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3:04-CV-02184 USA V. GUESS

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\*DECL.\*

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*Brown*  
DEPUTY

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8 UNITED STATES DISTRICT COURT  
9 SOUTHERN DISTRICT OF CALIFORNIA

10  
11 UNITED STATES OF AMERICA,,  
12 Plaintiff,  
13 vs.  
14 L. DONALD GUESS, et al.,  
15 Defendants.

Case No. 04-CV-2184 LAB (AJB)

DECLARATION OF JOHN R. PATTON

Date: December 3, 2004  
Time: 1:30 p.m.  
Ctm: Hon. Larry A. Burns

16  
17 I, John R. Patton, declare as follows:

- 18 1. I am an attorney and a partner in the Roberts & Patton Law Firm in Ligonier,  
19 Pennsylvania, and am licensed in the State of Texas, a member of the Texas Bar Association,  
20 President of McCarran Ferguson Consulting, Inc., a third party administrator of insurance  
21 services, and a member of the Executive Committee of the Life and Health Compliance  
22 Association.
- 23 2. I have advised Doctors Benefit Insurance Company, Ltd. (DBIC), a Barbados  
24 licensed insurance company, as to its insurance operations since January, 2002 and have  
25 performed, and currently perform, third party administrative services for the company and its  
26 services providers, including claims and premium administration, and database administration, and  
27 through this administration, I prepare records, assist with DBIC's recordkeeping, and am a  
28 custodian of records for DBIC, and therefore, have knowledge of the information provided herein,

1 and have caused various reports to be retrieved from the company's database and other reports to  
2 be prepared using both database information and certificateholder file information for purposes of  
3 this Declaration. The reports relied upon for this Declaration are, in my belief, a substantially  
4 accurate portrayal of the status of each and every current and former participant in DBIC's  
5 insurance policies.

6 3. I have reviewed the All Insurances report (attached as Exhibit 1), prepared for  
7 purposes of this Declaration, and am aware that DBIC has had a grand total of 2345 insurance  
8 certificateholders since the inception of its insurance products in 1995, and has received a grand  
9 total of \$604,114,209.00 in premium contributions paid on behalf of these insureds.

10 4. I have reviewed the All Insurances report, prepared for purposes of this  
11 Declaration, and am aware that of the total 2345 insurance certificateholders since the inception of  
12 the insurance products in 1995, there are 359 former certificateholder insureds, in one of five (5)  
13 categories, and that on behalf of these, DBIC has received a total of \$69,137,078.00 in premium  
14 contributions, of which \$449,350.00 was lapsed due to failure to pay premium contributions on  
15 behalf of 29 former insureds, resulting in \$68,687,728.00 total premiums attributable to the  
16 remaining 330 former insureds.

17 5. I have reviewed the All Insurances report, prepared for purposes of this  
18 Declaration, and am aware that of the remaining 330 former participants and the premiums  
19 attributable to these, 77 of these insurance certificates, with total premium contributions of  
20 \$6,285,854.00, were rescinded and a total amount of \$6,434,921.66 was returned to the premium  
21 payors.

22 6. I have reviewed the All Insurances report, prepared for purposes of this  
23 Declaration, and am aware that of the remaining 330 former insureds and the premiums  
24 attributable to these, 151 of these insurance certificates, with total premium contributions of  
25 \$24,697,646.00, were agreed settlements and a total amount of \$23,983,054.63 was returned to the  
26 premium payors.

27 7. I have reviewed the All Insurances report, prepared for purposes of this  
28 Declaration, and am aware that of the remaining 330 former insureds and the premiums

1 attributable to these, 77 of these insurance certificates, with total premium contributions of  
2 \$35,771,457.00, were terminated upon request for the experience adjusted refund benefit, and a  
3 total amount of \$34,040,758.98 was returned to the premium payors.

4 8. I have reviewed the All Insurances report, prepared for purposes of this  
5 Declaration, and am aware that of the remaining 330 former insureds and the premiums  
6 attributable to these, 25 of these insurance certificates, with total premium contributions of  
7 \$1,932,771.00, were terminated upon fulfillment of payable claim benefits, and a total amount of  
8 \$2,433,405.58 was paid to the claimants.

9 9. I have reviewed the All Insurances report, prepared for purposes of this  
10 Declaration, and am aware that of the total 2345 insurance certificateholders since the inception of  
11 the insurance products in 1995, there remain 1986 active insurance certificateholders, in one of  
12 five (5) categories.

