financial statements for the period ending December 31, 2006 were presented fairly, in all material respects. Auditor reports a Members' deficit of (\$6,135,463). The auditor notes that as the Trust may face the revocation of its self-insurance due to its deficit position in light of Trust's deficit position, a substantial doubt is raised "about the ability of the Trust to continue as a going concern." Note H indicates that the Trust pays a monthly fee to an affiliated entity to provide management and administrative services and the entities are considered related "based on the fact that the management company has significant control over the management and operating policies of the Trust." Also reported is that claims are administrated by an entity that is 100% owned by the management company noted above.

May 4, 2007 - Trust has 572 total members, 121 active and 451 inactive.

May 9, 2007 - Trustee meeting held. NYCM updates Trustees on assessment and Consent Agreement.

May 10, 2007 - Trustee Vercesi's term begins.

May 23, 2007 - The WCB issues Level I report for the fiscal year ending December 31, 2006 and deems Trust underfunded with a regulatory deficit of (\$7,044,223) and a regulatory trust equity ratio of 49.74%. The WCB notes range of reserves presented by the Trust's actuary appears to be too broad for regulatory purposes and WCB expresses concern about the 5% discount rate factor used by the actuary.

June 15, 2007 -The WCB conducts conference call meeting with Trust.

June 22, 2007 - The WCB conducts conference call meeting with Trust representatives. The WCB discusses 2006 Level I Review report and accrued assessment adjustment, factors Trustees should consider when making decisions on behalf of the Trust, the Trust's steadily declining trust equity ratio, reinsurance expense increase, 2006/07 financial results, 2007 breakeven analysis, consent agreement terms, assessment collections to date (\$650,000 of \$3.6 million billed) and 2007 rates.

November 26, 2007 - The WCB conducts teleconference with Trustees and NYCM. The WCB is advised that Trustees have voted to voluntarily terminate the Trust, effective March 1, 2008. Members are to be notified and NYCM to continue as administrator.

December 19, 2007 - Trustees Nelson and Vercesi sign a formal resolution terminating the Trust in accordance with their unanimous vote on November 26.

December 26, 2007 - Trustees Nelson and Vercesi send letter to Members explaining the Trust's "insurmountable deficit" and closure as of February 28, 2008. NYCM sends letter to insurance agent network announcing Trust's closure.

January 14, 2008 - The WCB sends letter to the NYCM and Members regarding Termination of Coverage, effective as of February 29, 2008.

February 28, 2008 - Effective date of Administration Agreement to continue NYCM as administrator after Trust's closure.

February 29, 2008 - Effective date of Trust closure.

April 16, 2008 - NYCM sends update to Members on Trust's financial status.

April 17, 2008 - WCB meets with Trustees and NYCM via conference call. Trust to continue pursuit of 2007 assessment collections.

April 29, 2008 - MERC's independent auditor concludes that MERC's financial statements for the period ending December 31, 2007 were presented fairly, in all material respects. Auditor reports a Members' deficit of (\$5,034,440). The auditor notes that as the Trust was terminated effective February 29, 2008 and will be liquidated. Note H indicates that the Trust pays a monthly fee to an affiliated entity to provide management and administrative services and the entities are considered related "based on the fact that the management company has significant control over the management and operating policies of the Trust." Also reported is that claims are administered by an entity that is 100% owned by the management company noted above.

November 17, 2008 - Trust retains law firm to assist with assessment collection effort.

August 26, 2008 - The WCB deems the Trust underfunded for the year ended December 31, 2007 with a regulatory deficit of \$6,363,008 and trust equity ratio of 47.06%.

April 30, 2009 - Trustee meeting held. Trustees Coakley, Rhoads, and Green begin Trustee terms.

May 5, 2009 - Trustee Vercesi's term ends, leaving Trustees Nelson, Coakley, Rhoads, and Green as the active voting Trustees.

May 7, 2009 - MERC's independent auditor concludes that MERC's financial statements for the period ending December 31, 2008 were presented fairly, in all material respects. Auditor reports net liabilities in liquidation of (\$4,342,137). The auditors note that as the Trust was terminated effective February 29, 2008 and will be liquidated. Note H indicates that the Trust has entered into an agreement with an affiliated management company for management of the Trust during its liquidation for a monthly fee of \$55,000 and that claims are administered by the same management company.

July 1, 2009 - The WCB meets with NYCM and Trustees. The WCB acknowledges improvement in Trust's cash position, but requests that collection efforts continue as deficit position continues.

April 26, 2010 - MERC's independent auditor concludes that MERC's financial statements for the period ending December 31, 2009 were presented fairly, in all material respects. Auditor reports net liabilities in liquidation of (\$3,426,766). Note H indicates that the Trust has entered into an agreement with an affiliated management company for management of the Trust during its liquidation and that claims are administered by the same management company.

October 1, 2010 - Trust executes Administration Agreement with USA-TPA, Inc. to provide administrative and claims services during run-off, retroactive to February 28, 2009 through February 28, 2011.

February 21, 2011 - Trust meeting held via teleconference.

April 21, 2011 - MERC's independent auditor concludes that MERC's financial statements for the period ending December 31, 2010 were presented fairly, in all material respects. Auditor reports net liabilities in liquidation of (\$3,195,673). Note H indicates that the "Trust has entered into an agreement with an affiliated management Trust for management of the Trust and administration of claims during its liquidation.

June 1, 2011 - Trust executes Administration Agreement with USA-TPA, Inc. to provide continuing administrative and claims services during run-off, retroactive to February 28, 2010 through February 28, 2013.

January 4, 2011- NYCM COO Chris Mason advises the WCB that Lake Effect Claims Service no longer represents self-insured groups and will not be seeking renewal of its third-party administration license.

June 6, 2011 - USA-TPA files a third-party administration license renewal application to the WCB.

October 12, 2011 - Trustee meeting held.

October 19, 2011 - USA-TPA COO and Qualifying Officer Chris Mason appears before the WCB for an oral interview relating to USA-TPA's license renewal application.

January 7, 2012 - The WCB meets with Trust.

January 23, 2012 - Trustee meeting held. Trustees approve Investment Management Agreement with Howe & Rusling.

February 7, 2012 - WCB meets with Trustees and NYCM.

February 17, 2012 - The WCB advises Trustees that the Trust “has demonstrated an inability to properly administer its liabilities”, and that effective April 1, 2012, the WCB would be assuming “the administration and final distribution of the group’s assets and liabilities.

May 15, 2012 - The WCB notifies Chris Mason that based on its review of the documents and transcripts of the October 19 interview, the WCB’s full Board of Commissioners approved a WCB review panel’s recommendation not to renew the license for USA-TPA and Mason, as proposed Qualifying Officer, for failing to meet the standards and requirements of WCL 50 (3-b) and 12 NYCRR 302 *et al.*

May 23, 2012 - The WCB meets with Trust Members and provides an overview of the Trust’s historical funding issues and remediation efforts.

June 1, 2012 - Trust’s run-off transferred to State-appointed third party administrator.

July 1, 2012 - NYCM’s TPA license expires and is not renewed.

II. OBSERVATIONS

A. Trust Formation

New York State Laws governing the formation of group self-insured trusts require that the group self-insured trust be formed by a group of employers in a similar industry. Interviews and documents indicate that the Trust was formed in or about June 1994 by a group of Upstate New York retail food distribution and sales operators and New York Compensation Managers, Inc. (“NYCM”), a Syracuse-based licensed workers’ compensation insurance administrator formed as a New York State Domestic Business Corporation on September 2, 1993.

On June 6, 1994, George Gelsomin¹¹ (Sweetheart Corner, Inc.) and Lance Vella (Vella Enterprises), acting in the capacity of Trustees, executed a Trust Agreement establishing the Supermarket & Grocers Insurance Trust to provide workers’ compensation insurance for employers engaged in the retail distribution and sale of food products (Exhibit 1). In a letter to the WCB also dated June 6, 1994, Trustees Gelsomin and Vella appointed NYCM “to represent our interest in filing for group self insurance privileges and to further represent us as administrators if our application to operate as a group self insurer is approved.”

NYCM Secretary/Treasurer David E. Francey, in a transmittal to the WCB dated June 29, 1994, submitted an application package to establish the Supermarket & Grocers Insurance Trust, with a proposed effective date of October 1, 1994. Included was the Application for Group Self-Insurance (GSI-1), an *Application for Group Self-Insurance* (GSI-1.1) for each of the initial charter members, Trust Agreement, and a Trustee certification. Fleet Bank was identified as the group’s banking institution and NYCM was identified as the group’s licensed self-insurance representative.

¹¹ Gelsomin was identified on various documents as Secretary.

The WCB Chair approved the Application on October 7, 1994, and in a letter to NYCM dated October 25, 1994, the WCB transmitted a Notice of Qualification as a Group Self-Insurer approving the Supermarket & Grocers Insurance Trust as a group self-surer, effective October 1, 1994. By the end of 1994, the Trust had attracted 20 members.¹²

Trustee Vella, who served as a Trustee from October 1994 to July 2, 2002, graciously agreed to a telephone interview with SaxBST LLP.¹³ He told SaxBST LLP that the Trust was initiated by NYCM and a group of grocers who were not satisfied with the State Insurance Fund. He said it made good business sense for his company to join. Vella added that NYCM put the Trust together, and it was “theirs.”

Vella noted that he and his other family members provided start-up loans to get the Trust operating and were repaid in full. He believed they were paid interest, but could not recall the exact interest rate.¹⁴ Trust records reflect at least 12 investors provided start-up funds to the Trust. These included, but were not limited to, Trustee Vella and a number of his relatives, Trustee Gelsomin, David Francey, and “Pro Associates Pension Fund.”¹⁵

Former NYCM President Lew Rumsmoke,¹⁶ in a written response to SaxBST LLP through his legal counsel, stated: “MERC started as a group of grocers that came to NYCM from a State Fund safety group. They wanted out and wanted to know if they could do something different... We had an initial meeting, got the information necessary to file for a group self administrator, and assisted them with filing the forms.” He did not believe the grocers solicited assistance from any other group administrator.

The 1994 Trust Agreement delineated the purpose of the Trust, Trustee selection; Trustee powers, duties and obligations; employer participation requirements; and various administrative and financial guidelines. As noted previously, Trust records contain another similarly-worded version of the June 6, 1994 document, circa July 28, 2000 containing the signatures of Vella and Gelsomin, in addition to Joseph Wiedenbeck (Convenience Express) and Edwin L. Olmstead (NYCM). Specific provisions of the Trust Agreements will be discussed in the applicable sections of this report.

Trustee Vella advised SaxBST LLP that he could not recall the specifics of the Trust Agreement, but did acknowledge signing it, adding that NYCM presented the document to him for signature.

¹² Marketing of the Trust was achieved primarily through NYCM and a state-wide network of insurance brokers/agents.

¹³ SaxBST LLP sent Trustee Vella a copy of SaxBST LLP’s interview summary for his review. SaxBST LLP incorporated all edits made by Trustee Vella into the final interview summary.

¹⁴ The Trust’s 1995 and 1996 Audited Financial Statements reflect Notes Payable of \$435,000 to investors with a 12% per annum interest rate. Notes were due on October 1, 1996. Interest paid on these Notes in 1995 and 1996 totaled \$90,000.

¹⁵ NYCM’s written response identified the initial investors as “the founding grocery stores.”

¹⁶ Rumsmoke indicated that he has not been involved in NYCM’s day-to-day operations since he retired in 2002, and was never involved in USA-TPA’s day-to-to operations.

Rumsmoke recounted to SaxBST LLP that the Trust formation documents were derived from those prepared for another self-insured group, New York Lumberman's Insurance Trust Fund,¹⁷ and were approved by MERC.¹⁸ He did not recall if MERC had its own independent counsel, but believed individual Members did.¹⁹ He believed the Trust documents were provided to, and approved by the WCB.

In January/February 2001, the WCB approved a request from the Trust to modify the Trust's membership criteria by adding and eliminating certain eligible SIC Codes²⁰ and to rename the Trust the Mercantile Self-Insurance Trust ("MERC"). On March 1, 2001, the Trustees²¹ executed a new Trust Agreement to reflect, inter alia, the name change, and eligibility criteria (Exhibit 2).²²

The 1994 Trust Agreement makes no reference to the adoption of By-laws, and SaxBST LLP found no evidence that the Trustees adopted By-laws at the Trust's formation. Records do indicate that By-laws were adopted effective March 1, 2001 reflecting, inter alia, the Trust's name change (Exhibit 3).²³ The By-laws provided a somewhat detailed framework relating to the Trust's governance, administration and operation, addressing topics such as participant eligibility, application and termination; Trustee officers, powers, duties, selection, and meetings; duties of the Group Administrator and Claims Administrator; and handling of Trust assets, investments and excess funds. Specific provisions of the By-laws will be discussed in the applicable sections of this report.

As noted above, the Trustees appointed NYCM as Trust Administrator in a June 6, 1994 letter to the WCB. Article IV, Section 2 (g) of the 1994 Trust Agreement granted the Trustees the authority to "enter into any and all contracts and agreements for carrying out the terms of this Agreement and Declaration of Trust and for the Administration of the Trust Fund..." and would

¹⁷ This trust, formed in April 1981, was and remains administered by W. J. Cox Associates, Inc., and has been authorized by the WCB to continue coverage through 2013.

¹⁸ This is corroborated by NYCM's joint response.

¹⁹ NYCM's joint response identified the Trustees' counsel as the "Mackenzie Law firm." Trust records show Mackenzie Law Firm, LLP as providing professional legal services to the Trust from 1995 to 2007.

²⁰ WCB records contain the following related reference: January 30, 2001 Submission of revised Agreement and Declaration of Trust, Participation Agreement, and Bylaws. Revisions include: eliminate businesses engaged in wholesale sales and restrict participation to businesses engaged in retail sale of goods; added common ownership provision; eliminated the following codes from the bylaws: SIC Code 2052 (Manufacturers of Cookies and Crackers), SIC Division F (Wholesale Trade), SIC Code 5271 (Mobile Home Dealers), SIC Major Group 55 (Automotive Dealers and Gasoline Stations), SIC Code 5813 (Drinking Places), SIC Code 5983 (Fuel Oil Dealers), SIC Code 5984 (Liquefied Petroleum Gas [Bottled Gas] Dealers), and SIC Code 5989 (Fuel Oil Dealers NOC). SIC Code 5812 (Eating Places) is restricted to restaurants with over-the counter sale of foods and/or counter service of convenience food (ready-to-eat), with no table services and further restricted to those restaurants that do not have an alcohol beverage license and do not serve alcohol beverages.

²¹ The Trustees included Vella, Gelsomin, Wiedenbeck and Olmstead.

²² SaxBST LLP was unable to obtain a signed version of this document.

²³ While the 2001 document's Preamble shows an effective of March 1, 2001, the document's Table of Contents cites an effective date of April 15, 2001.

appear to provide the basis for NYCM's appointment. However, we have found no evidence that a formal, written contract was ever executed between the Trust and NYCM specifying NYCM's duties, responsibilities and compensation until April 15, 2001 (Exhibit 4). This is supported by the Trust's audited financial statements for the years 1996-1999, that reported the fees paid to NYCM "are based on terms of an informal agreement."

The apparent absence of such a written, legally binding agreement for this extended period exposed the Trust to potential financial liability, and denied the Trust a solid legal basis to hold NYCM accountable for its actions/inactions on behalf of the Trust. This will be discussed in more detail below.

In summary, the documents reviewed and the interviews conducted show that:

- The Trust was formed by NYCM and a group of retail grocers.
- NYCM prepared the Trust formation documents which the Trustees signed without independent legal review to ensure the documents adequately protected the interests of the Members.

B. Board of Trustees

Trustee Powers

Article IV, Section 2 of the 1994 Trust Agreement sets forth the Trustees' powers that include, but are not limited to, the following:

- Pay or provide for the payment of all reasonable and necessary expenses of collecting Employer payments and administering the affairs of the Fund.
- Pay or provide for the payment of premiums due from Employers on the policy or policies, and establish a contribution rate for each Employer which shall be sufficient to pay all of the estimated expenses of the Fund and all of the estimated obligations due.
- Establish and accumulate as part of the Fund an adequate reserve to carry out the purpose of the amount then currently required for payment of a quarterly premium on all the policies, together with the estimated plan expense.
- In the event of termination of this Agreement and Trust, make equitable distribution among Employers then participating, of the Fund remaining after payment of all obligations then outstanding, as the Trustees may determine.
- Enter into any and all contracts and agreements.
- Delegate any of their ministerial powers or duties hereunder to any of their agents or employees.
- Adopt all necessary rules and regulations for the proper administration of the Fund and to supervise the same.

Article VI, Section 6.3 of the 2001 Trust Agreement defines Trustee responsibilities as follows:

The Trustees shall be responsible for performing such duties as may be necessary to operate and maintain this Trust to continue to provide workers compensation coverage to eligible employees of the Participants, and for the maintenance and preservation of Trust Assets sufficient to meet all the financial obligations of the Trust, consistent with this Declaration of Trust, the Participation Agreement and the Bylaws.

Article VI, Section 6.7 of the 2001 Trust Agreement sets forth the Trustees' powers that include, but are not limited to, the following:

- Make and enter into contracts and to incur debts, liabilities and obligations.
- Collect all contributions, assessments and all other debts or payments due to or in connection with the Trust, and to pay from the Trust Assets all expenses incurred in connection with the operation of the Trust.
- Provide or procure administrative and management services for the Trust (including management of the Trust Assets) or otherwise related to the interests of Participants, including the employment or retainer of a Group Administrator and Claims Administrator and other suitable agents for actuarial services, accounting services, legal services, investment and fund management services, loss prevention services, or any other service or function as the Trustees may deem reasonable or necessary.
- Enter into contracts with and determine the duties and responsibilities of the Group Administrator, the Claims Administrator and other agents retained by the Trust, and to direct the performance of their obligations under the terms of this Declaration of Trust, the Participation Agreement and the Bylaws.
- Designate a bank or banks authorized to do business in New York State as a depository of the Trust Assets, and designate one or more persons (which may include the Group Administrator or the Claims Administrator) who may order payments from the Trust.
- Purchase reinsurance, excess insurance, or other insurance deemed necessary.
- Enforce the provisions of the Declaration of Trust, the Participation Agreement and the Bylaws.
- Invest all or any part of the Trust Assets in interest bearing deposits with a bank or similar financial institution, including but not limited to investments and time deposits, savings deposits, certificates of deposit or time accounts which bear reasonable rates of interest.

In addition, Article VIII, Section 8.1 off the 2001 Agreement further provides:

Each Trustee shall discharge his or her duties pursuant to this Declaration of Trust solely in the interest of the Participants and for the purposes set forth

herein with such ordinary- care, skill, prudence and diligence which under the circumstances then prevailing a prudent person acting in a like capacity would use in the conduct of an enterprise of a like character and with like aims, all in accordance with the provisions of this Declaration of Trust...

Article V, Section 5.1 of the Trust's 2001 By-Laws states:

5.1 General Powers and Duties: Policies and Plan of Operation. The Trust shall be managed by its Trustees, who shall have the powers and duties set forth in the Declaration of Trust and these Bylaws. In addition to these provisions, the Trustees may adopt policy for the Trust and its Participants as they deem necessary to implement the provisions of the Declaration of Trust, the Participation Agreement and these Bylaws. Policies adopted by the Trustees shall be in accordance with the Law, the Rules and Regulations of the Chair, the requirements of any Insurer, and the recommendations of the Group Administrator, and shall be binding on all parties hereto and all persons claiming any rights in the Trust.

In summary, the above-referenced Trust Agreements and By-Law provisions granted the Trustees broad powers to ensure the proper operation and administration of the Trust and its assets on behalf of the Trust's Members, and to do so in a reasonably responsible manner. We will discuss and evaluate how the Trustee's fulfilled their duties and responsibilities in the appropriate sections of this report.

Trustee Selection and Term

Article III of the 1994 Trust Agreement requires the Trust be administered by not less than three Trustees, the Trustees be appointed from participating Employers on the effective date of the Trust, and successor Trustees be elected by the Trustees as necessary. Article III further provides "...until such time as a successor Trustee is appointed or elected, the remaining Trustees shall have power to act in the manner specified in this Agreement and Declaration of Trust."