13 10. I have reviewed the All Insurances report, prepared for purposes of this  
14 Declaration, and am aware that of the remaining 1986 active insurance certificateholders, 37 are  
15 currently approved to receive monthly supplemental disability insurance claim benefits, of which  
16 four (4) are still listed in the company database as active, one (1) is currently approved to receive  
17 monthly supplemental long term care claim benefits, and DBIC has received for the benefit of  
18 these 38 claimants total premium contributions of \$9,812,667.00, and has paid out to these  
19 insureds a total of \$3,067,021.21 in claim benefits.

20 11. I have reviewed the All Insurances report, prepared for purposes of this  
21 Declaration, and am aware that of the remaining 1986 active insurance certificateholders, there are  
22 1946 not currently receiving monthly claim benefits, but one of these 1946 was at one time on  
23 claim and has now returned to active status, and DBIC has received total premium contributions  
24 on behalf of this one insured in the amount of \$102,681.00, and has paid to this insured claim  
25 benefits in the amount of \$50,000.00.

26 12. I have reviewed the All Insurances report, prepared for purposes of this  
27 Declaration, and am aware that of the remaining 1986 active insurance certificateholders, there are  
28 1945 not currently receiving monthly claim benefits, and that never received monthly benefits, but

1 some of these did receive either malpractice benefits or medical savings reimbursement benefits,  
2 and DBIC has received total premium contributions on behalf of these insureds in the amount of  
3 \$523,250,283.00, and has paid to these insureds claim benefits in the amount of \$1,077,013.82.

4 13. I have reviewed the All Insurances report, prepared for purposes of this  
5 Declaration, and am aware that of the remaining 1986 active insurance certificateholders, there are  
6 two (2) that signed and entered into structured settlement agreements and thus not active in the  
7 truest sense of the word, and DBIC has received total premium contributions on behalf of these  
8 two in the amount of \$1,811,500.00, and has paid to one of these a settlement installment amount  
9 of \$75,047.79.

10 14. I have reviewed the All Insurances report, prepared for purposes of this  
11 Declaration, and am aware that of the remaining 1986 active insurance certificateholders, DBIC  
12 has received total premium contributions on behalf of these insureds in the amount of  
13 \$534,977,131.00, and has paid to these insureds claim benefits or otherwise a total amount of  
14 \$4,269,082.82, resulting in \$530,708,048.18 total remaining premiums attributable to active  
15 insureds.

16 15. I have reviewed documents pertaining to various accounts of DBIC and believe the  
17 following represents a current accounting of liquid assets:

18 Vanguard	\$507,467,678.41	
19 Bank of Butterfield	\$ 16,762,014.55	
20 Wachovia - London	\$ 3,210,076.36	
21 First Union - Harrisburg - Claims	\$ 63,889.93	
22 First Union - Harrisburg - Money Mkt	\$ 63,883.99	
23 Royal Bank - Barbados	\$ 401,538.31	
24 Nerine Trust (premium receivable)	\$ 135,593.02	
25 Euro-American Trust (premium receivable)	\$ 170,010.57	
26 Bond Settlement Trust (GTR trust acct)	\$ <u>113,519.95</u>	
27 Total Liquid Assets		\$528,388,205.09

1           16.     If DBIC were to rescind all insurance in place, utilizing only current Total Liquid  
2 Assets shown in No. 15 above, by dividing that amount, \$528,388,205.09, by the total remaining  
3 premiums attributable to active insureds from No. 14, \$530,708,048.18, it would essentially be  
4 able to return 99.56% of all premium contributions attributable to current insureds, a shortfall of  
5 only \$2,319,843.09.

6           17.     However, as can be seen from No. 15 above, this total includes only liquid assets.  
7 DBIC holds almost \$22,000,000 in Viatical Contracts (\$21,744,690 to be exact according to the  
8 Declaration of Steven K. Farrington filed herein). These Viatical contracts are not easy to value.  
9 If not held to fruition (when face amount proceeds are paid upon the death of the insured), they  
10 can only be sold at a price that willing buyers are willing to pay from time to time. DBIC has  
11 previously sold three contracts it owned at an average of 58.5% of the face amount (a \$62,000 face  
12 amount investment was sold for \$34,100, or 55%; a \$215,996 face amount investment was sold  
13 for \$129,600, or 60%; and a \$400,000 face amount investment was sold for \$233,160, or 58.5%,  
14 for a weighted average of 58.5%). Assuming that same return, DBIC could potentially recover  
15 \$12,700,000, leaving a substantial surplus after paying off all rescissions.

16           18.     Further, based upon additional information provided by Steven K. Farrington  
17 (attached as Exhibit 2), I am aware that DBIC has paid to the IRS a total of \$8,092,612.84 in  
18 excise taxes and excise tax interest pursuant to its insurance operations. If the company were  
19 forced to rescind all premiums to active certificateholders, I would assume such action would be  
20 on order of the court based upon the finding that DBIC is not an insurance company and the  
21 insurance policies it has in place are not insurance. Based on those premises, the logical  
22 conclusion then would be that DBIC is entitled to a full refund of those excise taxes and interest  
23 paid. This refund provides DBIC a substantial cushion against dissipation of current liquid assets  
24 to a level where current participants would be unable to realize their entire premium in the event  
25 of an order requiring rescission.

26           19.     SEI was a vendor to DBIC for several years. It produced monthly statements for  
27 the insureds of DBIC. However, the manner in which SEI could present information was limited,  
28 so its statements were perceived to give an incomplete view of the insurance product. I believe

1 DBIC was its only insurance company client. DBIC moved its reserves from SEI to Vanguard in  
2 2003 achieving much lower fees and better services. I also believe the company decided, in  
3 conjunction with that move to Vanguard, to issue only semi-annual statements reflecting the  
4 potential benefits under a certificate of insurance. As Vanguard does not track the sub-accounting  
5 necessary to show any particular certificateholder's certificate value on any given date, DBIC  
6 hired Johnson and Lambert to assist in tracking these values on a daily basis. Johnson and  
7 Lambert was also requested to prepare and send the semi-annual statement of benefits to each  
8 certificateholder.

9       20. On information and belief, it has always been my understanding that SEI  
10 maintained sub-accounts for the benefit of DBIC's certificateholders. However, these were not  
11 "separate accounts" as that term is generally used in the insurance industry. The Life Office  
12 Management Association (LOMA) publishes a glossary of terms generally used and understood  
13 within the insurance industry. A separate account is a term used in conjunction with investment  
14 contracts and variable annuities *in the United States*. A separate account is entirely separate and  
15 distinct from the general liabilities of the issuer of such a contract. A "segregated account" is the  
16 term used *in Canada* to mean the same thing as separate account in the U.S. Use of such  
17 terminology, i.e., "segregated accounts" in marketing materials by xélan years ago, carries no legal  
18 import in the United States, and, based on my experience was only intended to reflect that a sub-  
19 accounting would take place in order to keep track of an insured's potential benefit values. It is  
20 my understanding that the use of this terminology was changed prior to 2001 for marketing  
21 materials used after that time.

22       21. I have reviewed a Premium Summary workbook report prepared provided to me by  
23 Steve Farrington (attached as Exhibit 3), DBIC's accountant, and prepared for purposes of this  
24 Declaration and to address certain allegations made by the Government, and their underlying  
25 assumptions, such allegations being that of an estimated total taxes due from certificateholders of  
26 \$420 million. The first assumption is that the doctors' contributions are not deductible. The  
27 second assumption is that each of 4000 doctors paid \$100,000.00 per year for the last three years  
28 into one of the xélan programs. This assumption leads to estimated contributions of \$1.2 billion.

1 The third assumption is that the doctors pay income tax at a 35% marginal rate on this \$1.2 billion  
2 to come up with the \$420 million estimate. The actual premium contributions received by DBIC  
3 since October, 2000 is \$406,274,834, a period of four (4) years. Of this amount, the premiums  
4 received from October of 2000 through January of 2001 were most certainly for the tax year,  
5 2000, and likely the statute of limitations has run on those amounts totaling \$78,809,612.  
6 Subtracting that amount from the total premiums of \$406,274,834 leaves a liberal total of  
7 \$327,465,222 subject to audit. I call this a liberal total because the processing of premium  
8 contributions often continues into spring of the following year for contributions ultimately  
9 attributed to the previous year. Subsequent to receiving the workbook from Mr. Farrington, I have  
10 caused to be created an additional report, Total Premiums by Premium Year (attached as Exhibit  
11 4), which shows total premiums credited by premium year for the years 2001, 2002, 2003, and  
12 2004 to be a total of \$324,572,028.26. This report also includes the crediting year, 2000, but that  
13 crediting year is likely past any statute of limitations for audit purposes except to the extent that  
14 some audits are already in place for some participants. Thus, the liberal total subject to audit  
15 referenced above is substantially similar to that which this newly created report shows. Also using  
16 the liberal 35% marginal tax rate yields only \$114,612,827 as the potential tax liability, so this  
17 number is probably an outside maximum if DBIC were to lose on every issue, a worse case  
18 scenario.