Article VI, Section 6.1 of the 2001 Trust Agreement provides the Trustees shall consist of no less than three (3) and no more than ten (10) natural persons designated as Trustees by this Declaration of Trust or elected thereafter by the existing Trustees. Each Trustee shall be a representative of a Participant of the Mercantile Self-insurance Trust; no Participant may have more than one representative serve concurrently as Trustees of the Trust.

In addition and of noteworthy importance, Section 6.1 further requires the Trustees to "appoint one additional Trustee who shall be the Group Administrator, or a principal or employee of the Group Administrator if the Group Administrator is a business, partnership, or corporation; this additional Trustee shall serve as a non-voting Trustee and shall serve for the term of the Trust's Agreement with the Group Administrator." The appointment of a Trustee, albeit non-voting, representing the Group Administrator could appear, on its face, to constitute a conflict of

interest. Perhaps this would have been identified up front had the Trustees retained independent legal counsel.

Section 6.4 permits Trustees to serve until their resignation, removal by the remaining Trustees, death or incapacitation, or refusal perform their duties. Section 6.6 provides for successor Trustees to “be elected by a majority of the Trustees then serving as Trustees.” In the event a vacancy is not filled within 30 days and the number of remaining Trustees is less than that required to act, Section 6.6 grants the Group Administrator to “take or direct such action as may be necessary to install successor Trustees.” In addition, if vacancies result in no Trustees in office, “successor Trustees shall be elected by the Participants in accordance with the voting procedures in the Bylaws.”

Section 5.2 of the 2001 Bylaws states the following:

The Trust shall be governed by the voting Trustees designated in the Declaration of Trust, with the number of Trustees subject to change in accordance with the provisions of the Declaration of Trust providing for additional Trustees. Each Trustee shall be a representative of a Participant of the Mercantile Self-Insurance Trust. Each Trustee shall hold office until a successor is elected. Non-voting Trustees shall be appointed in accordance with the provisions of the Declaration of Trust.

Pursuant to the above-referenced provisions, Trust records indicate that nine (9) Member representatives served as Trustees during the Trust’s tenure.²⁴ In addition, a NYCM representative served as a non-voting Trustee as noted above. NYCM Vice President Edwin Olmsted served in this capacity from 1994 to 2003. However, evidence strongly indicated the Trust had difficulty recruiting and retaining Member representatives to serve as voting Trustees and functioned for extended, critical periods without the required minimum three (3) Trustees.

As governance reforms have taken on greater relevance, it has become increasingly more important for boards to find the proper mix of trustees who have the appropriate spectrum of industry expertise and business perspectives. The failure to establish and maintain an active, diverse Board of Trustees may have also facilitated an atmosphere lacking fresh ideas and new perspectives.

Rumsmoke stated to SaxBST LLP that NYCM assisted in the recruitment of new Trustees, but noted it was difficult “...because no one wanted to serve; there was no pay or benefit to the trustees.” In NYCM’s joint response, the responders said they had no knowledge of Trustee recruitment efforts prior to 2006,²⁵ but added that “subsequent to 2006 there were letters sent

²⁴ Trustee meeting minutes for January 18, 1996 make reference to a tenth Trustee, Mike Farrugia, but this individual is not reflected elsewhere in Trust records as a Trustee, including on the official Designation of Trustee form.

²⁵ The lack of purported knowledge of Trustee recruitment efforts prior to 2006 is interesting given that David Francey regularly attended Trustee meetings from 1995 to at least 2005.

asking MERC members if they were interested in becoming Trustees. New trustees were obtained.”

Records indicate that the three initial voting Trustees - Vella, Gelsomin and Wiedenbeck served from the Trust’s formation in 1994 until 2002.²⁶ The Trust operated without a voting Trustee from July 3, 2002 through October 8, 2002, when Trustee Barry J. Thaler (Granny’s Kitchen) was appointed. Thaler served as the sole voting Trustee until February 5, 2003 when Trustee John D. Nelson (Material Handling Products Corp.) was appointed. Thaler’s term ended on December 31, 2004 and Nelson served as sole voting Trustee for nearly 2½ years, until Paul Vercesi (Vercesi’s Hardware Corp.) was appointed on May 10, 2007.²⁷ Nelson and Vercesi served as the voting Trustees through the Trust’s closure on February 29, 2008. Vercesi’s term ended on May 5, 2009. On April 30, 2009, while the Trust was in run-off, three additional Trustees - William Coakley (John P. Coakley Sons, Inc.), Molly Rhoads (L.P.S. Enterprises of New York, Ltd.), and Edward “Ned” Green (Wieder’s Hardware, Inc.) were appointed, and they served along with Nelson through the Trust’s transfer to the WCB’s new group administrator in June 2012.

Most Members interviewed did not recall the Trustees’ names, those who did mentioned the Trustees in place during the Trust’s run-off phase.

Available Trustee meeting minutes reflected periodic discussion by the Trustees and NYCM regarding the recruitment and retention of Trustees. For example, minutes for August 10, 2005 noted “NYCM polled the Trust to see if there was any interest of member to become additional Trustees and there were very few responses.”²⁸ Minutes for November 8, 2005 report “The Trust is below the minimum and new trustees need to be recruited” and that NYCM would send out a solicitation Trustee solicitation letter to the Members.

The WCB was cognizant of and concerned about the Trust’s inability to recruit new Trustees. A Consent Agreement signed by the WCB Chair on January 12, 2007 stipulated, inter alia, “The WCB expects that the Trust will actively pursue additional Trustees. It is expected that the Trust will be in compliance with their Trust Document requirement of no less than three (3) Trustees and no more than ten (10) by March 31, 2007.” The Trust was unable to comply with this directive as Trustee Nelson, according to available records, continued to serve as sole trustee until he was officially joined by Trustee Paul Vercesi on May 10, 2007. However, available documents suggest that Trustee Vercesi was only minimally involved, and Trustee Nelson essentially remained as the only active voting Trustee.

Nelson’s frustration became apparent as reflected in the minutes for February 24, 2009 which he is reported to have stated that he “did not feel comfortable making the Trustee decisions on his

²⁶ Vella’s and Gelsomin’s terms ended July 2, 2002 and Wiedenbeck’s on March 31, 2002.

²⁷ Had the Trustees retained independent legal counsel to vet the Trust formation documents, perhaps a quorum would have been more appropriately defined to include a minimum number of Trustees to strengthen Trust oversight and governance.

²⁸ The minutes note that the WCB “is encouraging a more active role of the Trustees.”

own” as Trustee Vercesi “has been contacted multiple times and has not been responsive about participating in the meetings.”

On April 23, 2009, a Trustee meeting was held to follow up on Nelson’s concerns. In attendance were Coakley, Rhoads and Green who had expressed an interest in becoming Trustees. On April 30, 2009, Nelson formally approved the three as Trustees. The Trustees also voted to contact Trustee Vercesi to determine his interest in remaining a Trustee. Vercesi’s tenure as Trustee subsequently terminated on May 5, 2009.

The commitment and contributions of the voting Trustees notwithstanding, the inability of the Trust to attract and retain a suitable number of Trustees until after the Trust was closed in February 2008 denied the membership of meaningful representation, and perhaps more importantly, an effective check and balance over the activities of NYCM. Moreover, the efficacy of the steps taken by NYCM to attract more Trustee participation over the Trust’s 18 years must be called into question. In this context, it is challenging to critique the performance of the few Trustees who stood up to serve an entity of over 570 members, but it remains unfortunate these Trustees declined to participate in our review.

The governing documents do not specify Trustee terms. However, limiting Trustee terms, though typically a best practice, when recruitment of new Trustees was all but impossible, would appear to have been counterproductive under the circumstance.

Trustee/Member Meetings

Article IV, Section 8 of the 1994 Trust Agreement required that any action taken with respect to the Agreement “may be taken either at a meeting or in writing without a meeting” and that a meeting “may be called at any time by the Chairman of the Trustees; but, in no event shall be any less frequently than annually.” Section 9 adds that any action taken by the Trustees “shall be by the concurrence of a majority of all the Trustees serving at that time.”

The 2001 Agreement makes no reference to frequency of Trustee meetings. Article XI, Section 11.3 requires that all Trustee actions “shall be authorized by at least a majority of the persons serving as Trustees and entitled to vote thereon.” In addition, this provision prohibits a Trustee from voting on any matter “which relates to him or her or to the Participant he or she represents by name, or from which he or she alone or the Participant he or she represents would profit financially...”

Article V, Section 5.3 of the 2001 Bylaws requires Trustees to “meet at least annually” and regular Trustee meetings to be held “as frequently as the Trustees determine meetings to be necessary, at such times and places as may be designated by resolution of the Trustees, or as determined by the Chairman.” The Chairman may also call a special meeting if requested in writing by any two Trustees. Sections 5.8 and 5.9 permit meetings by teleconference and votes by mail or fax ballot, respectively.

Article V further defines a meeting quorum as a “majority of the Trustees then in office,” and notes that the “vote of a majority of the Trustees then in office and entitled to vote shall be the act of all the Trustees.”

SaxBST LLP was unable to determine if it was provided with a complete set of Trustee meeting minutes. We did review minutes provided covering the period from August 1995 through April 19, 2012. During this period, available records reflect that a required annual Trustee meeting was not held in 2000, 2001, 2004, 2006 and 2008.²⁹ Records further show that in 1995, 1998, 1999, 2003 and 2007 one Trustee meeting was conducted. Following the Trust’s closure in February 2008, the frequency of Trustee meetings increased with 7 meetings in 2009, 6 in 2010, 2 in 2011 and 4 in 2012. Meetings were typically held in NYCM’s Syracuse office, and were between 1-2 hours’ duration.

Rumsmoke did not recall how often meetings occurred; but believed they occurred “more often at the beginning.” He noted that getting the Trustees “together for a meeting was difficult.” He said David Francey from NYCM prepared the meeting agenda along with an overview that were sent to the Trustees and the WCB. Records show that although he reported to SaxBST LLP that he retired in 2002, Rumsmoke attended Trustee meetings as late as August 10, 2005.

The intermittent occurrence of Trustee meetings, particularly during the years 2003-2007 when the Trust was experiencing substantial deficits is troubling as more, not less communications among the Trustees, NYCM and the membership would appear to have been warranted. Of course, for 2½ years during this crucial time period, the Trust functioned with only one voting Trustee, John Nelson who respectfully declined to be interviewed for this report.

Meeting minutes were prepared by NYCM (this was confirmed by Rumsmoke and NYCM) and generally provided a brief 2-4 page summary of the proceedings which typically included presentations by NYCM relating to such topics as investments, claims, income and expenses, reserves, loss runs, actuarial analysis, excess insurance, rates, WCB issues, and contracts.³⁰ The minutes report Trustee questions being raised and responded to. The breadth of topics addressed is not surprising due to the extended periods between meetings. Minutes suggest, and Trustee Vella confirmed that NYCM, not the Trustees directed the meetings.

Minutes reflect regular discussion by NYCM of the Trust’s financial condition; however, minutes do not reflect a formal Trustee approval of the financial statements. Available minutes reflect only a few occasions where the Trust’s CPA firm was in attendance over the life of the Trust.

²⁹ Records do show that the Trustee met jointly with NYCM and the WCB in 2006, 2007 and 2008.

³⁰ A WCB Level II report as of December 31, 2002 noted “The minutes provided to the WCB as part of this review process did not provide the level of detail necessary to determine if the trustees had an active role in the meeting.” The Report further indicated that Trustee meetings “have not occurred annually.”

Trustee Vella advised SaxBST LLP that NYCM would provide materials at the meetings, not in advance.³¹ He felt the meetings were well organized NYCM discussing claims, safety, reserves, finances, WCB accounting requirements and other things to the Trustees. He felt he was well-informed as a Trustee and found the meetings to be productive. His questions were answered by NYCM and issues raised were dealt with. He stated that he missed meetings occasionally because of other business matters, but tried to attend as often as he could. Trustees received no compensation. He recalled NYCM sent periodic newsletters out to the Members to keep them informed.

Minutes reflect that multiple NYCM representatives were always in attendance, typically including, but not limited to Edwin Olmstead (non-voting Trustee), Lew Rumsmoke, David Francey and later Chris Mason and Tony D'Amato. Other NYCM staff were also in attendance to provide content updates. Occasionally but rarely, representatives from the Trust's investment advisors, outside legal counsel, and accounting firm would also attend.

Evidence suggests that copies of Trustee minutes were not sent to Members. None of the Members interviewed recalled receiving copies of Trustee minutes or annual financial statements. This is further supported by the minutes of May 19, 2010 that stated, in part: "It was agreed, that Trustee minutes would not be shared, that financials would be made available upon request, and that a letter outlining the Trust's status would be sent to all members." The NYCM told SaxBST LLP that financial statements were provided to Members only upon request.

Article IV, Section 4.1 of the 2001 Bylaws requires that Members "meet once annually to transact any business that may come before the (Members), and to discuss those issues which are of general concern to the (Members)." Available minutes indicate that annual Member meetings were held in the Trust's early years in conjunction with Trustee meetings, but became infrequent as the years went on. None of the Members interviewed recalled ever attending a general member meeting. One recalled attending a meeting only when the Trust dissolved.

Concerning the annual meetings, Rumsmoke stated there were a couple of instances where Members were invited, but they "rarely showed up." Overall, he believed "communications between NYCM and the members were adequate." NYCM confirmed to SaxBST LLP that annual Member meetings were not held each year, but indicated that overall communication between the Trust and the Members was adequate.

Members interviewed generally indicated they received very little general information from the Trust until they received their assessment notices and related correspondence.

Appointment of Officers

Article VI of the 2001 By-laws provides for the selection of Trust Officers to include a Chairman, Treasurer and Secretary (or combined Secretary-Treasurer), and "such other Officers

³¹ Minutes for November 8, 2005 note that NYCM indicated materials could be sent to the Trustees before the meetings with the Trustees feeling that would be helpful. SaxBST LLP could not determine if this accommodation was made to the Trustees.

as may from time to time be deemed necessary by the Trustees.” The Chairman was authorized to “preside at all meeting of the Participants and of the Trustees...;” the Treasurer to provide “general supervision of all funds of the Trust;” and the Secretary to “supervise the record keeping of all proceedings of the Participants and Trustees at their respective meetings...”

As noted previously, records show Trustee Gelsomin served as Secretary-Treasurer at the Trust’s inception. However, Trust records indicate that no one served as Trust Chair. As noted above, evidence indicates that NYCM arranged Trustee meeting dates and agendas, presided over the meetings, and maintained the meeting minutes.

The absence of a strong Chair and cadre of officers greatly weakened the Trustees’ (and Members’) ability to adequately monitor and supervise NYCM’s activities, and allowed NYCM substantial latitude and autonomy. This situation was further exacerbated by the Trustees’ apparent failure to execute a written Administrative Services Agreement with NYCM for the period October 1995 through April 15, 2001 through which they could hold NYCM accountable for its performance and cost of services.

NYCM’s level of control over the Trust’s activities is essentially confirmed by the Trust’s own audited financial statements. Note H to the statements from 2005-2007 state:

The Trust pays a monthly fee to an affiliated entity to provide management and administrative services, under an agreement that expires on April 15, 2011 and automatically renews through April 15, 2016. The entities are considered related based of the fact that the management company has significant control over the management and operating policies of the Trust.

Trust Investments

The sound management of investments is important to the financial stability of any self-insured trust as returns on these investments are a potential source of revenue to help offset a trust’s administrative costs and claims expenses exceeding established cash reserves. Interviews and documents reveal that the Trust engaged four firms to manage the Trust’s investments during the term of the Trust - M&T Bank Investment, City Capital, Inc., Mellon Private Trust Company, NA., and Howe and Rusling.

Effective January 31, 2001, new WCB regulations³² restricted the investments of self-insured trusts to Government Obligations, Obligations of American Institutions, Preferred Shares of American Institutions, and Equity Interests. In addition, investments could not exceed five percent (5%) of total trust assets in any one American institution. Also, total equity investments could not exceed twenty-five percent (25%) of total trust assets and those investments must maintain adequate ratings in order to be recognized an acceptable asset.³³

The 1994 Trust Agreement does not specifically address the Trustees’ duties with respect to the investment of Trust funds. Article VI, Section 6.7 of the 2001 Trust Agreement and Article VIII

³² NYCRR Title 12, Sections 317.8c and 317.8d.

³³ The equity investments must also be with American Institutions.

of the 2001 By-laws; however, authorize the Trustees to procure investment and fund management services, and to invest Trust assets.

Available meeting minutes reflect periodic discussions of the Trust's investments by NYCM, and on at least three occasions according to minutes, directly by representatives of the Trust's investment advisor. Minutes for April 18, 1996 note the Trust would "continue in be invested in short term CD's (currently at 5%)."

SaxBST LLP could not identify a written investment policy formally approved by the Trustees, but did locate an Investment Policy Statement signed by NYCM (David Francey) on or around March 8, 2004 purporting to represent a policy established by the Trustees.³⁴ A review of the policy reveals that it is consistent with the aforementioned WCB regulations.

Rumsmoke indicated to SaxBST LLP that he did not know if there was an investment policy, but if there was "it was limited because they could only invest excess funds." He was not aware if MERC had an investment manager, or funds to manage. NYCM informed SaxBST LLP that the Trustees adopted an investment policy, selected investment instruments upon the advice of the investment manager, and were advised by the investment manager regarding WCB regulatory compliance.

WCB Level I Reviews for the years 2003, 2006 and 2007 found the Trust's investments to be within the limitations prescribed in the Rules and Regulations. For the years 2004 and 2005, the WCB found the Trust generally in compliance, but disallowed \$104,436 and \$29,537 in foreign investments for those years, respectively.

Records and interviews indicate that the Trust moved its investment management from M&T Bank Investments³⁵ to City Capital, Inc. in Atlanta, GA, on or about December 2003 at which time NYCM (David E. Francey) entered into an Investment Management Agreement with City Capital. The Agreement provided for City Capital to be compensated an "annual fee based upon the total market value of the assets of the account under management (including cash or its equivalent held for investment)..." in accordance with a set fee schedule with a minimum annual fee of \$10,000.

Minutes for September 16, 2003 report that NYCM and the Trustees discussed the possible selection of City Capital as the Trust's new Investment Manager. Minutes show that a Trustee vote would be sent "under separate cover to determine if the Trust will invest with City Group (sic)." Attached to the Minutes was a draft ballot to be sent by NYCM to the Members seeking their approval or disapproval of City Capital's selection. We were unable to determine if the ballots were sent, or if so, the voting results.

³⁴ We were not provided with any Trustee minutes for 2004, and therefore were unable to determine if the Trustees had, in fact, approved such a policy at that time. Available minutes do not reflect such an approval.

³⁵ M&T remained the custodian of the Trust's bank accounts.

In October 2005, the Trust's Investment Agreement with City Capital was assigned to Mellon Private Trust Company, N.A. following Mellon's acquisition of City Capital. Records show that sometime between 2006 and 2008 the Trust moved its investment management to Howe and Rusling, Inc. Available meeting minutes reveal no formal Trustee approval of this transaction.

Based on WCB's findings over the years and other available evidence, the Trust pursued a relatively conservative investment strategy, and remained in substantial compliance with WCB's 2001 investment regulations.

Fidelity Insurance

Part 317.11 NYCRR requires every group self-insurer to obtain fidelity insurance for theft, disappearance or destruction of money, securities, or other property to protect the Trust against dishonest acts of the group administrator or a Trustee, employee, or agent of the group. Each group is required to file evidence of such insurance with WCB.

A WCB Level II Review for 2002 and Level I Reviews for the years 2003 through 2007 report that the Trust was asked to provide evidence of this insurance coverage, and that the Trust failed to provide documentation that any such coverage existed. In each instance, WCB recommended the Trust obtain such coverage and provide satisfactory proof to WCB. However, Trust accounting records reflect payments for Fidelity Bond expenses for the period 2004-2007.

NYCM did not respond to SaxBST LLP's question if NYCM had obtained a Fidelity Bond. Rumsmoke indicated that he believed a Fidelity Bond had been obtained as required. SaxBST LLP is unaware of any sanctions imposed by WCB to enforce its Level I and II regulatory findings.

Before offering its conclusions relating to the foregoing Trustee-related issues, SaxBST LLP would like to once again express its concern about the lack of cooperation from the Trustees contacted to participate in this review. With the exception of Trustee Vella, the Trustees' reticence has made our task of presenting a complete assessment much more difficult. Of particular importance was our inability to speak with Trustee Nelson who was the longest-tenured Trustee (2003-2012), and the sole Trustee for approximately 2 ½ years. His insights and observations would have been invaluable.

Article VIII, Section 8.1 of the 2001 Trust Agreement provides that each Trustee shall discharge his or her duties with "care, skill, prudence and diligence..." As reflected in the following observations, the absence of a full complement of Trustees may have prevented the few serving Trustees from satisfactorily fulfilling their duties in this fashion.

In summary, the documents reviewed and the interviews conducted show that:

- The Trust operated as a group administrator-controlled, limited-participatory entity with Trustees and Members having minimal involvement in the decision-making process.

- The Trustees and NYCM failed to effectively recruit and retain a full complement of Trustees, resulting in the Trust functioning for extended, critical periods without the required minimum of three (3) Trustees. Their collective failure to attract and retain a suitable number of Trustees denied the membership of meaningful representation, and an effective check and balance over NYCM's activities.
- The Trustees delegated their assigned duties and responsibilities to NYCM and provided little oversight of NYCM's performance of these duties and responsibilities.
- The Trustees failed to meet their fiduciary duties by engaging and continuing the services of NYCM from October 1995 through April 14, 2001 based on an "informal agreement" without a written, specified scope of services or fee structure, thereby restricting their ability to adequately monitor and supervise NYCM's activities and safeguard the Members' interests.
- The Trustees and NYCM did not comply with Article V, Section 5.3 of the 2001 Bylaws by failing to have an annual meeting of the Trustees each and every year. In light of the Trust's ongoing financial difficulties more frequent Trustee meetings would seem to have been in order.
- NYCM controlled the Trustee meeting process by presiding over the meeting, setting the agendas, and preparing the minutes.
- Trustee minutes and audited financial statements were not sent to Members as a matter of routine, denying the Members of ongoing communication concerning the Trust's performance and financial condition necessary for Members to assess their continued participation in the Trust, particularly in light of the Trust's ongoing deficit position.
- The Trustees and NYCM did not comply with Article IV, Section 4.1 of the 2001 Bylaws by failing to conduct annual Member meetings each and every year "to transact any business that may come before the (Members), and to discuss those issues which are of general concern to the (Members)."
- The Trustees failed to adopt a formal written investment policy. However, actual investment practices generally conformed to WCB investment regulations, 12NYCRR Part 317.8.
- The Trustees did not select Trust officers - Chairman, Treasurer and Secretary (or combined Secretary-Treasurer) in accordance with Article VI of the 2001 Bylaws,

denying the Board the strong leadership necessary to adequately represent the interests of the general membership and oversee NYCM's activities.

- The Trustees and NYCM may not have complied with Part 317.11 NYCRR by failing to purchase and file with WCB evidence of fidelity insurance for theft, disappearance or destruction of money, securities, or other property to protect the Trust against dishonest acts of the group administrator or a Trustee, employee, or agent of the group.

C. Program Administrator – New York Compensation Managers/USA-TPA³⁶

Article IV, Section 2(a) of the 1994 Trust Agreement (Exhibit 1) authorizes the Trustees to employ "...administrative, legal, actuarial and other expert assistance or services, auditing, bookkeeping and clerical services or assistance...as the Trustees in their discretion find necessary or appropriate in the performance of their duties." Section 2(g) permits the Trustees to "enter into any and all contracts and agreements for carrying out the terms of this Agreement and Declaration of Trust and for the Administration of the Trust Fund and to do all acts as they, in their discretion, may deem necessary or advisable." Pursuant to Section 2(i), the Trustees may "...delegate any of their ministerial powers or duties hereunder to any of their agents or employees."

Article IV, Section 3 provides for compensation to be made to the Administrator for special executive or administrative services performed in connection with the direction, administration or operation of the Trust Fund or the policies."

Article VII, Section 7.1 of the 2001 By-Laws³⁷ (Exhibit 3) provides for the Trustees' selection of a Group Administrator to provide the following services to the Trust:

- risk management;
- administration of audits;
- compliance with informational filings required by the New York Workers Compensation Law and the Rules and Regulations of the Chair;
- underwriting and insurance services required by the Trust;
- provision of administrative services;
- establishment of an office for the Trust;
- coordinating notices to Trustees as required;
- coordinating meetings of the Trustees and the Participants;
- bringing to the attention of the Trustees and the Participants any business which requires their attention; and

³⁶ WCB records indicate that MERC was the first of a number of other self-insured groups administered by NYCM/USA-TPA.

³⁷ Section 7.2 provides for the selection of a Claims Administrator, a role NYCM served concurrently with its role of Group Administrator.

- other duties contained in the agreement between the Trust and the Group Administrator.

Section 7.1 further provides that the agreement with the Group Administrator is to be “a written instrument which shall delegate authority to the Group Administrator to act as agent of the Trustees for the management and operation of the Group at the direction of the Trustees, the limitations on the authority of the Group Administration compensation due to the Group Administrator, and the term of the agreement.” Section 7.3 grants the Group Administrator (and Claims Administrator) the “authority to approve or execute any contracts on behalf of the Trust with the approval of the Trustees.”

Article VIII, Section 8.2 permits the Trustees to delegate the general supervision and administration of the Trust’s assets to the Group Administrator, Claims Administrator, or Trust’s investment advisor.

As previously discussed, Trustee Vella, one of the founding Trustees, recounted to SaxBST LLP that NYCM and a group of grocers formed the Trust. Consistent with the above-referenced provisions, and as discussed previously, Vella and the other founding Trustees essentially appointed NYCM as Trust Administrator in a June 6, 1994 letter to the WCB. Vella said he did not recall NYCM’s official scope of services or fee structure, and whether or not there was a formal contract with them. However, he was satisfied overall with the services NYCM provided. NYCM’s response did not address SaxBST LLP’s question relating to whether or not a contract was in place between NYCM and the Trust throughout the life of the Trust.

While Article IV, Section 2 (g) granted the Trustees authority to “enter into any and all contracts and agreements” with the Administrator, SaxBST LLP found no evidence that a formal written contract was ever executed between the Trust and NYCM until April 15, 2001. This is supported by the Trust’s audited financial statements for the years 1996-1999 that reported the fees paid to NYCM “are based on terms of an informal agreement.”³⁸

Rumsmoke said he believed NYCM made a proposal to the Trust, and an agreement was negotiated. He believed an agreement was in place, but he had no copies of any NYCM agreements with MERC. He did not recall the specific fee arrangement. SaxBST LLP finds it highly unusual and contrary to good business practice that the services of a group administrator would be engaged and continue without a written contract specifying terms and conditions, scope of services, and fees. Said practice is highly inappropriate given the Trustees fiduciary responsibilities as it relates to the administration of the Trust.

New York Compensation Managers, Inc., located in Syracuse New York, was formed as a New York State Domestic Business Corporation on September 2, 1993. Records identify the

³⁸ The absence of a written agreement for group administration (and claims administration) is interesting in that NYCM had entered into a written 10-year agreement on October 30, 1997 with another of its group self-insured trusts, The Manufacturing Self-Insurance Trust (“MSIT”) which was created on April 22, 1997. The fee was based on 20% of employers’ contributions.

following corporate officers - Lew E. Rumsmoke, President; Edwin L. Olmstead, Vice President; and David E. Francey, Secretary/Treasurer. Available minutes show that the three officers attended Trustee meetings on a regular basis in the Trust's early years, with Olmstead being designated as NYCM's non-voting Trustee.

On April 15, 2001, Trustees Vella, Gelsomin and Wiedenbeck executed a notarized Administration Services Agreement ("Administration Agreement") with NYCM (Exhibit 4).³⁹ NYCM Secretary Treasurer David E. Francey signed on behalf of NYCM. The Administration Agreement identifies the following services to be performed by the Administrator:

- review each claim and loss submitted to the Trust;
- conduct an investigation of each qualified claim or loss;
- maintain a file for each qualified claim or loss;
- adjust, settle or compromise all qualified claims or losses;
- perform necessary and customary administrative and clerical work in connection with each qualified claim or loss;
- establish and update claims reserves;
- coordinate investigations on litigated claims with attorneys representing the Trust and excess carrier as required;
- arrange for representatives or attorneys to represent the Trust at all workers compensation hearings;
- prepare and submit annual status and other reports to the Trust;
- attend meetings with representatives of the Trust;
- arrange at the Trust's expense, all other professional services as required in the sole discretion of the Administrator;
- perform all services necessary for the timely billing and collection of monthly contributions from employer members with maintenance of eligibility records;
- enroll and service participating employers and notify participants of changes in the Trust and its operation;
- administer and manage the Trust fund including asset accounting and furnish a written report of all funds received, funds expended, assets and values as necessary;
- prepare and issue checks payable to the employee participants, insurance companies, accountants, auditors, attorneys, consultants or others as necessary;
- provide secretarial, bookkeeping and clerical personnel and maintain and keep all records for a period of six (6) years;
- obtain all relevant information and recommend to the Trustees participant contribution levels necessary for the prudent and sound operation of the Trust Fund's benefits; and
- market and promote the Trust members and assist in the implementation and coordination of such program.⁴⁰

³⁹ The Agreement states: "This Agreement constitutes the sole and only agreement (and supersedes any prior understandings, either written or oral) between the parties respecting the subject matter herein." The NYCM Response indicated that this Agreement was "Copied from agreement given to trust by WCB."

⁴⁰ Available Trustee minutes did not reflect discussion of this Agreement.

As can be seen by the breadth of the Administration Agreement, NYCM had responsibility for the complete range of management, administrative, and claims handling duties on behalf of the Trust. This broad scope of duties is not atypical for a group administrator. However, when combined with the aforementioned absence of a full complement of Trustees or strong Trustee leadership to properly oversee NYCM's activities and a non-voting NYCM representative on the Board of Trustees, NYCM exercised significant control and influence over the Trust's operation. Not surprisingly, the extent of NYCM's level of control and influence was specifically referenced in the Notes to the Trust's audited financial statements for the years 2005-2007 as follows:

NOTE H - RELATED PARTY TRANSACTION

The Trust pays a monthly fee to an affiliated entity to provide management and administrative services ... The entities are considered related based on the fact that the management company has significant control over the management and operating policies of the Trust.⁴¹

This representation seems to suggest that NYCM and the Trust did not have the typical client-consultant relationship, but rather a less than arm's-length affiliation where the Trust's interests were subordinate to those of NYCM. With NYCM essentially "calling the shots," the potential for NYCM's financial interests to take precedence over those of the Trust's Members was indeed substantial.

Moreover, the Administration Agreement further provides for an unusually lengthy minimum contract term of ten (10) years - April 15, 2001 through April 15, 2011, with an automatic renewal of an additional five (5) years, subject to cancellation by either party. The Agreement specifically justifies the unusual ten (10) year term as follows:

The initial ten (10) year term of this Agreement has been determined in recognition of the considerable efforts of the FUND ADMINISTRATOR in establishing the TRUST, and can only be terminated if FUND ADMINISTRATOR willfully fails to perform its obligations under the terms hereof.⁴²

This special recognition seems to belie the fact that NYCM by April 2001 had already served, apparently without a written agreement, as the Trust's sole Administrator for almost seven (7) years and received approximately \$900,000 in fees.

⁴¹ Notes to the audited financial statements for the years 2008-2009 state: "The Trust has entered into an agreement with an affiliated management company for management of the Trust during its liquidation." Notes to the audited financial statements for the year 2010 state: "The Trust has entered into an agreement with an affiliated management Trust for management of the Trust and administration of claims during its liquidation."

⁴² NYCM's Administration Agreement with MSIT effective October 30, 1997 contains identical language.

The Administration Agreement provided for “a fee in the amount 20% of employer's (sic) contributions on a monthly basis.” From Trust inception through December 31, 2010, NYCM/USA-TPA received approximately \$12 million in administrative fees or approximately 21% of total contributions.⁴³ Based on our review of 14 other trusts where similar services were provided by the group administrator, NYCM’s fees are high when compared to the other trusts paying approximately a 16% fee. In addition and as previously addressed, Lake Effect Claims Service, an NYCM affiliate, received approximately \$1.3 million in excess fees for services specified in the Administration Agreement.

SaxBST LLP found no evidence that the Administration Agreement was vetted by independent legal counsel on behalf of the Trustees to ensure its compliance with laws, rules, regulations and good business practices.⁴⁴

Trustee minutes for September 16, 2003 report that Christopher Mason, Esq. joined the firm in February 2003 as Trust Counsel and Anthony D’Amato in May 2003 as Director of Trust Services.⁴⁵ Available meeting minutes reflect that after this meeting Olmstead, NYCM’s non-voting Trustee, no longer attended. Meeting minutes further reflect that after approximately August 2005, both Rumsmoke and Francey discontinued meeting participation with Mason, D’Amato and CFO Edward Coombs, CPA being the consistent NYCM representatives. Evidence indicates that from at least 2005 forward, the management team of Mason, D’Amato and Coombs controlled NYCM’s operations and relationship with the Trust.

On September 18, 2003, USA-TPA, Inc. was formed as a New York State Domestic Business Corporation and would later become the Trust’s Administrator in 2006. USA- TPA’s website notes it was formerly known as Lake Effect Claims⁴⁶ and identifies itself as an NYCM affiliate.

Rumsmoke informed SaxBST LLP that “NYCM and USA-TPA are two separate and distinct corporations” with NYCM focusing on groups, and USA-TPA on individual entities. In addition, he said he has not been involved in the day-to-day operations of NYCM since he retired in 2002, was never involved in the day to day business operations of USA-TPA, and has very little knowledge regarding USA-TPA. As noted above, records reveal Rumsmoke attended Trustee meetings until mid-2005.

⁴³ Contributions ended in 2008 with the Trust’s closing but NYCM continued to receive run-off fees.

⁴⁴ The absence of such independent legal review is consistent with SaxBST LLP’s findings relative to its review of other trusts.

⁴⁵ One must question how Mason could represent the Trust’s best legal interests while being a senior NYCM official.

⁴⁶ Lake Effect Claims Service, Inc.’s predecessor firm Rankin-Larose, Inc. was incorporated as a Domestic Business Corporation on July 16, 1982. Lake Effect Claims Service assumed that name on December 8, 1986. USA-TPA’s website as of August 7, 2012 contained the following reference to Lake Effect: “USA-TPA, Inc. is an affiliated company of New York Compensation Managers, Inc., a leading provider of group self-insurance services. USA-TPA, formerly Lake Effect Claims, has been providing professional claim services for over 40 years. We employ an aggressive, integrated approach to claim administration resulting in lower costs to our member clients.”

NYCM officials confirmed to SaxBST LLP NYCM's and USA-TPA's corporate relationship, and added "There was not a transition from one to another, but rather USA-TPA acquired the assets of NYCM (in 2011)." NYCM owners were identified as David Francey, Edwin Olmstead and Lew Rumsmoke, and USA-TPA's ownership as Edwin Olmstead, Lew Rumsmoke, David Francey, Chris Mason and Tony D'Amato.⁴⁷ The response further identified NYCM as having common ownership with Lake Effect Claims, and Med NY, an entity providing case management services to the Trust.

Trust records contain an Administration Services Agreement between the Trust and NYCM with a stated execution date of September 1, 2006 (Exhibit 5). However, the document was not signed by Trustees Green and Vercesi, and NYCM COO David Francey until January 8, 2008.⁴⁸ A letter dated January 11, 2007 from Francey to Trustees Green and Vercesi transmits a proposed copy of the Agreement "for continuing administration of the Mercantile Self Insurance Trust subsequent to February 28, 2008."⁴⁹

The Agreement had an effective date of February 28, 2008 and automatically renewed "for an additional one year term until such time as the Trust has met all its obligations for payment of claims and other obligations as determined by the Workers compensation (sic) Board." NYCM's fee was established at \$55,000 per month (\$660,000 per year) plus an additional fee of "twenty percent (20%) of billed premium shall be paid for any audit premiums in excess of \$10,000 relating to a members participation in the Trust for any prior period."

Trustee minutes for February 24, 2009 report discussion of the 2008 Agreement's expiration on February 28, 2009. NYCM proposed a one-year extension at \$20,000 per month (\$240,000 per year), but Trustee Green wanted additional Trustee involvement before agreeing to these terms. NYCM and Green agreed to a 30-day extension of the expiring contract, and a \$20,000 monthly fee for March 2009. Subsequent minutes reflect that NYCM continued receiving a \$20,000 monthly fee through sometime in mid- 2010. Minutes for September 22, 2010 note that the monthly fee was "\$12,000 per month pending finalization of the contract."

Trustee minutes for September 30, 2010, reflect Trustee approval of a contract between the Trust and USA-TPA retroactive to February 29, 2009, and expiring on February 28, 2011 (Exhibit 6). NYCM/USA-TPA's Chris Mason provided the following explanation to the Trustees concerning why the Agreement involved USA-TPA and not NYCM:

Chris Mason explained that the contract is between USA-TPA and the Mercantile Trust due to the fact that within the past year, the Insurance department, in conjunction with a complaint filed by a former member as a result of the assessment, has advised that an administrator of a self insurance trust should be

⁴⁷ The response further stated that NYCM was no longer an operating business, with its TPA license being "resigned and returned effective 7/1/2012 upon its expiration."

⁴⁸ It appears NYCM used the boilerplate from an agreement executed with its Manufacturing Trust on September 1, 2006.

⁴⁹ The proposed and signed contracts were identical.

licensed with the insurance department pursuant to Insurance Law section 2101. In response, and on the advice of counsel, all the adjusters handling claims have been licensed, and USA-TPA has been licensed as a corporate Independent adjuster entity. The Trustees were advised that the same personnel would be handling the overall trust administration. (sic)

This signed Agreement provided for USA-TPA to provide administrative and claims services related to the Trust at a monthly fee \$15,500 for the period May 1, 2010 through February 28, 2011 (\$10,000 for administrative services and \$5,500 for claims services).⁵⁰

The Trustees subsequently approved a new contract with USA-TPA, effective June 1, 2011 (Exhibit 7) to provide administrative and claims services related to the Trust at a monthly fee \$10,000 for the period March 1, 2011 through February 28, 2013. In addition, the Trust agreed to pay “\$550 annually per claim for all open claims administered during each contract year.”⁵¹

For the period of the Trust’s closure on February 28, 2008 through December 31, 2010, the Trust’s audited financial statements show NYCM/USA-TPA received over \$1,035,000 in additional Trust administration fees.

Concerning NYCM’s overall performance, Trustee Vella recounted that Trustee meetings were well organized and NYCM discussed claims, safety, reserves, finances, WCB accounting requirements and other things to the Trustees. He felt he was well-informed as a Trustee and found the meetings to be productive. His questions were answered by NYCM and issues raised were addressed. Unfortunately, we were unable to obtain any related feedback from other Trustees.

Consistent with our findings relating to poor Member communications, a number of Members interviewed claimed they could not recall the name of the Trust’s group administrator, and noted that they had limited direct contact with the administrator, with most communications going through their insurance broker/agent. Most recalled that any contact they had come when the assessment billings were issued. Some Members did have direct contact relating to claims they had filed. One would expect that another point of contact would have been through the safety program, but as will be discussed later in this report, most Members interviewed reported little to no contact from NYCM’s safety personnel.

⁵⁰ Item 11 of this Agreement identifies notices to be directed to the Fund Administrator at New York Compensation Manager’s, Inc.

⁵¹ Item 11 of this Agreement identifies notices to be directed to the Fund Administrator at New York Compensation Manager’s, Inc.

Purchase of Excess Insurance

Section 317.10 of the NYCRR, effective January 31, 2001, requires group self-insurers to obtain excess insurance.⁵² Section 317.2(b) requires the group self-insurer to “notify the chair, in writing, of any change in its excess insurance.”

Pursuant to this regulatory requirement, Article VI, Section 6.7 (g) of the 2001 Trust Agreement authorizes the Trustees to “purchase reinsurance, excess insurance, or other insurance deemed necessary to protect the interests and integrity of the Trust and the Participants or as required by the Rules and Regulations of the Chair...” This responsibility was delegated by the Trustees to NYCM, although both the 2001 and 2006 Administration Agreements do not specifically address the purchase of excess insurance.⁵³

The Trust paid over \$5.6 million in excess insurance premium costs from 1995-2008. Annual premium costs incurred by the Trust increased ten-fold from \$225,465 in 2003 to \$2,435,752 in 2006.

Available Trustee meeting minutes reflect very little discussion by NYCM of excess insurance issues with the Trustees. Trustee Vella recalled some discussion of excess insurance, but had no specific recollection of the particulars.

A Level II Review as of December 31, 2002 performed by WCB in consultation with PricewaterhouseCoopers LLP (PwC) found the Trust to be generally in compliance with excess insurance requirements from Trust inception to date. However, a WCB Level I Review as of December 31, 2004, dated July 19, 2005 found the Trust had raised the excess policy’s retention level from \$400,000 self-insured retention (SIR) to \$500,000 SIR without prior WCB approval, as required by Section 317.2(b) NYCRR. WCB directed the Trust to reduce its retention back to \$400,000 SIR.

It appears the basis for the retention increase was to reduce the Trust’s annual excess insurance premium costs (while increasing the Trust’s overall potential liability). Trustee minutes for August 10, 2005 confirm NYCM’s attempt to increase the SIR “to lower the cost” and the WCB’s disapproval. The minutes note further that upon NYCM’s recommendation Trustees Nelson and Thaler approved a motion to increase the SIR from \$400,000 to \$500,000, and for NYCM to present this motion to the WCB. SaxBST LLP was unable to determine whether or not this request was ever made to the WCB, but records show the SIR remained at \$400,000 for the remainder of the Trust’s operation.⁵⁴

⁵² Section 317.2(f) defines excess insurance as “... insurance, purchased from an insurance company authorized by the superintendent of insurance, which reduces the exposure of the group self-insurer i) for workers' compensation claims and ii) for employers' liability. Such excess insurance may be specific, aggregate or other insurance, singly or in combination, in amounts and form acceptable to the chair.

⁵³ Section 1(g) of the 2001 Agreement requires the Administrator to coordinate investigations “with representatives of the excess carrier...” Section 1(f) of the 2006 Agreement requires the Administrator to “coordinate professional services including...insurance...”

⁵⁴ Records for NYCM’s AUTO Trust show a \$500,000 SIR.

Minutes for November 8, 2005 reflect discussion of excess insurance, but only in the context of a downgraded rating for its carrier, Alea, and the possibility of soliciting a new carrier.

The Trust's Actuarial Report as of December 31, 2004 dated April 25, 2005 reported, inter alia, the following:

The Trust purchases specific excess reinsurance from Alea North America Insurance Company. Individual losses are limited to \$400,000 per accident. The 2004 excess policy has a corridor deductible⁵⁵ of \$1.2 million in the layer \$600,000 excess of \$400,000 per accident.

Records show that the Trust's initial 2005 excess policy increased the per accident retention to \$500,000 with a corridor deductible of \$1.5 million in excess of \$500,000.

WCB's Level I Review as of December 31, 2005 referenced the 2004 Actuarial Report, and the fact that the corridor deductible had been obtained without the WCB's required prior approval.⁵⁶ In a letter dated June 23, 2006, NYCM advised the WCB, inter alia, that the Trust's excess insurance coverage had been changed to reflect a \$400,000 SIR and no corridor deductible.⁵⁷ WCB's Level I Review as of December 31, 2006 and December 31, 2007 reported no areas of non-compliance relative to the Trust's excess coverage.

Trust records contain an Excess of Loss Reinsurance Agreement for the period March 1, 2006 and 12:01 a.m. January 1, 2007 between Various Underwriters at Lloyd's, London and the Mercantile and Automobile Service & Repair Trusts. As such, the premiums paid by the two trusts had to be appropriately allocated based on their respective payrolls. A review of the Trust auditor's 2006 work papers by another accounting firm engaged by the WCB to evaluate the AUTO Trust found the Trust's auditors "performed testing that indicated 11% of the applicable premium was paid by AUTO and 89% by Mercantile Self-Insurance Trust."

As noted previously, available Trustee meeting minutes reflect some discussion of excess insurance issues, primarily relating to the increase of SIR to reduce costs. These minutes do not reflect, however, any discussion with the Trustees of the purchase of a corridor deductible plan, nor the potential impact of such a plan on the Trust's liability exposure. Therefore, it remains unclear as to the extent of the Trustees' participation in or awareness of reinsurance purchase decisions.

Concerning the purchase of excess insurance, Rumsmoke confirmed "NYCM assisted with obtaining the excess coverage and contacted excess carriers," and identified Dave Francey and

⁵⁵ The International Risk Management Institute (IRMI) defines a corridor SIR as a self-insured layer, separating the primary layer of risk - whether insured, self-insured, or funded in a captive - from the layer immediately excess of the primary. There is defined protection on the bottom and on the top - but no coverage in the middle. Such policies help reduce premium costs but increase exposure for claims in the middle tier.

⁵⁶ The Trust's 2004 audited financial statements reflect no excess insurance recoveries. The 2006 statements report recoveries of \$ 123,000 and \$72,000 during 2006 and 2005, respectively.

⁵⁷ Records show the Trust amended its 2005 policy with a standard \$400,000 SIR, effective May 1, 2005.

Tony D'Amato as handling this task. He noted "there was a period of time when the market was bad and no carriers would write excess policies in New York." Concerning the corridor plan, he said it was "the only excess insurance available." Rumsmoke recalled "NYCM went to every carrier, so one would write excess on self-insurance in New York. This was the only company that would write the policy." He thought the Trustees were made aware of this.

As to NYCM's role in the placement of excess insurance, NYCM officials stated that NYCM prepared the submission and referred it to a broker. In terms of how the excess carrier was selected, they indicated, "In most cases there were not a lot of choices." NYCM said it received no commissions from the placements, and that Aegis Insurance "brokered the coverage for a period of time through a wholesaler."

NYCM officials further asserted that MERC's excess policy was purchased jointly with another NYCM trust in "an attempt to gain volume pricing by the excess carriers to reduce costs for each program." They added that the dramatic increase in excess insurance costs were attributable to several factors, including "growth of the Trust over the years and hard market subsequent to 9/11."

The Trust's audited financial statements show that excess insurance costs increased from \$393,451 (4.99% of reinsurance cost/contributions) in 2004 to \$843,362 (11.50% of reinsurance cost/contributions) in 2005, a 114% increase.

It appears NYCM was becoming cost-conscious about the rising cost of excess insurance, particularly in light of the Trust's growing deficit and attempted to mitigate these costs through the purchase of the corridor plan. However, NYCM neither sought, nor obtained the WCB's prior approval and subjected the Trust to increased liability in the event excess claims reached the uncovered insurance layer.

Payments to The Aegis Group of Central New York

As referenced above, The Aegis Group of Central New York ("Aegis") placed excess insurance on behalf of the Trust. Trust records reveal that the Trust made premium payments from 1994-2004 to Aegis for excess insurance and fidelity insurance.⁵⁸ Additionally, Aegis received broker commissions of at least \$14,681.43 from 2002-2007 for the placement of Members into the Trust.

New York State Department of Financial Services records identify Aegis as a licensed property/casualty broker and agent, and its current President as Edwin H. Olmstead, a licensed property casualty broker since November 4, 2000. Rumsmoke advised SaxBST LLP that Ed Olmstead (Edwin L.) from NYCM (and a non-voting MERC Trustee) was an owner of Aegis, and that Olmstead's son (likely Edwin H.) and daughter bought the firm from him.⁵⁹ This was confirmed in NYCM's response.

⁵⁸ Aegis would have received any commission payments directly from the excess and fidelity insurance carriers.

⁵⁹ We did not determine the date of this purported purchase.

Available Trustee minutes and other records reviewed by SaxBST LLP do not reflect any disclosure by NYCM to the Trustees of this less-than arm's-length relationship between a MERC vendor, senior NYCM official, and most importantly, a non-voting Trustee. While there was no evidence brought to our attention that the payments to Aegis were either unwarranted or excessive, we believe the apparent failure of Olmstead and NYCM to affirmatively disclose this relationship to the voting Trustees constitutes a noteworthy ethical lapse or a deliberate attempt to conceal this relationship.

Payments to Lake Effect Claims Services, Inc.

The 2001 Administration Services Agreement (items 1a-g) referenced above provided for NYCM to perform claims management services and to be compensated for these services as part of its 20% of member contribution fee. Evidence shows, however, that claims management was actually performed by two outside vendors, initially Utica Mutual, and subsequently Lake Effect Claims Services, Inc. ("Lake Effect"), the latter being a wholly-owned NYCM subsidiary.⁶⁰ Reports prepared on behalf of the WCB indicate that Lake Effect performed similar fee-based services for NYCM's AUTO and Manufacturing Trusts.

Available accounts payable records reviewed by SaxBST LLP do not reflect Trust payments to Utica Mutual, and SaxBST LLP could not determine the related fee structure and whether the costs were incurred by NYCM, or the Trust itself. SaxBST LLP did identify Trust payments to Lake Effect of approximately \$1.3 million for the period July 18, 2002 to February 5, 2007.⁶¹ We are unable to determine what payments, if any, were made to Lake Effect prior to July 18, 2002. However, it is clear that the Trust incurred unnecessary costs for claims administration and, in effect, paid twice for the same services. As such, these additional costs contributed to the Trust's deficit condition. Moreover, as will be discussed in greater detail in Section M - Claims Handling of this report, the claims services provided by Lake Effect were replete with overpayments and under billings to vendors, and the incurring of unnecessary expenses.

Available meeting minutes reviewed by SaxBST LLP revealed no discussion of Lake Effect with the Trustees, or discussion relating to the duplicative claims management fees paid by the Trust. It is unclear the extent to which the Trustees were aware of the relationship between NYCM and Lake Effect. Trustee Vella recounted to SaxBST LLP that NYCM was the Trust's claims administrator.

WCB's Level II report dated March 29, 2004 for the period ending December 31, 2004⁶² identifies NYCM as the Trust's claims administrator and makes no reference to Lake Effect. Two things become seemingly apparent from this. First, NYCM did not affirmatively disclose to the reviewers the role of Lake Effect in the claims administration process or the related fees.

⁶⁰ NYCM's website on April 18, 2001 contained the following narrative: "New York Compensation Managers, Inc. and its wholly owned subsidiary Lake Effects Claims Service administer workers compensation programs for several hundred employers and municipalities." Rumsmoke confirmed to SaxBST LLP that Lake Effect had "an overlap of ownership with NYCM."

⁶¹ SaxBST LLP's claims consultant, KBM, found payments to Lake Effect of approximately \$1.14 million.

⁶² The WCB retained PricewaterhouseCoopers, LLP to assist in this review.

Second, the participation of Lake Effect in the process may have been in name only, as the reviewers did not appear to independently identify anything referring to Lake Effect during their interviews or file reviews.

Additionally, the Trust's audited financial statements also make no reference to this obvious and long-standing related-party transactional relationship until 2006 when the following reference was made in Note H:

Claims are administrated by an entity that is 100% owned by the management company noted above. Fees paid to this entity are included in professional and administrative fees and were \$218,000 and \$317,000 in 2006 and 2005, respectively. Amounts due to this entity included in account payable at December 31, 2006 and 2005 were \$3,362 and \$0, respectively.

The audited financial statements for 2007 and 2008 make similar disclosures. The 2007 statement does not specify the fees paid specifically for claims administration, noting the fees were included in the total administrative fees reported. The 2008 statements report that \$102,316 was paid in 2008 for claims administration.

It is noteworthy that the Trust's general ledger reports NYCM's administrative fees in the "5300-Management Fee" expense account while the payments to Lake Effect were charged to "5110-Losses Paid" suggesting that the Trust made separate payments for claims services already covered under NYCM's Administration Agreement.

In response to SaxBST LLP's inquiry relating to the payment of claims handling fees, NYCM offered the following explanation:

Services were performed by outside vendor Utica Mutual and showed up on individual claims and loss runs and financial statements. Later same arrangement with Lake Effects Claims Services.

It is important to note that by serving as both MERC's Group and Claims Administrator, NYCM and Lake Effect were in a position to manipulate individual case reserves to portray the Trust in the most favorable financial light, thereby preserving their own financial interests as Group Administrator for MERC, and for the other NYCM trusts. This dual role has been viewed by many in the industry as inherently conflicted, and some jurisdictions, such as the State of California, and the State of New York as of 2013, prohibit program administrators from having a financial interest in a claims administrator. The potential conflict is further worsened by the fact that as Group Administrator, NYCM coordinated the Trust's actuarial services, thereby having influence in establishing the Trust's reserve liabilities. This will be discussed in more detail in the Actuarial and Claims Handling sections of this report.

Concerning this potential conflict of interest, NYCM stated "all parties and regulator were aware of relationship." This relationship notwithstanding, we must seriously question the propriety of

NYCM approving over \$1.3 million payments to Lake Effect relating to services for which it was already being compensated pursuant to the Administration Agreement.

SaxBST LLP's claims consultant, KBM Management, Inc. (KBM), similarly identified and questioned the payments made to Lake Effect, and their observations relating to NYCM's claims administration practices will be detailed in Section M.

License Non-Renewal/Revocation

WCB records reflect that Lake Effect's New York State third party administration license expired on December 31, 2010. By letter dated January 4, 2011, NYCM COO Chris Mason wrote to the WCB advising that "Lake Effect Claims Service no longer represents self insured groups and accordingly will not be seeking renewal of its Third Party Administration license." Mr. Mason was the Qualifying Officer for both NYCM and Lake Effect Claims Services, Inc.

USA-TPA's license, # 1214, to represent claimants pursuant to Section 50 (3-b) of the Workers' Compensation Law (WCL) expired on June 30, 2011, and USA-TPA filed a renewal application to the WCB on June 6, 2011. On October 19, 2011, USA-TPA COO and Qualifying Officer Chris Mason appeared before the WCB for an oral interview pursuant to WCL 50 (3-b) (b) and 12 NYCRR 302-1.4. Mason produced, through his attorney, certain documents to the WCB following the interview.

In a letter dated May 15, 2012 (Exhibit 8), the WCB notified Mason that based on its review of the documents and transcripts of the October 19 interview, the WCB's full Board of Commissioners approved a WCB review panel's recommendation not to renew the license for USA-TPA and Mason, as proposed Qualifying Officer, for failing to meet the standards and requirements of WCL 50 (3-b) and 12 NYCRR 302 *et al* by:

1. Improper billing practices in connection with the Manufacturing Self-insurance Trust (MSIT).
2. Manipulation of administrative fees for MSIT.
3. Use of a reserving methodology that was inadequate and caused financial harm to clients.
4. Conducting financial transactions to the detriment of clients with respect to security deposits.
5. The making of statements by Mr. Mason during the interview, and in the November 11, 2011 and March 9, 2012 responses, which were inconsistent with official documents, filings and written submittals from USA-TPA and/or New York Compensation Managers, Inc. (NYCM) and/or Lake Effect Claims Service (Lake Effect) and on the USA-TPA website. USA-TPA, NYCM and Lake Effect are inextricably intertwined such that statements made to the contrary were false and misleading.

In summary, the documents reviewed and the interviews conducted show that:

- NYCM played a prominent role in the establishment of MERC in 1994, including the preparation of key Trust formation documents such as the Trust Agreement.
- NYCM was delegated the complete range of management, administrative, and claims handling duties on behalf of the Trust that is not atypical for a group administrator. However, NYCM exercised a high degree of control over the Trust's activities due to the absence of active Trustee participation and strong Trustee leadership and oversight.
- NYCM served as the group administrator from 1994 to 2001 without a written agreement with the Trust specifying its duties or fees, thereby having substantial discretion in executing its duties as Group Administrator.
- SaxBST LLP found no evidence that the 2001 Administration Agreement was vetted by independent legal counsel on behalf of the Trustees to ensure its compliance with laws, rules, regulations and good business practices.
- The term of the 2001 Administration Agreement had an unusually lengthy ten (10) year initial term with a five (5) year renewal option.
- There was no periodic, competitive process undertaken by the Trust to determine or help ensure that fees paid to NYCM were competitive.
- NYCM served concurrently as the Trust's Group Administrator and Claims Administrator creating the potential for a conflict of interest whereby individual claims reserves could be established for the financial benefit of NYCM and not the Trust.
- NYCM improperly authorized Trust payments to an affiliated entity, Lake Effect Claims Service, of approximately \$1.3 for claims administration functions for which it already was being compensated pursuant to the Administration Agreement. This less than arms-length transaction was not disclosed in the Trust's audited financial statements until 2006.
- NYCM failed to inform the WCB of changes to excess insurance coverage in violation of Section 317.2(b) NYCRR. While purchase of a corridor plan was a cost saving measure, the Trust was exposed to increased retention liability without the knowledge of the WCB, the Trustees or the Members.
- NYCM entered into a less-than arm's-length business relationship with Aegis Insurance Group that was owned and operated by a senior NYCM official and non-voting Trustee. NYCM failed to disclose this relationship to the Trustees.
- NYCM purchased an excess insurance corridor plan without Trustee approval.

D. Actuary - Financial Risk Analysts, LLC

12NYCRR Section 317.19 requires, in part, all Trusts to submit on an annual basis an actuarial report certified by a qualified actuary verifying claims as defined in 12NYCRR Section 317.2c and the method of calculating such claims be based upon accepted actuarial standards of practice.⁶³

The actuarial reports provided an estimate of MERC's reserve liabilities and expenses, which then allowed the NYCM and the MERC Trustees to evaluate the reasonableness of Member premiums, discounts and dividends. The cost of the Member premiums, and up-front premium discounts directly influenced which employers joined MERC, as employers seeking coverage tend to select the carrier offering the lowest premium, and highest discount potential.⁶⁴ Furthermore, these factors also had a direct impact on NYCM's revenues, as lower premiums, higher discounts and better dividend potential encouraged more employers to join, generating additional revenues for NYCM.

NYCM, pursuant to its Administration Agreement with MERC, was responsible for coordinating required professional services. NYCM procured the services of Financial Risk Analysts, LLC, (FRA) an actuarial consulting firm with offices in Vernon, Connecticut and Davidson, North Carolina. FRA prepared independent actuarial reports on behalf of MERC for the fiscal years ended December 31, 1995 through December 31, 2010.⁶⁵

Available Trustee meeting minutes indicate that a FRA representative never attended a Trustee meeting and that all communications between FRA and the Trustees was handled through NYCM. Trustee Vella did not recall the Trust actuary's name when interviewed, but indicated Trust reserves were discussed by NYCM at the Trustee meetings. Available meeting minutes indicate that the actuary's reports were provided to the Trustees but reflect minimal discussion of the reports before 2005, and little thereafter.

Documents reviewed by SaxBST LLP reveal the loss reserve amounts reported on the Trust's audited financial statements were within a reasonable range estimated by the Trust's actuary.

Pursuant to current WCB policy, as long as a trust is at least 90% funded, the WCB does not implement remediation procedures for that trust. These remediation procedures include limitation or elimination of the amount of allowable discounts provided to existing members and/or the restriction or elimination of the number of new Members allowed to participate in the trust. These procedures are designed to restore the trust to a funded position and/or limit the exposure of additional members to an under-funded trust. This fact was known to NYCM and is important for several reasons.

⁶³ The rules became effective January 31, 2001.

⁶⁴ This was confirmed through interviews with certain members.

⁶⁵ FRA provided actuarial services to NYCM's Manufacturing Trust for the period 2003-2006.

First, in the event that the WCB implemented these procedures for a NYCM administered trust, such as MERC, the procedures would have had the effect of substantially reducing the fees earned by NYCM and its insurance broker/agent network. This is because administrative fees were based upon the number and size of participants in the Trust, and if the Trust was precluded from accepting new Members, or was effectively priced as unattractive to current Members by virtue of the reduction or elimination of discounts, the fee base could dramatically decrease.

Second, fees were earned fees based upon “member contributions” for a particular Member. As fees would remain the same whether or not a particular Member received a large discount or no discount whatsoever, there existed no economic disincentive to provide the greatest possible discounts to Members regardless of whether or not the ensuing premiums collected were sufficient to meet the actuarially determined necessary reserves. Thus, there was a financial incentive for NYCM to have MERC appear to be at least 90% funded and for reserves to be set as low as possible. However, as detailed above, the reserves reported on the Trust’s audited financial statements were generally within a reasonable range of that estimated by the actuary, and therefore, unless incorrect information was being provided to the actuary, the reserves as reported appear to have been reasonable.

The definition of trust assets and liabilities defined in NYCRR Title 12, Section 317.2 differs from that provided for in Generally Accepted Accounting Principles (GAAP), and accordingly, a group’s regulatory funding position may differ, in some cases significantly, from the financial statements prepared in accordance with GAAP.

Evidence indicates that the WCB had identified concerns regarding the Trust’s reserving practices over the years. The WCB Level II review conducted by PwC for the year ended December 31, 2002, reported that the Trust’s reserves were “inadequate by a range from \$617,000 (low estimate) to \$1.08M (high estimate).” Based upon these findings, the WCB adjusted the Trust’s reserves presented by \$617,000, from \$2.3M up to \$2.9M. In a response to the WCB, NYCM objected to this reserve adjustment.

The WCB made no adjustments to the Trust’s reserves for the year ended December 31, 2003, but did increase the claims reserve liability by \$2,193,000 for the year ended December 31, 2004.⁶⁶ The WCB further questioned the Trust’s reserving practices in its 2004 report as follows:

...in almost every twelve month development phase, the development factor selected for this Trust is lower than, or at least very close to, the Industry factor; in some phases significantly lower. Therefore, the basis for the management decision to deviate from actuarial projections does not appear to be warranted.

For the year ended December 31, 2005, the WCB found the reserves “to be in a reasonable range of actuarial estimate,” but did find the use of a 5% discount rate as possibly “too optimistic” and

⁶⁶ The Trust’s reserve was \$2,193,000 below the lowest acceptable reserve amount.

that “the actual earning capacity may be somewhat limited since the Trust is underfunded.” For the years ended December 31, 2006 and 2007, the WCB again found the Trust’s reserves to be acceptable, but similarly cautioned the 5% and 4% discount factors used for those years respectively because of the Trust’s continuing underfunded condition.

We were not made aware of any third-party actuarial analysis of the Trust being requested by NYCM or the Trustees during the life of the Trust.

As part of our analysis, SaxBST LLP retained By The Numbers Actuarial Consulting, Inc. (BYNAC), to review the Trust’s actuarial reports and audited financial statements for the period 1996-2010, and provide an expert analysis of these documents. The BYNAC report to SaxBST LLP, dated January 28, 2013, (see Exhibit 9) offered a number of observations, none of which would have had a material impact on the estimates calculated by FRA.

Based on the foregoing, evidence indicates that NYCM made decisions regarding the setting of the Trust’s reserves with minimal Trustee input. Trustee meeting minutes show little discussion of Trust reserves by NYCM. Communications to and from the actuary were channeled through NYCM and the actuary never attended Trustee meetings where direct dialogue between the Trustees and actuary could occur. No independent assessment of the Trust’s reserving practices was performed by the Trustees, nor apparently suggested by NYCM.⁶⁷

E. Independent Auditors - Kruth, Stein, Squadrito, Liberman & Silverman, CPA’s, LLP

12 NYCRR Section 317.19 requires, in part, all Trusts to submit audited financial statements prepared in accordance with Generally Accepted Accounting Principles (GAAP) and certified by an independent certified public accountant.⁶⁸ The largest liability and expense appearing on MERC’s financial statements relate to the Members’ claims (loss reserves); accordingly, these account balances at any point in time are material to the overall fairness of the financial statements.⁶⁹

Individual claim loss reserves appear to have been established by NYCM upon notification and examination of the injury claims filed by its Members. The loss reserve amounts established by NYCM were, in turn, relied upon by MERC’s actuary when estimating loss reserves that were used as the basis for reporting the claim liability and expense on the financial statements prepared by NYCM. MERC, through NYCM, engaged Kruth, Stein, Squadrito, Liberman & Silverman CPA’s, LLP (“Kruth”) to conduct an annual audit of MERC’s financial statements.⁷⁰

⁶⁷ The Trustees of a number of other trusts reviewed by SaxBST LLP on behalf of WCB commissioned independent actuarial reviews to assess the adequacy of trust reserves.

⁶⁸ The rules became effective January 31, 2001.

⁶⁹ The loss reserves represent the amount that NYCM believes MERC will have to pay out as a result of injury claims.

⁷⁰ Kruth merged with D’Arcangelo & Co., LLP in January 2012, and operates under D’Arcangelo & Co., LLP with seven offices located in New York State. According to NYCM, Kruth also prepares NYCM’s tax returns.

Rumsmoke told SaxBST LLP he did not know how Kruth was selected as the Trust's independent auditor but did recall that Kruth provided similar services to other NYCM trusts.

Available Trustee meeting minutes show that a Kruth representative meet in person with the Trustees only in 2003, 2009 and 2010 to discuss the audited financial statements.⁷¹ Records show that annual and interim financial information was presented by NYCM to the Trustees. In the earlier years this was done by Olmstead or Francey, and beginning in 2005 by Ed Coombs. Available minutes do not reflect formal annual Trustee approval of the Trust's audited financial statements.

Inherent within GAAP is the principle of conservatism, which requires the preparers of financial statements to make evaluations and estimates, to deliver opinions, and to select procedures, and to do so in a way that neither overstates nor understates the affairs of the business or the results of operation.

While NYCM had the responsibility to apply the concept of conservatism, it was the independent auditor's responsibility to determine whether the claims liability/expense amounts reported by NYCM were not materially misstated, and opining on the overall fairness of MERC's financial statements. During the periods ended December 31, 1995 through December 31, 2010, the independent auditor concluded that NYMPT's financial statements were presented fairly, in all material respects. For the periods ended December 31, 2005 and 2006, Kruth noted that, due the possibility of the Trust having its self-insurance license revoked because of its ongoing deficit position, there is "substantial doubt about the ability of the Trust to continue as a going concern."

In conducting its audit, the independent auditor was obliged to follow Generally Accepted Auditing Standards (GAAS) used in the United States. Statements on Auditing Standards (SAS) provide guidance to auditors on GAAS in regard to auditing an entity and preparing a report.

SAS 73, *Using the Work of a Specialist*, requires the auditor to evaluate whether the specialist's findings support the assertions in the financial statements. SAS 73 applies to various specialists, including actuaries such as FRA's. Accordingly, if the auditor believed FRA's findings (claims reserves) were unreasonable;⁷² the auditor should apply additional audit procedures, which may include obtaining the opinion of another actuary.

As noted above, SAS 73 requires the auditor to evaluate whether a specialist's (including actuaries') findings support the assertions in the financial statements. Accordingly, if the auditor believed FRA's findings (claims reserves) were unreasonable, the auditor should have applied additional audit procedures, which may include obtaining the opinion of another actuary.

SaxBST LLP obtained and reviewed selected work papers prepared by Kruth which supported their opinions concerning the 2006 through 2010 audited financial statements.⁷³ The work

⁷¹ NYCM stated that the auditor presented the audited financial statements to the Trustees annually.

⁷² The Trustees relied on the claims reserves set by NYCM based the amounts reported by the actuary.

⁷³ The work papers were furnished by D'Arcangelo & Co., LLP.

papers indicate that they reviewed and tested certain aspects of the actuary’s report and evaluated the credentials of the actuary.

F. Marketing

The success of any group self-insurance plan relies, in part, on its ability to attract and differentiate itself from its competitors and offer favorable rates to Members with good loss histories. As Group Administrator, NYCM had primary responsibility for marketing activities. Section 1(r) of the 2001 Administration Agreement provides for NYCM to “use its best efforts to market and promote the Trust members and assist in the implementation and coordination of such program to insure its ongoing success.” The Agreement provides for no separate fees for these services.⁷⁴

Section 317.17 of the NYCRR, effective January 31, 2001, requires prospective group members be fully advised of their rights and responsibilities of participating in the group, and that no “material misrepresentation or omission of a material fact” be presented to prospective group members.⁷⁵ In addition, insurance brokers involved in the solicitation process must be duly licensed by the Insurance Department (now the NYS Department of Financial Services). Section 317.18 requires that the marketing materials of self-insurers be factual, truthful, accurate and verifiable, and not be deceptive, misleading, or coercive.⁷⁶

Similar to most other group self-insured trusts, MERC was “broker-driven” in that the primary source of marketing was through a network of licensed insurance brokers/agents (collectively, “brokers”). Trust records show this included approximately 80 licensed brokers located across New York State. Records further indicate that brokers signed an Agent Information & Commission Agreement (“Commission Agreement”) with NYCM. A sample 2003 Commission Agreement reviewed by SaxBST LLP specified the broker’s responsibilities as follows:⁷⁷

1. Solicit, receive, and transmit to the trust administrator applications for participation in one of our self-insured trusts.
2. Explain to prospective clients what a self-insured trust is how it operates and the significance of joint and several liability.
3. Submit to trust administrator any material necessary to underwrite their prospective client pursuant to the Underwriting Guidelines of the Trust Administrator.
4. Upon authorization from New York Compensation Managers submit original completed and signed Workers' Compensation Board form GS 1.1 and the Trust

⁷⁴ The 2008 Agreement does not address marketing as the Trust was in run-off status.

⁷⁵ Prior rules and regulations did not address these marketing-related issues.

⁷⁶ On April 18, 2001, NYCM officials testified at a WCB Section 111 Hearing relating to possible marketing material irregularities for another NYCM trust. SaxBST LLP is unaware of the outcome of these proceedings.

⁷⁷ The Commission Agreement did not identify MERC and is likely a generic document used for all of NYCM’s trusts.

Participation Agreement for approval by the Workers' Compensation Board along with the first month's contribution payment.

The sample Commission Agreement further provided for a (5%) commission on net collected premium, and for the first twelve (12) months following the commencement date of coverage, an additional five percent (5%) commission on net collected premium.⁷⁸ NYCM officials confirmed that brokers received "10% on new business and 5% on renewal."

With the exception for the years 2005-2007, the Trust's audited financial statements reported brokers' commissions paid as part NYCM's total professional and administrative fees paid. The 2005-2007 audited financial statements separately reported commissions totaling \$363,999, \$424,182, and \$250,670, or 5%, 5%, and 4% of total contributions for these years, respectively. Records indicate commissions were paid on a monthly basis. These commissions appear to be consistent with industry standards.

Available Trust payment records also reflect modest payments totaling approximately \$11,600 to vendors for marketing-related services such as brochures, newsletters, and advertising.

Rumsmoke told SaxBST LLP that NYCM marketed to agents through an agents' association, and confirmed payments to them were on a commission basis. He recalled that NYCM produced marketing materials on how trusts were formed and operated, but did not recall if the Trustees reviewed the materials. He had no copies of such materials to share. NYCM officials advised SaxBST LLP that initially, the Trustees solicited Members by word of mouth, and then the Trust then went to agency system so brokers marketed to new Members. NYCM itself employed marketing representatives to market to brokers, and not directly to Members.

Records and interviews indicate that the Trust was also marketed as an endorsed insurance product through various trade group associations, such as the National Retail Hardware Association. Documents reflect that the National Retail Hardware Association in mid-2006 was exploring with the WCB opportunities for its 82 participating Trust Members (reportedly representing \$450,000-\$500,000 in premium) to leave the Trust because of its poor financial condition. The WCB met with the Association's CFO/COO⁷⁹ and Trustee Green, an Association Member to discuss these alternatives.

The offering of discounts was a major marketing tool employed by NYCM to attract new Members. NYCM's website in 1998 advertised "Our group members' pay up to 40% less than state published rates." Members and brokers interviewed concurred that low premiums was the major factor for joining the price. One broker candidly indicated that despite the joint and several liability obligations, his clients were shopping for "price, price, price."

⁷⁸ Net collected contribution was defined as "gross collected premium less cancellations and return contributions according to the trust administrators books and records."

⁷⁹ SaxBST LLP attempted to contact the Association's CFO/COO via email for an interview, but was unsuccessful.

Available Trustee meeting minutes reflect limited discussion of marketing issues with the Trustees. Minutes for August 15, 1995 report that NYCM asked Members to use personal contacts to market the Trust. Minutes for January 18, 1996 note Olmstead saying “There is an obligation of all members to encourage growth.”

Trustee Vella recalled that his company dealt directly with NYCM upon joining the Trust and not through an insurance broker. He said most Members early on similarly joined directly through NYCM, but brokers later became increasingly involved.⁸⁰ Vella indicated that he was made aware of joint and several liability upon joining, but this was not identified by anyone as a potential problem area.

Members interviewed recalled joining the Trust thorough an agent, through the Hardware Association,⁸¹ or through word-of-mouth from other grocers. Most Members noted they joined due to the lower premium costs, adding that their premium costs were reduced upon joining the Trust.⁸² They did not recall receiving any marketing materials. Some Members recalled being informed of their joint and several liability obligations, while others had no recollection of being informed.

Trust records reveal that beginning in or around 1996, Members signed a Participation Agreement upon entering the Trust agreeing, inter alia, to the terms of the Trust documents and acknowledging their joint and several liability (Exhibit 10). Therefore, it appears Members were appropriately advised of their responsibilities and obligations as a Member. One broker, whose firm represented a number of Hardware Association Members, advised SaxBST LLP that his agency specifically advised its clients who entered any self-insured trust, in writing, of the risks associated with joining a trust.

As previously noted, the original Supermarket & Grocers Insurance Trust was limited to food retailers. From inception through the end of 2000, the Trust had attracted only 84 Members, or about 14.2 % of its eventual total membership of 575. In February 2001, the WCB approved a Trust request to expand the Trust’s homogeneity requirements and to rename the Trust, Mercantile Self-Insurance Trust.⁸³ With its expanded eligibility criteria, the Trust grew dramatically between 2001 and 2004, adding 487 new Members, or 85% of its total membership. This growth appears to have been facilitated by greater use of the broker/agent network.

In late 2004 and early 2005, the Trust’s rapid growth came to an abrupt halt with the formation of another NYCM trust, Automotive Service and Repair Self-Insurance Trust (“AUTO”), effective January 1, 2005. The WCB had previously approved the inclusion of automobile service and repair employers into MERC with the understanding NYCM would establish AUTO

⁸⁰ Records show that commission payments to brokers begin in or around 1999, consistent with Vella’s recollection. In addition, minutes for June 22, 1999 report the Trustees approving the Trust to “start paying a 5% percent commission to Agents.”

⁸¹ This Member indicated the Association marketed the product.

⁸² NYCM’s website in 1998 advertised “Our group members pay up to 40% less than state published rates.”

⁸³ The WCB rejected another Trust request in 2003 to again expand its homogeneity criteria.

by January 1, 2005 because of concerns relating to MERC's deficit position. The inclusion of this group of employers greatly contributed to MERC's swift expansion the previous few years. With AUTO's formation, MERC's continued deficit position, and the WCB's related membership restrictions, only four (4) new Members joined MERC between January 1, 2005 and February 29, 2008.

MERC lost 145 Members in 2004, approximately 100 of them going to AUTO on or about January 1, 2005. MERC lost an additional 105 members in 2005 and 2006, resulting in MERC losing 43% of its total Members in that 3-year period. However, despite the dramatic loss of Members, Member contributions increased from \$7,332,976 in 2005 to \$9,160,560 in 2006. However by 2007, contributions had decreased to \$6,988,160.

Minutes for May 9, 2007 reflect NYCM's description of this situation to the Trustees. NYCM noted that while the number of active Members dropped from 241 to 112, the average experience modification (emod) dropped from .96 to .90, making for a "better performing" group overall. Although this may be true, the Trust was still carrying the accumulated debt from the prior years, now with a reduced revenue stream.

We were unable to obtain sample copies of any marketing materials used by NYCM or the brokers to solicit new Members. However, marketing materials examined as part of the WCB's Level II Review in 2002 concluded that the materials "are free of any falsehoods and/or misrepresentations." The WCB also found that no independent complaints had been filed with the WCB regarding the Trust's marketing practices. NYCM commented to SaxBST LLP relating to its marketing material: "In light of regulatory requirements, every effort was made to be truthful and accurate." However, the promise and offering of low rates and discounts, in the final analysis, may have been misleading in that the early benefits derived from these were offset by subsequent Member assessments.

As previously discussed, Members reported to SaxBST LLP that communications to/from the Trust was largely channeled through the broker/agent network, and that information regarding the Trust's financial problems in some instances came to them only after the assessments had become a *fait accompli*.

In summary, the documents examined and the interviews reveal the following:

- NYCM effectively used a network of brokers/agents and professional associations to rapidly grow the Trust from 2001-2004. The promise and offering of low rates and discounts to entice membership, however, became unsustainable over time as losses mounted and revenue dropped.
- The commissions paid to the brokers/agents appear to have been reasonable and within industry standards.

- In some instances, Members may not have received from their brokers/agents timely information regarding the Trust's poor financial condition thereby hindering the Members' ability to adequately evaluate the benefit of their continuing membership in the Trust.

G. Underwriting

Prudent business practices dictate that Member underwriting criteria be established, documented, and re-evaluated over time. We found the Trust established underwriting guidelines and applied these guidelines over the course of the life of the Trust, but not always in a consistent manner.⁸⁴

The 1994 Trust Agreement generally defines employer eligibility criteria as follows:

- (1) Are, or shall hereafter become, engaged in the retail distribution and sale of food products.
- (2) Are accepted as participants in this Trust by the Trustees in accordance with the terms of this Agreement.
- (3) Signify a desire in writing to become a participant in this Trust and agree in writing to be bound by the terms and provisions of this Trust Agreement and any duly adopted regulations of the Trustees.

The 2001 Trust Agreement identifies eligible employers as those engaged in the business of retail sales of goods, subject to any further qualifications established by the Trust's By-laws. The 2001 Bylaws set forth the following qualifications for Trust participation:

- 1) Be an employer within the meaning of the New York Workers' Compensation Law, doing business in the State of New York.
- 2) Be engaged in the business retail or wholesale sales of goods and having or qualifying for specified Standard Industrial Classification Codes.
- 3) Meet the qualifications for participation as established by these Bylaws, the Declaration of Trust, and the Participation Agreement.
- 4) Meet the underwriting criteria for participation adopted by the Trust and any insurer providing a contract of insurance for the Trust.
- 5) Satisfy the requirements for participation established by the Chair of the New York Workers' Compensation Board.

As provided by the By-laws, the Trust adopted Member underwriting criteria. In his interview with SaxBST LLP, Trustee Vella did not recall if there were specific underwriting criteria, but he believed loss history and safety programs played a role in the process. He had no recollection of Trustees being involved in approving new Members. Rumsmoke indicated Trustees were informed of applicants at their meetings. In addition, he was not sure what specific underwriting guidelines were used, but recalled that "underwriters and managers prepared the guidelines after

⁸⁴ The Trust must also adhere to the underwriting guidelines established by the excess insurance carrier.

the WCB started to require them around 2001.” He believed “some applications were rejected, for example if the applicant applied to the wrong trust or didn’t meet the WCB criteria.”

NYCM explained to SaxBST LLP that applicants were “rejected for a variety of reasons: class codes, loss history, contribution amount, lack of loss control, etc.” NYCM also noted that it recommended underwriting guidelines to the Trustees consistent with excess carrier criteria, and that the “Trustees authorized NYCM to approve new members.” NYCM provided SaxBST LLP with undated written underwriting guidelines purported to be in effect in 2006. The guidelines are as follows:

- 1) New York operations only.
- 2) Should have a current experience modification of 1.25 or less. (Refer exceptions to Underwriting)
- 3) Should have four year loss ratio of less than 65%.
- 4) Should have a minimum of three (3) years in business.
- 5) Acceptable financial condition as indicated by current financial statements.
- 6) Should have an active return to work and light duty program.
- 7) Should be willing to work closely with our Loss Control and Claims/Case Management Departments to help control exposures.
- 8) Predominant exposures should be in Industry Groups within the following SIC codes:
 - Major Group 52 (Building Materials, Hardware, Garden Supply and Mobile Home Dealers)
 - Major Group 53 (General Merchandise Stores)
 - Major Group 54 (Food Stores)
 - Major Group 56 (Apparel and Accessory Stores)
 - Major Group 57 (Home Furniture, Furnishings and Equipment Stores)
 - Major Group 58 (Eating and Drinking Places)
 - Major Group 59 (Miscellaneous Retail)
 - Major Group 50 Wholesale Trade Durable Goods
 - Major Group 51: Wholesale Trade Non-Durable Goods
- 9) Exceptions are to be discussed with Underwriting Department.

These guidelines are substantially consistent with the only other written guidelines found by SaxBST LLP, a copy submitted by NYCM as part of its 2003 excess insurance application.⁸⁵ The 2003 version included a minimum \$15,000 manual rated premium requirement while the latter did not.

The WCB’s 2002 level II Review report explained NYCM’s underwriting process as follows:

In general the underwriting guidelines of the Trust require that the applicant have an experience modification factor of 1.25 or less. However, the Group

⁸⁵ These guidelines are consistent with those identified by the WCB’s Level II Review in 2002.

Administrator does make exceptions where an applicant can show that the higher experience modification factor is due to one unusual accident loss or if the higher rating is due to the fact that the applicant did not have a safety program in place in the past, but has since implemented a program. In order to accept an applicant with a higher modification, the Group Administrator must obtain approval from the excess insurance carrier. In addition, the Director of Underwriting must approve the experience modification factor used.

While the above evidence suggests formal guidelines were established, available Trustee meeting minutes reflect no official Trustee approval of the underwriting guidelines. NYCM appears to have had a great deal of autonomy in accepting or rejecting new Members into the Trust with little to no Trustee input or oversight.

Concerning required documentations from applicants, NYCM officials said they required “whatever WCB requested, loss runs when available, experience modifier, prior insurance carrier information etc.” Consistent with the Level II Review’s findings, NYCM added that exceptions were made to these criteria for “extenuating circumstances” such as a “high loss ratio caused by 1 shock loss.”

SaxBST LLP reviewed a judgmental sample of Member files to determine if the Members had the minimum three years in business upon joining the Trust. We identified at least eight (8) Members not meeting this requirement. Records suggest one Member, Aurora Group, was incorporated on May 17, 2004 and admitted to the Trust effective the next day, May 18, 2004. Three additional sample Members were in operation 2.5 months or less before joining the Trust. Not only did these Members not meet the Trust’s underwriting criteria, but their lack of loss history against which their risk could be properly assessed, unnecessarily exposed the Trust to possible financial liability.

We were missing a number of payroll audit documents hindering a complete analysis of Member experience modifications. However, based on our review of available payroll records we found that overall, proportionally few of the Trust’s Members had experience modifications in excess of the 1.25. Our limited file review did identify twenty-two (22) Members having an emod in excess of 1.25 for at least one year. Five (5) of these members had an emod in excess of 1.25 for at least two consecutive years. Two (2) Members had an emod in excess of 1.25 for three consecutive years, and one (1) Member had an emod in excess of 1.25 for four consecutive years. Seven (7) Members received a premium discount in at least one year in which their emod exceeded 1.25. Two (2) Members received a discount for two consecutive years in which their emod exceeded 1.25. Three (3) Members were assessed a surcharge of 10%, 18% and 20%, respectively.

Industry experts interviewed (including an actuary) advised SaxBST LLP that it is not a common industry practice for trust members to retain the same experience modification rate (emod) for several consecutive years. Emods typically, but not always, fluctuate from year to year based on

losses incurred, and classification and gross payroll changes. Our analysis showed a surprising number of Members that retained the same emod for multiple consecutive years as follows:

- 181 or about 32% of the total Trust Members had that same emod for at least 3 consecutive years;
- 80 Members had that same emod for 3 consecutive years;
- 44 Members had that same emod for 4 consecutive years;
- 21 Members had that same emod for 5 consecutive years;
- 28 Members had that same emod for 6 consecutive years;
- 2 Members had that same emod for 7 consecutive years; and
- 6 Members had that same emod for 8 consecutive years.

We further determined that Members, with the full range of contribution levels, retained the same emod for 3 or more consecutive years. In addition, it is interesting to note that we found that at least 31 or 17% of the 181 Members were hardware stores,⁸⁶ most of whom had an emod of an even 1.00 for multiple consecutive years. This could suggest this group of Members was given some form of special consideration by the Trust, though we have no direct evidence to that effect.

In summary, the documents reviewed and the interview results show that:

- The Trust adopted standard underwriting criteria years after the Trust was formed to assess the suitability of applicants to join the Trust; however, NYCM applied these criteria inconsistently;
- The Trustees delegated all underwriting decisions to NYCM and were not involved in decisions regarding the suitability of applicants for membership;
- NYCM approved applicants with less than three years' business experience in violation of the Trust's underwriting guidelines, exposing the Trust to unnecessary liability;
- NYCM permitted Members with experience modification rates greater than the 1.25 underwriting threshold to remain in the Trust, and receive premium discounts; and
- Approximately 33% of total Trust Members retained the same emod for at least 3 consecutive years raising a serious question as to the efficacy of NYCM's underwriting and renewal processes.

⁸⁶ These Members had "Hardware" as part of their business name. Other hardware establishments without this moniker may have been part of the 181 Member group but were not included.

H. Discounts/Dividends

Premium discounts are typically one of the methods used to attract potential members into a group self-insured trust.⁸⁷ Given the highly competitive market for workers' compensation insurance, it was important that MERC offer competitive discounts to prospective Members and current Members, especially those Members with low loss rates. The success of any group self-insured trust is, in part, due to the ability to attract and retain Members with low loss histories with the hope that the discounts will be offset with efficiencies realized over the long-run, provided the Members' cumulative loss ratios do not materially increase.

Theoretically, higher discounts should be offered to Members with low experience modification rates and/or loss runs, with lower/no discounts being offered to more marginal Members presenting a greater loss risk to the trust. A differentiated discount structure also serves as a financial incentive for Members to embrace robust safety and loss control practices.

Whatever the discount offered to members, the discount should not have an adverse financial impact on the trust. Section 317.7 of the NYCRR (effective January 31, 2001) states, in part:

“The contribution rates utilized by a group self-insurer shall not be inadequate or detrimental to the solvency of the group.”

Article IV, Section 2(c) of the 1994 Trust Agreement provides that the Trustees “establish a contribution rate for each Employer which shall be sufficient to pay all of the estimated expenses of the Fund and all of the estimated obligations due under the Workers' Compensation Law for eligible employees.” Article VI, Section 6.9 of the 2001 Trust Agreement provides that the Trustees “annually determine the amount of contributions the Trust shall collect to ensure the Trust Assets will be sufficient to meet the obligations of the Trust to the Participants and to comply with the Rules and Regulations of the Chair.” Therefore, these regulatory and Trust document provisions essentially require that any discounts given should be consistent with the need to ensure contribution rates are sufficient to meet the Trust's financial requirements, and that this responsibility was vested with the Trustees.

Available Trustee meeting minutes reflected limited discussion regarding the setting and calculation of contribution rates and Member discounts; however, the Trustees would undoubtedly have been aware of their own businesses' discounts, and its impact on annual premium payments. Minutes show that NYCM's discussion of rates with the Trustees grew in later years as the need to raise rates to cover the mounting deficit became more apparent.

Trustee Vella recalled, “Trustees played no role in setting contribution rates,” and he had no recollection if premium discounts were given to Members. Concerning the setting of contribution rates, Rums smoke advised SaxBST LLP, “MERC followed the lead of the Lumberman's Trust and used WCB rates at a discount; these were approved by the WCB. Rates

⁸⁷ Some trusts also offer member dividends, MERC did not.

would change to satisfy losses.” Rumsmoke stated the Trustees were aware of the Member discounts, but was unsure of the Trustees’ role in this process.

NYCM officials conveyed to SaxBST LLP that initial rates were estimated, based on the loss and expenses of prior years, and when the WCB’s new regulations went into effect, actuaries helped determine the rates. Concerning discounts, NYCM stated the discounts initially were based on existing State Insurance Fund discounts, and later by actual experience and actuary information. They further indicated that the “Trustees were involved with overall discount assumptions, but let NYCM determine actual account by account discounts during underwriting process.” As noted above, minutes do not reflect much discussion of discounts with the Trustees, so the extent to which they were involved in developing or aware of the assumptions is unclear.

As noted previously, the offering of discounts was a major marketing tool employed by NYCM to attract new Members. NYCM’s website in 1998 advertised “Our group members’ pay up to 40% less than state published rates.”

In a Section 111 Hearing with WCB on April 18, 2001,⁸⁸ NYCM Secretary/Treasurer Francey provided the following testimony relating to NYCM’s discounting practices in response to a question whether each applicant receives a 40% discount:

If they meet our criteria. So if they have got a good loss ratio and they’re over 15 thousand dollars in annual, they should be getting a 40 percent discount.... If they come in and they’re not as good as other members, we may give them a 20 percent discount or something like that....What we’re saying, if you look on those there, you’ll see the manual rates, then that’s 40 percent discount on those, and we adjust it for their current experience modifier, and then you’ll see expense constant. We don’t charge that, so there’s none of the New York State assessment, we don’t charge that, so there’s none...We don’t charge a New York State assessment. We don’t charge service fees.

A complete analysis of discounts was hampered by the numerous missing Member payroll audit records. Available records do not discernibly reflect discounts during the Trust’s earlier years, 1994-1999, though other evidence suggests discounts were applied. Records beginning in 2000 do reflect discounts up to 40% of the manual contribution, adjusted for experience modification. From 2003-2006, the highest discount offered, with a few exceptions, was 25%. In 2007, discounts were discontinued mostly altogether due to the Trust’s escalating deficit. This will be more fully discussed in Section L - Member Deficit.

NYCM implemented a differentiated, though inconsistent, process for awarding Member discounts to individual Members. Available records showed that seven (7) Members received a premium discount in at least one year in which their emod exceeded 1.25 and two (2) Members received a discount for two consecutive years in which their emod exceeded 1.25. However, three (3) other Members with emods greater than 1.25 were assessed a surcharge of 10%, 18%

⁸⁸ The hearing related to marketing practices concerning NYCM’s Contractors’ Trust.

and 20%, respectively, suggesting that at least some Members were penalized for having excessive losses, but were allowed to remain in the Trust.

A comparison of discounts offered and contribution paid showed that larger premium Members generally received no special consideration for larger discounts. However, we did identify one Member with an annual contribution exceeding \$230,000 that received a 30% discount for two consecutive years, despite having an emod of 1.30 over this period.

Available data also showed no direct correlation between emod and discount awarded. For example, different Members with the same emod in the same year were awarded different discounts, and Members with higher emods were awarded higher discounts than those with lower emods.

We reviewed the available records of Trustee employers and found no overt evidence of preferential treatment with respect to the awarding of discounts.⁸⁹ However, a number of Trustees' firms incurred noteworthy cumulative losses: John Nelson - Material Handling Products (\$377,939); Lance Vella -Vella's Enterprises (\$524,706); George Gelsomin, Jr. - Sweetheart Corners (\$291,125); and Barry Thaler - Blum Rose Corp., a.k.a. Granny's Kitchen (\$2,886,303).

NYCM's discount practices, though imperfect and implemented without any substantive Trustee input were more rational than those of other trusts we examined, where across-the-board discounts were awarded with little to no regard to individual Member loss history. However, this being said, the wisdom of even offering discounts through 2006 in light of the Trust's GAAP deficit having reached over \$5.7 million by the end of 2005 is highly questionable. Evidence suggests that the continuance of discounts and reluctance to raise rates was intended to support Member retention and stem the tide of the Member defections from the Trust. As will be discussed later in this report, by 2007 the cumulative effect of Member discounts and low rates made the Trust's financial recovery virtually unattainable.

In summary, the documents reviewed and the interview results show that:

- NYCM used the promise of premium discounts and low rates as an effective marketing tool to attract and retain Members;
- The Trustees did not participate in rate setting or the awarding of discounts throughout the life of the Trust, this process being handled exclusively by NYCM;
- The Trustees and NYCM failed to sufficiently adjust contribution rates and discounts to reflect the Trust's continuing underfunded status, thus contributing to the Member deficit; and

⁸⁹ We did not include the Trustees who joined the Board of Trustees after the Trust's closure. Also, a number of payroll records for the Trustees we did review were missing so our analysis was incomplete.

- NYCM implemented a differentiated, rational process for awarding Member discounts, but this process was not always equally applied amongst the Members.

I. Payroll Audits

Standard industry practices require audits of trust members' payroll to reconcile the members' premiums that were previously based on an estimate of the members' payroll. The performance of these audits is imperative because of the direct correlation between the members' premiums billed and the payroll reported. As such, there exists a financial incentive for members to misclassify the payroll for the riskier job positions to reduce their annual premiums.

Pursuant to Article IV, Section 4.3 of the 2001 Trust Agreement, the Group Administrator had the responsibility to perform, or cause to be performed annual payroll audits. NYCM retained Charles E. Hock Associates, Inc. from 1996 to 2004, and Overland Solutions from 2004-2007 to perform these audits.

Member interviews, Member files and other documents revealed that annual payroll audits were performed, but not for all Members each year; and corresponding adjustments were made to the Members' annual premium, as necessary.⁹⁰ However, we also found that hundreds of annual Member audits, an extraordinarily large number, were missing, suggesting they were either not performed at all, or were improperly filed. The absence of these audit records hampered our Member analysis efforts.

Rumsmoke advised SaxBST LLP "there may have been a time when individual audits were done on small accounts." NYCM officials informed SaxBST LLP that annual audits were not performed on occasion, but only for "non-cooperating former members and those that had gone out of business." Among the missing audits we identified, however, were many long-standing Members of the Trust who appear to have been in good standing. These include Trustee employers.

Available Trustee meeting minutes contained virtually no discussion of payroll audits or related issues. However, Trustee Vella noted that annual payroll audits were performed and premium adjustments made as necessary. NYCM explained to SaxBST LLP that "audits were discussed with Trustees along with collections of audits" and that the "Trustees authorized NYCM to collect audits and to pursue legal action if NYCM could not collect."

Members interviewed generally recalled the annual payroll audit process, and that adjustments were made to their premiums based on these audits, when necessary.

In summary, annual member payroll audits were conducted and adjustments were made to Members' premium billings as required. However, not all Members were audited each year denying the Trust of any additional revenue due or Members of a premium credit or refund to

⁹⁰ This was confirmed also by Trustee Vella and Member interviews.

which they may have been entitled. In addition, NYCM's inability to produce all Member payrolls and the magnitude of missing payrolls may be indicative of inadequacies with NYCM's record keeping system.

J. Safety Programs

The implementation of a robust safety program is generally recognized as an insurance industry best practice, and an effective method through which group self-insured trusts, and any insured organization, can potentially reduce their loss exposure due to employee accident or injury.

At the time of MERC's formation in 1994, there was no statutory requirement for self-insured groups to identify a safety program at the time of application to the WCB. NYCRR Section 317.4, effective January 31, 2001, requires "new" self-insured employer groups to provide the WCB with a description of the trust's proposed safety program, if any. Therefore, no safety program was required for MERC.

The 1994 Trust Agreement made no reference to safety or loss control programs. Article VI, Section 6.7(d) of the 2001 Agreement, however, specifically authorizes the Trustees to provide or procure administrative and management services, including loss prevention services. Article IV, Section 4.6(d) also provides that Members may be terminated for, inter alia, failing to participate in loss control services. Interestingly, the 2001 By-laws, and 2001 Administrative Services Agreement with NYCM do not address safety and loss duties or responsibilities.

Consistent with the 2001 Trust Agreement, Participation Agreements signed by the Members contained a clause that participation in the Trust was contingent upon, inter alia, "Participation in the claims and loss control, rehabilitation and return to work, and drug-free workplace programs adopted by the Trust."⁹¹

SaxBST LLP found that NYCM did implement a targeted safety program, and fees for these services were generally included in NYCM's administrative fee structure.⁹² Trust records reflect approximately \$11,000 in "safety expenses" to five consultants, primarily during 2006-2007.

Available Trustee meeting minutes make little reference to the Trust's safety and loss control activities. Such discussion occurred in the Trust's early years, 1995-1997, with virtually none thereafter, except for one reference in the August 10, 2005 meeting minutes.

Trustee minutes for August 15, 1995 refer to a Safety Committee discussion about safety in the work place and developing a safety check list on meat and deli equipment. We did not identify any further reference to the Safety Committee in other available minutes, nor were we provided with any Safety Committee minutes, if they existed. The viability of a meaningful Safety Committee in the absence of a full complement of Trustees would seem doubtful.

⁹¹ SaxBST LLP found little documentation or reference in available records relating to the Trust's rehabilitation and return to work, and drug-free workplace program efforts.

⁹² This was confirmed by Rumsmoke.

Trustee minutes for January 18, 1996 report NYCM's introduction to the Trustees of its Loss Control Specialist who discussed his visits to the Members' stores. He found the stores "to be in good shape" and that "most accidents had occurred on slicers both when being cleaned and being operated." He further stressed the use of accident investigation forms and safety inspection forms which he provided to the stores he visited. Available minutes show the Loss Control Specialist being in attendance for the benefit of the Trustees at only two more meetings, one on August 28, 1996, and again on August 20, 1997.

Available minutes after August 20, 1997 reflect virtually no discussion of safety issues with the Trustees until August 10, 2005 when NYCM, in response to a Trustee question about the status of safety programs, "explained the loss control program using outside vendors." NYCM further indicated that "an in-house education committee has been formed to get the word out to members and agents and also update the start-up kits to assist members." This reference to outside vendors is consistent with the consultant safety expenses discussed above.

NYCM Secretary/Treasurer David Francey offered some insights into NYCM's safety program philosophy and practices in the following April 2001 Section 111 Hearing testimony:

We might say to them, you have got a lot of claims here, and unless you get safety service other than what we provide, you need somebody coming in there every other week, you're going to be out of the trust or you're not going to get any discount or whatever, you have got to pay your losses and expenses for this program. That's the only other time that they would be asked to pay funds is if we said you need to go get a guy to get these things straightened out, but our claims services are provided to guide them. We inspect the places, we go more as consultants and say, you know, if OSHA came in here, this and this and this should be done, and I hope it will be corrected. You know, we're not out there with a whip and a chain. And it's an alternative for, rather than asking them to leave, we give them these other options that they, can -- we don't want to lose clients, but we don't want them to jeopardize the rest of the trust members either.

Periodic, pro-active on-site inspections by qualified safety professionals are a primary accident and injury prevention tool typically employed by most self-insured groups. The purpose of these proactive visits is to keep both employers and workers cognizant of safety risks, identify and correct safety hazards, and offer guidance to mitigate these risks thereby reducing losses. We found that NYCM implemented a site inspection program using in-house staff, and later contract safety consultants; and that this valuable tool was applied inconsistently to the membership.

Trustee Vella told SaxBST LLP that NYCM had its own safety staff, and made frequent site visits for inspections and training, however, these visits were more frequent in the earlier years. He would receive safety reports, and NYCM would follow-up on issues. Overall, he felt the safety program was very effective.

Former NYCM President Rumsmoke stated that NYCM had a person on staff to handle the safety program. He noted site inspections were done annually by a third party, or when requested. He said he received no complaints about the quality of the program from the Members. He recalled safety reports were provided at the Trustee meetings and additional information was provided to Trustees when asked for.

NYCM officials told SaxBST LLP, “NYCM representative and or contracted vendors conducted on site visits when necessary, provided recommendations for action, provided newsletters and online tools for Members to access.” NYCM added that annual inspections were the “target goal.”

We identified an NYCM document, circa 2003, entitled *Loss Control Site Visits Policy and Procedure*. The document describes the process for providing loss control services to Members, and states, “The type of on-site surveys will be selected by New York Compensation Managers Inc. and determined by the trust status and/or special circumstances that may warrant a site survey.”

In brief, the document provides for new Members to receive an on-site evaluation survey and completion of a comprehensive or modified risk assessment report. Existing Members “should have on site surveys performed within 12-18 months from the date of their last survey. Reassessments can be required prior to that if deemed appropriate by New York Compensation Managers Inc. staff.” Following the survey, and if there is no change in business function or processes, a modified risk assessment will be completed. If there has been a change in business function or processes, a comprehensive risk assessment is to be completed. NYCM will track and monitor safety recommendations.

We sampled Member files for safety program documentation, and found all files did not contain such documentation. We did find safety reports going back to the Trust’s inception. The reports became more comprehensive and detailed as the years progressed, presented evidence of on-site training activities, and the providing of safety-related materials, including videos. The reports generally made recommendations for improvement where warranted. Generally, the quality of the reports reviewed appeared adequate and beneficial to mitigate Member risk. We also found evidence of a Safety Newsletter prepared by NYCM, but could not determine its frequency of distribution.

Overall, none of the randomly-selected Members interviewed were complimentary of the NYCM’s safety program efforts. One Member claimed they had only \$660 in losses and \$70,000 in premium, and never received a safety visit or safety audit.⁹³ Another Member indicated the safety program was “not well publicized, nearly non-existent”, and not as aggressive as their prior insurance carriers’ programs. A six-year Member told SaxBST LLP “There wasn’t one (a safety program) that I knew of.” Another four-year Member recounted that NYCM had a safety contact person “who stopped in once,” while an additional three-year plus Member reported he was “never introduced to the Trust’s Safety/Loss Control Program.” Finally, a ten-year Member

⁹³ Loss runs show this Member had \$754 in losses, still a comparatively impressive loss history.

characterized NYCM's safety program as "non-existent." The consistency of these Members' comments must be given particular weight in our evaluation of NYCM's safety efforts.

Records show that the Trust paid and reserved for claims totaling over \$38 million dollars from January 1, 1995 through May 31, 2012. Loss run reports reveal that approximately 86 Members or 15% of total Members had total losses over \$75,000. Included in this total were fifty-five (55) with losses in excess of \$150,000, with thirteen (13) of these in excess of \$750,000, and five (5) over \$1.5 million.

Based on the information presented above, it appears that on-site inspections of Trust Members were not routinized, but rather targeted to select Members, ostensibly those Members perhaps demonstrating a pattern of high losses, or with a higher level of contributions. While this arguably could be a cost effective administrative approach, the failure to visit all Members on a more regular basis may have resulted in preventable losses (and employee injuries) that contributed to the Member deficit. Mr. Rumsdake stated it was "principally excess losses" that contributed to the Trust's continuing deficit position, and it would seem that a more vigorous safety and loss control effort by NYCM feasibly could have sufficiently mitigated these losses to help reduce or perhaps eliminate the deficit.

In summary, the documents reviewed and the interview results show that:

- The Trustees were not sufficiently involved in the development and ongoing oversight of the Trust's safety and loss control program; and
- NYCM's safety and loss control activities may have been of good quality, but apparently were not applied equally to all Members, resulting in unnecessary risk exposure to certain Members and consequently, the Trust in general. A more rigorous program could have better mitigated Member losses and reduced the deficit.

K. Renewal Process

Prudent business practices dictate that a trust Member's loss runs and loss history should be reviewed and evaluated prior to accepting and/or renewing the Member. In addition, a thorough and complete analysis of the trust's cumulative member deficit, if any, should be considered before discounts are offered to the Member on a forward basis. As discussed above, discounts were continued to be given by NYCM to Members despite the Trust's continuing Member deficit.

The 2001 Trust Agreement does not specifically address the renewal process; however, Article VI, Section 4.6 of the 2001 Trust Agreement authorizes the Trustees to terminate the membership of any employer upon the occurrence of any of the following:⁹⁴

⁹⁴ The 1994 Agreement provides for termination if a Member fails to make an employer contribution; ceases to qualify under or by reason of any State or Federal law; fails to comply with the rules and regulations made by the Trustees; or no longer satisfies the homogeneity requirements.

- (a) fails to pay all contributions and assessments; or
- (b) ceases to be eligible to participate in the Trust under the terms of the Law, the Rules and Regulations of the Chair, this Declaration of Trust, the Participation Agreement or the Bylaws; or
- (c) no longer meets the underwriting standards; or
- (d) fails to participate in the claims and loss control, rehabilitation and return to work, and drug-free workplace programs adopted by the Trust.

Section 3.7 of the 2001 By-laws provides for termination if a Member fails to comply with the requirements for Trust participation established by these Bylaws, the Declaration of Trust, the Participation Agreement, or the Law or Rules and Regulations of the WCB Chair.

Trust records indicate that Members had rolling, and not uniform annual renewal dates.

Evidence indicates that NYCM controlled the Member renewal process with no Trustee participation. NYCM told SaxBST LLP that the Trustees authorized NYCM to handle this process. Consistent with this, available minutes reflected virtually no discussion of Member renewal issues.

Concerning the annual renewal process, NYCM explained that a Member’s “history of losses, payments, cooperation, experience mod, loss ratio, business operations, safety performance were reviewed by an underwriter.” NYCM added that Members might not be renewed if they demonstrated “persistent poor performance and/or cooperation.” Also, NYCM stated that if Members did not provide adequate notice to the Trust for voluntary termination, penalties would be assessed as outlined in the Participation Agreement.⁹⁵

We reviewed the *Notice of Termination of Employer’s Participation in Group Self-insurance Plan*, WCB Form GSI-3.1, for 60 judgmentally-selected Trust Members and found the following with respect to the reason for Membership termination as reported on WCB Form GSI-3.1:

<u>Reason for Terminating</u>	<u>Number</u>	<u>%</u>
Out of Business/Other Business	10	17
Member Cancellation ⁹⁶	37	61
Underwriting Reason	4	7
Non-payment of Premium	9	15
Total	60	100

Source: WCB Form GSI-3.1

⁹⁵ The Participation Agreement requires a 90 day written Member notice to the Trust. We did not perform an analysis of penalties due and paid for failure to meet this 90 day requirement.

⁹⁶ We did not include voluntary Member cancellations relating to the Trust’s closure in February 2008.

Based on this analysis, a majority of Members left the Trust voluntarily to obtain coverage with another carrier. The next most common basis was either sale or closure of the business. Only 4% were terminated for underwriting reasons.

As explained previously, we identified only a few Members who had emods in excess of 1.25 for multiple years suggesting perhaps higher loss Members were either terminated or their loss ratios had improved. However, we also found that 181 or about 32% of the total Trust Members had that same emod for at least 3 consecutive years, strongly suggesting that the renewal procedure may not have been as rigorous as it should have been, and raising questions as to the soundness of the annual emod recalculation process itself.

In summary, the documents reviewed and the interviews conducted show that:

- NYCM administered the Member renewal process with no Trustee involvement or participation; and
- Despite having an apparent structured renewal process, Members with experience modification rates in excess of 1.25 beyond one year were allowed to remain in the Trust.

L. Member Deficit

NYCRR Section 317.9, effective January 31, 2001, requires group self-insurers “to maintain at all times sufficient trust assets within the trust fund to exceed claims and all other liabilities” and specifies remedial actions to be taken by the WCB at its discretion to address underfunded situations.⁹⁷ Among these are the submission of a written remediation plan by the trust, suspension of new members, and the levy of an assessment upon the members. The WCB is further authorized to revoke the group’s self-insurance status if a fully-funded position cannot be restored.

In accordance with these regulations, Article VI, Section 6.10 of the 2001 Trust Agreement authorizes the Trustees to impose assessments upon the Members to make up any deficiency determined by the Trustees to exist; and to determine the formula and method of assessment subject the WCB’s approval. Each Member who joins the Trust, and is a Member in the Trust in a year, is obligated to pay such an assessment, whether or not they are a Member in the Trust at the time the assessment is levied.

As discussed previously, beginning in or around 1996, Members signed a Participation Agreement upon entering the Trust agreeing, inter alia, to the terms of the Trust documents and acknowledging their joint and several liability. Beginning in 2001, the Participation Agreement language was expanded to include a provision relating to Members’ obligation “to pay additional amounts of monthly contributions or assessments to meet its responsibilities of joint and several

⁹⁷ Section 317.6 defines an “underfunded” trust.

liability.” Therefore, Members appear to have been sufficiently placed on notice of their joint and several liability and assessment obligations.

The Trust experienced a tenuous funding position throughout its entire 13-year existence. Specifically, the Trust’s audited financial statements show the Trust having a GAAP deficit for all but three years between 1995 and 2007⁹⁸ while the WCB deemed the Trust to be inadequately or underfunded from a regulatory perspective each year from 1998 through 2007.

In a letter, dated August 13, 2004 to the MERC Trustees and NYCM, the WCB transmitted the afore-referenced Level II Review report for the year ended December 31, 2002 and Level I Review report for the year ended December 31, 2003.⁹⁹ The WCB directed the Trust to “suspend the addition of any new members into the Group, effective immediately”,¹⁰⁰ and “develop a mutually acceptable corrective action plan” to address the deficit.

NYCM had previously responded to a draft of the Level II Review report in a letter to the WCB, dated April 30, 2004 and questioned the report’s reserve analysis and various management findings. The WCB maintained its position as contained in the original Level II Review report and issued its Final Determination on August 13. Trust records indicate that in a letter dated, December 22, 2004, NYCM CEO advised its network of insurance brokers/agents of the WCB’s findings and suspension of new Members.

In a Level I Review report, dated July 19, 2005 for the year ended December 31, 2004, the WCB again deemed the Trust to be underfunded with its regulatory deficit increasing to \$3,099,319 and trust equity ratio decreasing to 64.92%. The report also pointed to the Trustees having no meetings in 2004, which is striking given the Trust’s deteriorating financial condition. The WCB further asked the Trust to update an action plan it submitted on September 30, 2004.

On August 22, 2005, the WCB received from NYCM a document entitled *Business Plan 2005* in response to the 2004 Level I Review report. The *Plan* stated that the Trust and NYCM have taken action to address the funding issue and improve the overall performance of the Trust. These actions have included:

- canceling poor performers;
- canceling uncooperative members;
- enhanced underwriting criteria;
- improved information technology;
- enhanced safety & loss control;
- increased staffing;

⁹⁸ GAAP deficits of over \$3 million were also reflected in the audited financial statements from 2008-2010 after the Trust closed.

⁹⁹ The Level I Review report for the year ended December 31, 2003 reported the Trust to have a regulatory deficit of \$1,569,793, and a trust equity ratio of 72.44%.

¹⁰⁰ The WCB allowed the Trust to honor quotes made prior to August 4, 2004. The Trust essentially remained closed to new Members through its dissolution.

- enhanced formal policies and procedures;
- created a quality assurance position;
- created claims teams to focus on Trust cases; and
- lowered credits.

The *Plan* further specified the Trust would be taking the following additional steps:

- further reduce credits to generate additional contributions to the Trust;
- limit credits for new and existing members; and
- limit growth of Trust members.

NYCM also requested that the WCB open the Trust to new Members.

On January 30, 2006, the WCB held a conference call with Trustees Nelson and Thaler, and NYCM officials. Trust minutes reported the Trust presented projections for 2005 showing a loss of \$700,000. The Trust noted that for 2006, there was a 10.3% CIRB rate increase amounting to \$800,000/year, and that discounts would be lowered to an average of 5% upon member's staggered renewals, equaling another \$400,000. They anticipated full benefit of these actions would be realized over a 2-year period. The WCB responded that the Member freeze would continue until after it could review the 2005 results, and encouraged the Trust "to look at an assessment for the years there was a shortfall." WCB documents for the meeting reflect concerns the Trust's 2004 funding level and deteriorating financial condition, and the establishment of a consent agreement with operating parameters.

The WCB's Level I Review report, dated June 7, 2006 for the year ended December 31, 2005, again found the Trust to be seriously underfunded having its regulatory deficit doubling to \$6,899,360 and trust equity ratio further decreasing to 51.15%. The WCB made reference in its report to the Trust's audited financial statements for the year ended December 31, 2005 wherein the Trust's auditors offered a "going concern" opinion because of the Trust's poor ratio of liquid assets to claim reserves.

On August 1, 2006, the WCB held a conference call with the Trustees and NYCM officials. A WCB summary of this meeting reported that a 2006 Breakeven Analysis showed that current Member rates needed to be increased by 29% to break even for 2006, and that existing rates would result in a \$1.4 million loss by the end of 2006, with an accumulated deficit to reach \$8 million. The WCB expressed concerns that the rate increase required, along with additional deficit assessments to address the accumulated deficit, might affect Member retention. The WCB directed NYCM to update the Members, and advised NYCM that no 2006/07 renewals should be issued until the rates have been agreed to by the WCB.

The WCB, Trustees, and NYCM held a follow-up conference call on August 7, 2006. NYCM presented a rate plan to achieve the 2007 breakeven level that included an assessment to be billed over a five-year period to cover the accumulated deficit. The WCB again expressed concerns about the impact of this on Member retention and noted that the assessment methodology needed

revision. NYCM was asked to again contact the Members to gain their reaction to the plan, and determine whether sufficient commitment existed to continue coverage.

Records show that on September 7, 2006, the WCB conducted another conference call with Trustee representatives. Among the topics discussed were that effective January 1 2007, each member would begin to be billed the increased rate (2005 CIRB manual rates +13%) regardless of renewal date, and that the equivalent of CIRB manual rates plus 13 % would be collected by December 31, 2007. In addition, the WCB directed the Trustees to develop and submit a plan to WCB by October 2, 2006 to address the accumulated deficit that may include a phased assessment methodology. In addition, rate increases and assessment plans were to be communicated to the Members by November 1, 2006, and Members choosing to leave the Trust due to the new rates would not be subject to a withdrawal penalty. The approved plan would be memorialized in a Consent Agreement.

In follow-up to the September 7 teleconference, NYCM Vice President D'Amato in a letter dated October 6, 2006 submitted the following action plan items to the WCB:

1. Effective January 1, 2007 all members contribution (regardless of current credit/surcharge and/or renewal date) will be adjusted to reflect the following formula: (Manual contribution x Experience Modification) x 1.13. This reflects NYCIRB manual rates + 13%.
2. The Trust will implement a phased deficit assessment plan based on losses for each respective year. The assessment will apply to both current and former members and in a timely manner. The first phase assessment will cover the years from 1995 thru 2002. Years 1994, 1995 and 1998 will not be assessed as there was no deficit in these years. The assessment will be based on the deficit amount provided by the WCB. The deficit will be apportioned to each member in the Trust in the respective year based on their percentage of contribution for that year. Members will be billed in 12 monthly installments beginning in January 2007. Member will be offered a 5% reduction if they pay the entire assessment within 30 days. The total planned assessment for the first phase will be approximately \$3.6M.
3. The Trust will send a letter to members regarding the rate increases and the assessment plan no later than November 1, 2006. This letter will be submitted to the WCB no later than October 15, 2006.
4. The Trust agrees not to hold members to the withdrawal penalties if they choose to leave the group based upon the revised rate structure. Members will not be allowed to go to another Trust. Should a member move to another group self-insured trust the WCB will intervene and not approve such a move.

5. The WCB will assist the Trust in communicating to members their Joint & Several obligations if they are not meeting or satisfied them.
6. The Mercantile Trust will be allowed to accept new members as of January 1, 2007. Growth and pricing will be discussed with the WCB.
7. The membership level will be evaluated February 2007 to determine reasonableness of rate structure.

Records reflect that D'Amato sent a letter to the Members on November 1, 2006 updating the Members on the shortfall and remediation plan, praising the work of the Trust on behalf of the Members, the imposition of an increased rate to reflect a 13% NYS Assessment, and the Member assessment. We identified draft follow-up letters from NYCM to the Members later in November, but could not confirm if the letters were actually sent.

Records show that the Special Assessment billings were sent by NYCM to Members in or around December 2006.

On January 12, 2007, the WCB Chair signed a Consent Order adopting a Consent Agreement signed by Trustee Nelson and non-voting Trustee Olmstead in December 2006. The Agreement parameters, in short, included the implementation of the new rate structure, continuation of no new Members, a special assessment to active and inactive Members for the program years 1996-2002 (with the exception of 1998) to be apportioned among active and inactive Members based upon a percentage of contribution. Billed collection was anticipated to be \$3.6 million with bills to be issued on or before January 1, 2007. A minimum of \$1.2 million was to be collected by December 31, 2007.

On May 9, 2007, Trustee Nelson met with NYCM officials. Meeting minutes report D'Amato stating that the Trust membership was strong, with its 112 current members having an active contribution of \$3.5M, and an experience mod of .90. He discussed the Consent Agreement and noted that regarding the special assessment, as of May 2007, the Trust had billed out \$ 1.4M and collected \$600,000, putting the Trust in line with the WCB requirements. In addition, he pointed out that that three of the larger assessments (about \$750,000) had yet to pay anything, two were in litigation, and their attorney was working on one. He also addressed the WCB's Level I Review report for the year ended December 31, 2006.

In the 2006 report, the WCB predictably again deemed the Trust to be underfunded and found the Trust's financial condition to be further deteriorating with its regulatory deficit increasing to \$7,044,223 and trust equity ratio further decreasing to 49.74%. Also, similar to its 2004 report, the WCB commented that the Trustees met only once in 2006, that involving a teleconference with the WCB. This lack of Trustee participation and oversight in the face of possible insolvency is quite shocking.¹⁰¹

¹⁰¹ The Trust's auditors again offered a "going concern" opinion as of December 31, 2006.

NYCM Vice President D'Amato, in a letter to WCB dated May 21, 2007, challenged portions of the Level I review report relating to the assessment accrual, effect of increased excess insurance cost on the Trust's bottom line, and impact of the membership restriction.¹⁰² D'Amato further explained that although membership was declining, "the remaining members' loss experience is better, the experience modifier has decreased from .95 to .91, there are no upfront discounts, a 13% assessment and the special assessment is being collected." He further offered that claims, claims expenses, and other operating costs had decreased due to the smaller group.

On June 22, 2007, the WCB held a conference call meeting with Trust representatives. Notes from this meeting reflect that the WCB discussed the 2006 Level I Review report and the accrued assessment adjustment, factors Trustees should consider when making decisions on behalf of the Trust, the Trust's steadily declining trust equity ratio, reinsurance expense increase, 2006/07 financial results, 2007 breakeven analysis, consent agreement terms, assessment collections to date (\$650,000 of \$3.6 million billed) and 2007 rates.

Records show that the WCB and NYCM remained in regular communication to formulate a workable plan to keep the Trust active. However, internal WCB records reflect the WCB's growing concerns about Member retention due to the assessments and NYCM's proposed rate structure that included using 2005, rather than 2007 CIRB rates for 2008.¹⁰³

On November 26, 2007, the WCB, Trustees, and NYCM conducted a teleconference meeting at which a decision was made regarding the Trustees' vote to voluntarily terminate the Trust, effective March 1, 2008 due to the Trust's severe financial position. It was agreed that 1) Members would be notified by the Trust of the termination by December 15, 2007, 2) the current rate structure would remain until termination, 3) no penalty would be assessed to Members leaving before the termination date, 4) NYCM would continue to administer the Trust after termination, 5) the WCB would receive monthly cash flow reports, 6) the WCB would take over the Trust in the event there was less than one year's worth of cash and investments to pay claims, and 7) after Member notification, the WCB would meet again with the Trust to discuss assessment plans.

On December 19, 2007, Trustees Nelson and Vercesi signed a formal resolution terminating the Trust in accordance with their unanimous vote on November 26. In a letter to the Members, dated December 26, 2007, Trustees Nelson and Vercesi explained the Trust's "insurmountable deficit," and announced the Trust's closure as of February 28, 2008. They further noted "the joint and several obligation as stated in the Declaration of Trust is not waived or removed because the Trust is closing." A copy of the closure resolution was attached to the letter.

Records also indicate that in a letter, dated December 26, 2007 NYCM Vice President D'Amato advised its network of insurance agents of the Trust's closure, providing a copy of the Member letter and Trustees' resolution.

¹⁰² The Trust used a new formula, based on new legislation, to calculate accrued assessment liability. The WCB had issued a circular to all trusts advising them to use the old methods for the 2006 year.

¹⁰³ WCB records indicate the 2005 rates were 20% higher than the 2007 rates.

In a letter to Trust Members dated January 14, 2008, the WCB reiterated the Trust's closure and the Members' joint and several liability obligation Pursuant to WCL §50(3-a) that could result in additional assessments.

On April 16, 2008, NYCM updated the Members on the Trust's financial status and its activities as group administrator. The WCB, NYCM, and Trustees conferred again by teleconference on April 17, 2008 for an update on the 2007 assessment and to plan the next assessment for years prior to 2007. NYCM sent a follow-up status letter to the Members on June 25, 2008, explaining the calculations for the pending assessment for 2003-2006 to be billed on or about July 1, 2008.

Not surprisingly, in a Level I In-Progress Report dated August 26, 2008, the WCB deemed the Trust underfunded for the year ended December 31, 2007 and found the Trust with a regulatory deficit of \$6,363,008 and trust equity ratio of 47.06%.

NYCM, in a written update to the WCB on October 28, 2008, reported that the number of open claims had been reduced from 256 on February 28, 2008 to 187 as of this date. In addition, NYCM confirmed that 10 months' of cash remained. NYCM reported that the pre-2007 assessment billings were issued in July, and that \$400,000 had been collected to date, and that an additional \$700,000 had been committed by Members with payment terms from 1-5 years. It was further indicated that the Trust had retained outside counsel (Frederick J. Micale, Esq., PC of Syracuse) to pursue collections from larger Members, and that lawsuits had been filed against two Members owing \$600,000.¹⁰⁴ NYCM said it would not be in the Trust's best interest for the WCB to take over the Trust in light of the progress made to date.

Included in the collection efforts of the Trust's outside counsel, were negotiation of "Standstill Agreements" with Members who had commenced legal action against the Trust and NYCM.¹⁰⁵ These Agreements essentially put the legal action, including any counter-claims, in abeyance provided the Member made installment payments against its assessment liability.

On April 23, 2009, a Trustee meeting was held at which three new potential Trustees Ned Greene, William Coakley, and Molly Rhoades were introduced, joining Trustee John Nelson.¹⁰⁶ An opportunity was provided for the potential Trustees to review the Trust's financial and claims information. At the Trustees' next meeting via teleconference on April 30, 2009, Greene, Coakley, and Rhoades were officially voted in as Trustees by Trustee Nelson.¹⁰⁷ The Trustees agreed to have NYCM send a letter seeking the Members' cooperation in the collection process. This letter was sent to the Members on or around May 5, 2009.

With the addition of Trustees Greene, Coakley, and Rhoades, the Trustees as a group became a more proactive force in the management of the Trust, albeit in the run-off phase. From April 30,

¹⁰⁴ Trustee meeting minutes for February 24, 2009 reported that lawsuits had been filed against all non-paying Members owing more than \$50,000.

¹⁰⁵ Records indicate the WCB approved the boilerplate language for these Agreements.

¹⁰⁶ The Trustees accepted Trustee Vercesi's resignation, effective May 15, 2009.

¹⁰⁷ Efforts to interview Trustees Nelson, Greene, Coakley, and Rhoades were unproductive.

2009 through the Trust's transfer to a new group administrator in June 2012, available minutes show the Trustees met substantially more frequently than at any time in the past. Minutes show the Trustees were actively engaged with NYCM in trying to manage and shrink the Trust's deficit.

On July 1, 2009, the WCB met with the Trustees and NYCM. The WCB, in a meeting follow-up letter to the Trustees dated July 15, 2009, acknowledged "that Mercantile, with the assistance of NYCOMP has made a major improvement in the cash position of the Trust." The WCB added, however, that the deficit position remained and that collection efforts must continue. The Trustees were reminded that if at some time in the future the Trust had less than twelve (12) months of cash available to pay claims and expenses, the WCB would assume the administration and final distribution of the Trust's assets and liabilities, transition the Trust to a new group administrator, and commence a forensic accounting review of the Trust.

By early 2012, the Trust's collection efforts had been unable to sufficiently reduce the Trust's overall deficit.¹⁰⁸ In a letter, dated February 17, 2012, the WCB advised the Trustees that the Trust "has demonstrated an inability to properly administer its liabilities", and that effective April 1, 2012, the WCB would be assuming "the administration and final distribution of the group's assets and liabilities" pursuant to 12 NYCRR Section 317.20(c). Administration of the Trust's run-off would be transferred to a new group administrator, NCA Comp, Inc. Also on this date, the WCB notified the Members by letter of the WCB's take-over.

The WCB met with Trust Members on May 23, 2012 and provided an overview of the Trust's historical funding issues and remediation efforts. NYCM and the Trustees petitioned the WCB to reconsider, enlisting the support of the Members, but on June 1, 2012, administration of the Trust's run-off was transferred to the new group administrator, NCAComp.

By the time of the transfer, the Trust had issued three (3) deficit assessments, totaling over \$13.7 million that generated collections of approximately \$7.1 million, according to NYCM records. After the Trust's closure on February 28, 2008, the Trust continued to run GAAP deficits of \$4.3, \$3.4 and \$3.2 million in 2008, 2009, and 2010, respectively.

WCB records reflect that in February 2008, the Trust had 20.73 months of cash and assets available to pay outstanding claims. By April 2012, this reserve had dwindled to only 7.2 months, despite the Trust's assessment and collection efforts. Approximately, ninety-five (95) claims still remained open at this time.

Most of the Members interviewed informed SaxBST LLP that the first hint of the Trust's financial problems came when they received or were advised of their assessment billings, there was no prior alert from NYCM or Trustees of the Trust's poor financial situation. As noted previously in this report, evidence suggests that communications from the Trust to Members primarily went through the agent network. Apparently, some agents were not diligent in keeping

¹⁰⁸ These efforts included exploring the purchase of a loss portfolio transfer policy.

their clients fully apprised of the Trust's problems, as these issues seem to have been commonly known in insurance circles.

One Member offered the following perspective of the Trust's funding problems:

I think the trust was already in trouble in 2002 when we became a member. The trustees realized they needed additional revenue so they offered substantial premium savings in comparison to other alternatives, which attracted a lot of people. Unfortunately they allowed anyone in willing to join and pay into a supermarket trust taking on higher risk.

Another Member provided SaxBST LLP with handwritten notations they made on NYCM's Trust status update letter to Members, dated November 1, 2006. Concerning NYCM's statement that the Trust had absorbed and not passed on to Members "increases of 25% in the New York State assessments as well as a 300% increase associated with securing excess insurance post 9/11," a handwritten notation stated "NYCM should have passed expenses along so that we could have made sound decisions at the time - this is bait and switch – deception."

SaxBST LLP asked NYCM officials to comment on the cause of the Trust's continuing deficit. Rumsmoke indicated that the deficit was "principally" caused by "too many losses by members and too large." In terms of the steps NYCM recommended to the Trustees to address the deficit problem, he responded NYCM recommended "increased premiums and more Members." He said he was not aware of losses until the WCB changed the regulations in 2001, which "resulted in the losses." He recalled that the WCB "shut down" the Trust to new Members, and he asserted that "when NYCM would go to the WCB for advice and guidance it would get ignored and wait a long time for little response."

Rumsmoke said he was not sure what steps were taken to reduce the deficit or whether or not the steps taken were successful, but did recall that an assessment was done and judgments were pursued against non-paying Members. He felt that the formation of AUTO had no effect on MERC, as "it was a separate trust," and that MERC's overall operation could have been improved by "avoiding losses."

In the joint reply submitted by other NYCM officials, no response was provided as to the causes of the Member deficit, but the elimination of discounts and member assessments were identified as the corrective steps taken. The officials concurred with Rumsmoke's position that AUTO's formation had no impact on MERC. Concerning how MERC's operation could have been improved, they pointed to increased regulatory oversight, greater Trustee involvement in the earlier years when the deficit occurred, permitting new Members when the Trust was underfunded to increase contributions from "good" performers, replacing "bad" performers, and an actuarial rate analysis early in the Trust's existence.

NYCM officials further stated that subsequent to the WCB's Level II audits "in 2003-2004, substantial efforts were made to help the Trust's balance sheet." These actions included

“cancellation of bad performers, reducing discounts, adding debits to members, issuing multiple assessments for the deficit years,” and recruiting new Trustees who “took an incredibly active role in efforts to alleviate the Trust’s deficit.” They felt the assessments were highly successful, and that their efforts of both the Trustees and NYCM were praised by the WCB as per the WCB’s letter, dated July 15, 2009, as previously referenced.

As noted previously, our termination sample found few Members were terminated for bad performance, Trustee oversight remained minimal, and the Trust continued to incur losses in 2005 and 2006.

The gross deficit assessment to Members as of December 31, 2014 is \$22,182,504.

In conclusion, the Trust had a tenuous financial footing for most of its existence, being deemed “not adequately funded” or “underfunded” by the WCB continuously from 1998 through 2007. The Trust’s dramatic growth from 2001 through 2004, when 85% of the Trust’s total Membership joined, provided a tremendous infusion of gross Member contributions. This was aided by low rates and premium discounts. In 2004, 145 Members, or 25% of total membership, left the Trust for NYCM’s newly-formed AUTO Trust. These Members took with them substantial premiums, but left the Trust with their liabilities (although these Members did retain their joint and several liability obligations). The Trust’s regulatory deficit went from approximately \$3 million in 2004 to \$6.9 and \$7 million in 2005 and 2006, respectively. The remaining Members simply could not absorb the rate increases and assessments necessary to bring the Trust to a fully-funded position making the end inevitable.

M. Claims Handling Procedures/Practices

The handling and processing of claims is an integral part of the group self-insured trust administration process. In addition to reduced premiums, employers joining a trust have a reasonable expectation that their claims would be managed equally as well, or even better than their existing insurer.

Article VII, Section 7.2 of the 2001 By-laws authorizes the Trustees to engage a Claims Administrator as follows:¹⁰⁹

The Trustees shall select an agent to discharge the duties of Claims Administrator, who shall provide certain services to the Trust, including but not limited to the administration and defense of the workers compensation claims of the Participants, and any other duties contained in the agreement between the Trust and the Claims Administrator. The agreement with the Claims Administrator shall be a written instrument which shall delegate authority to the Claims Administrator to act as agent of the Trustees for the administration of the Trust at the direction

¹⁰⁹ The 1994 Trust Agreement made no specific reference to Claims Administration.

of the Trustees, the limitations on the authority of the Claims Administrator, and the term of the agreement.

NYCM assumed the dual role of both the Trust's Group and Claims Administrator. In its role as Fund Administrator as defined in the 2001 Administration Services Agreement, NYCM was assigned the following claims administration functions:

- a. review each claim and loss submitted to the Trust;
- b. investigate each qualified claim or loss;
- c. maintain a file for each qualified claim or loss;
- d. adjust, settle or compromise all qualified claims or losses and resist any fraudulent or unqualified claims;
- e. perform administrative and clerical work in connection with each qualified claim or loss including the preparation of checks, vouchers, releases, agreements and other documents needed to finalize a claim;
- f. establish and update claim reserves as needed;
- g. coordinate investigations on litigated claims with attorneys and excess carriers; and
- h. arrange for representatives or attorneys at all Workers' Compensation hearings including appeals.

As claims administration duties were expressly provided for in the Administration Services Agreement, related fees were contractually included in NYCM's 20% management fee. As discussed previously in this report, however, additional fees totaling approximately \$1.3 million were paid by the Trust to an NYCM affiliated entity, Lake Effect Claims Service, ostensibly to perform these tasks.

Evidence shows that NYCM had its own in-house claims staff, and that the distinction between NYCM's and Lake Effect Claims personnel was nominal at best. This was essentially confirmed by former NYCM President Rumsmoke when he advised SaxBST LLP that "NYCM handled claims administration at first through a third party and later through licensed claims managers, case managers and R.N.'s on staff." He added that at the beginning of the Trust, NYCM used a national claims administrator having a Syracuse office. He said the fees paid for these services were "pursuant to the agreement."

NYCM officials identified Utica Mutual as the Trust's initial claims administrator, and the subsequent administrator as Lake Effect that was an existing claims services purchased by NYCM. They further noted that NYCM provided the Trustees with loss runs and answered any related questions Trustees had. Available Trustee meeting minutes confirm NYCM presenting claims updates to the Trustees.

Trustee minutes for September 16, 2003 report NYCM discussing the hiring of new claims adjusters to add to their existing adjuster staff. NYCM also provided an overview of its claims handling system - X-Claim, that features a paperless claims file allowing other NYCM offices

such as the Watertown office to access the files remotely. Records suggest that the original Lake Effect Claims was located in Watertown, Jefferson County, and became an NYCM satellite office when NYCM purchased that firm.¹¹⁰ None of the minutes reviewed by SaxBST LLP made any reference to Lake Effect as the Trust's claims administrator, the corporate relationship between NYCM and Lake Effect, or payments made to Lake Effect. This raises serious questions as to whether there was any related disclosure to the Trustees or Members, and if not, was it intentional.

As addressed earlier in this report, PwC performed a Level II Review of the Trust on behalf of the WCB as of December 31, 2002 and closely examined NYCM's claims case management practices. PwC's findings were largely favorable and included the following major observations:

- The claims in the sample had a few differences between existing individual case reserves and the Consultant's view of ultimate exposure.
- Sixty-Five percent of the claims sampled were reported to NIYCM more than 72 hours after the accident. It was recommended that NYCM continue to increase its focus on reducing member claim reporting lags.
- The quality of case management by the NYCM nurse case managers was among the best observed across the New York Trusts reviewed by the Consultant.
- Claims examiners did not always regularly review case reserves for adequacy and possible updating at each dairy date. It was recommended that NYCM continue to focus on the timeliness of case reserve changes.
- It was recommended that NYCM consider engaging an outside claims operation consultant to periodically provide a health check on the Claims Department.¹¹¹
- In light of NYCM's recent rapid growth, it was recommended that NYCM continue to review its existing claims staffing model.
- The claims handling Plans of Action do not consistently establish a timeline for completing the designated activities.

There was nothing reported in PwC's examination suggesting that anyone other than in-house NYCM staff were involved in the claims administration process; no reference to Lake Effect Claims was made.

For those Members interviewed filing claims, they were largely satisfied with the quality of the claims services provided.

Some insurance experts have opined that the roles of program administrator and claims administrator should remain separate to help ensure that claims are administered independently

¹¹⁰ Lake Effect Claims Service's predecessor firm Rankin-Larose, Inc. was incorporated in Jefferson County NY on July 16, 1982.

¹¹¹ No such recommended independent claims review was performed during the life of the Trust.

of any financial incentives the program administrator might realize from the deliberate under-reserving of claims. SaxBST LLP, itself, has found in its review of other group self-insured trusts that necessary claims reserves could easily be manipulated downward by a program administrator to artificially reduce a trust's liabilities. By doing so, the program administrator could present a misleading picture of a trust's financial stability when soliciting new Members from which the program administrator would derive additional management fees. This being said, SaxBST LLP found no evidence that NYCM engaged in such conduct, though the potential to do so remained throughout the Trust's life.

SaxBST LLP retained KBM Management, Inc. (KBM), a third-party claims consultant, to independently review the MERC claim files and determine whether claims were handled in accordance with written policy and industry standards, benefits were paid in a timely manner, and claims were appropriately reserved and adjusted as the cases matured.

KBM, in its January 2013 report noted that they audited claims processed on behalf of MERC by NYCM, and that the claims dated back to the origin of the Trust (Exhibit 11). Their claims audit, which included the examination of 15 closed and open files totaling \$1,890,371, in claims value. KBM's major observations/findings are as follows:

- The transfer of information from USA-TPA to NCA was incomplete and haphazard. Many of the files showed a net paid to date figure for indemnity and medical as \$0.00; while the grand paid to date totals appear to be correct.
- None of the files reviewed had reached or exceeded the stop-loss deductible, therefore no reimbursements were due at the time the audit was completed.
- There were no inconsistencies noted or reviewed in the area of independent medical exams (IME's).
- NYCM did not file five (5) eligible claims to the Special Disability Fund resulting in possible lost reimbursement opportunities to the Trust.
- NYCM did not appeal a Special Disability Fund reimbursement reduction although the necessary information existed to substantiate their initial claim resulting in a \$5,676.52 loss to Trust.
- NYCM did not follow-up on two Special Disability Fund reimbursement requests for which no reimbursements were received resulting in a \$12,249.34 loss to Trust.
- Of the seven open claims reviewed, three had low reserves and four had high reserves for the known exposures.
- Industry averages require 95% procedural accuracy; NYCM only processed 89.10% of the medical bills within 45 days of receipt.
- Of the fifteen (15) claims reviewed, thirteen (13) contained several financial errors (indemnity overpayments: \$1,959.43, medical overpayments: \$7,145.31, expense overpayments: \$95.00) and three (3)

contained penalties (\$1,813.28) which is significant when extrapolated to all the claims incurred during the Trust's entire active life.

- Twenty-seven (27) medical bills (\$5,317.72) remain unpaid, leaving the Trust open to a \$50 penalty for each medical bill in addition to interest on the unpaid amount from the date the bill was due until the date it is ultimately paid.
- USA-TPA charged \$2,250 for unnecessary Medicare set-asides (MSA's).

These findings seem to be in marked contrast to those of 2002, and appear to support the merit of PwC's recommendation to perform periodic, independent assessments of the NYCM's claims administration practices and processes that unfortunately was not implemented by neither NYCM, nor the Trustees.

Perhaps KBM's most significant finding, however, relates to payments to Lake Effect Claim Service corresponding to our own findings. We are providing KBM's comments *in toto*, due to their importance:

The largest single problem was the use of internal billing for "claim expenses." If they were billing internally, the only conclusion we can reach is that these billings were to their own benefit, because no checks were issued to others. Rather they had a separate but numbered billing system. While we could only review the files we audited directly, we received data from NCA listing similar information from all claims they had. There were \$19,395.75 Lake Effect transfer payments in files we reviewed. There were \$1,139,081.77 Lake Effect payments for the Trust as a whole. NYCM reported \$13,629.39 of these transfers listed in the claimant's name in our audit files which was \$394,788.53 for the Trust as a whole. Please note that the totals received from NCA were just the total paid to the vendor id#, KBM did not receive a breakdown of the payments therefore we cannot determine with complete accuracy that all of these charges are related to the internal billing for claim expenses. We investigated the "log notes" from NYCM available through NCA for some of claimant billings and the largest percentage was simple claims administration functions. Some had no identifier as to what the expense was for. The administrator's original contract for services included claims administration functions, and charging separately for these internally gives the appearance of impropriety. The very process used is questionable (see the Guideline for Billable Time on page 36).¹¹²

The Guideline for Billable Time is an internal NYCM schedule dated October 6, 2004 depicting time allotted for specific claims administration tasks, i.e. initial investigation - 1.5-2.0 hours, IME Review/POA - .5 hours. This schedule is included on page 36 of Exhibit 11.

¹¹² The Guideline for Billable Time is an internal NYCM schedule dated October 6, 2004 depicting time allotted for specific claims administration tasks, i.e. initial investigation - 1.5-2.0 hours, IME Review/POA - .5 hours.

As previously addressed, the lack of independence between the Trust's program and claims administration functions presented a potential conflict of interest situation where claims reserves could easily be manipulated downward by the program administrator to artificially reduce the Trust's liabilities. The failure of the Trustees to ensure the necessary independence between these two functions could have had an impact on the extent of the ultimate Member deficit. However, SaxBST LLP did not identify any evidence to suggest that the lack of independence contributed to the audited Member deficits noted during the years preceding the Trust's dissolution.

In conclusion, NYCM improperly billed the Trust between \$1.1 and \$1.3 million for claims administration services for which it was already being compensated pursuant to its Administration Services Agreement with the Trust. These duplicate expenses contributed to the Trust's deficit position. Evidence suggests that the claims services purportedly provided by Lake Effect Claims Service, for which these excess payments were made, were in actuality performed by in-house NYCM claims managers and staff. No information was brought to our attention that NYCM affirmatively disclosed to the Trustees, or the Members its relationship with, or payments to Lake Effect.¹¹³ Moreover, these duplicate payments paid for claims services that KBM found to be of inconsistent quality, at best. Had the Trustees or NYCM implemented periodic independent assessments of NYCM's claims administration as recommended in 2003, perhaps these qualitative shortcomings could have been mitigated.

¹¹³ As noted reviously, the Trust's audited financial statements make no reference to this obvious and long-standing related-party transactional relationship until 2006 when the Notes indicate that "Claims are administrated by an entity that is 100% owned by the management company noted above. Fees paid to this entity are included in professional and administrative fees and were \$218,000 and \$317,000 in 2006 and 2005, respectively." The audited financial statements for 2007 and 2008 make similar disclosures. The 2007 statement does not specify the fees paid specifically for claims administration, noting the fees were included in the total administrative fees reported. The 2008 statements report that \$102,316 was paid in 2008 for claims administration.

EXHIBIT #**DESCRIPTION**

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| 1 | Trust Agreement, June 6, 1994 |
| 2 | Trust Agreement, March 1, 2001 |
| 3 | Trust By-Laws, March 1, 2001 |
| 4 | Administration Agreement, April 15, 2001 |
| 5 | Administration Agreement, February 29, 2008 |
| 6 | Administration Agreement, February 29, 2009 |
| 7 | Administration Agreement, June 1, 2011 |
| 8 | USA-TPA License Revocation, May 15, 2012 |
| 9 | BYNAC Actuarial Review Report, January 28, 2013 |
| 10 | Participation Agreement Sample, March 1, 2004 |
| 11 | KBM Report to SaxBST LLP, January 2013 |