19 22. Arising out of a due diligence of the insurance company in January, 2002, my firm  
20 entered into a contract with the insurance company to perform certain third party administrative  
21 functions, including but not limited to, claims work-up, primary customer service responsibilities,  
22 and daily advisory services as to the operations of the company. In conjunction with this  
23 agreement, I was informed that certain changes to the policies had recently been initiated based on  
24 the advice of various legal counsel to the company. Chief among these changes were the  
25 elimination of the death benefit and the elimination of the investment election by participants as to  
26 the company's reserves attributable to premiums paid on behalf of an insured. Because the  
27 policies are group insurance policies, the insurer and the Group Master Policyholder retain the  
28 right to negotiate changes to the policies as long as the changes inure to the benefit of the insureds.



1 As to the death benefit, the argument was made to eliminate it to protect against any potential  
2 argument that any portion of premiums paid were for a life insurance benefit as opposed to  
3 disability benefit, because premiums paid for life insurance are not deductible by the premium  
4 payor. As to the investment election option, the argument for its elimination was based on getting  
5 rid of any potential appearance or perception that the insurance was an investment or anything  
6 other than insurance, even though the categories allowed within the investment elections were  
7 broad and the ultimate specific mix of investments was always determined by the company. These  
8 changes were communicated directly to the financial counselors related to the company's insured  
9 certificateholders in order that they be allowed to explain the changes face to face with the  
10 insureds. Subsequently, the annual Certificates of insurance coverage reflected the changes. As  
11 one might assume, there were a number of participants unhappy with these changes. Many of  
12 these decided to stay the course and remain insured through the company. Of course, the company  
13 did not wish to make its insureds stay in the insurance when they were unhappy and with that  
14 thought in mind, my firm was instructed to offer Settlement and Release Agreements to those who  
15 remained dissatisfied. To the best of my recollection, some of these were merely rescinded.

16 23. Based upon information and belief, no participant was ever advised that it could  
17 contribute up to 100% of a doctor's net practice income. In the early marketing materials used by  
18 xélan, included as an exhibit to the government's complaint, it was stated that "Participants may  
19 contribute amounts to the Trust sufficient to purchase insurance for up to 100% of their average  
20 net practice income in recent years, *integrated with any existing disability policies.*" (emphasis  
21 added) Based on knowledge obtained in the course of my services to DBIC, it is my belief that at  
22 the inception of DBIC's supplemental insurance policy, doctors could purchase primary disability  
23 insurance coverage in the range of \$18,000 to \$20,000 per month. Counselors for xélan were  
24 placing primary coverage with Royal Maccabees leading up to the disability insurance industry  
25 meltdown that occurred in 1994-95. This coverage required 10 years of premiums but contained a  
26 refund after that time of up to 80%. Royal Maccabees stopped offering coverage about the same  
27 time that DBIC's policies were put in place. Subsequently, counselors offered these doctors  
28 substantially similar coverage with Pan American Life Insurance Company. However, over the

1 ensuing years, the maximum monthly coverage for any one doctor has declined to \$10,000 per  
2 month. This maximum is available only to those with a net practice income in excess of \$375,000  
3 annually. A simple calculation of the maximum benefit divided by the required net practice  
4 income reveals that a doctor can only cover less than 33% of net practice income. DBIC's  
5 insurance was always intended to be supplemental and to provide coverage of only a portion of a  
6 doctor's net practice income. The terminology "integrated with any existing disability policies"  
7 discussed above, reflected that the company's underwriting included the requirement that a doctor  
8 have in place a primary policy. The policy currently reflects that a participant may not contribute  
9 more than 40% of net practice income in any one year in order to reflect more clearly the  
10 supplemental nature of this insurance. DBIC is offering a layer of coverage to doctors that they  
11 are unable to purchase anywhere else and it certainly does not allow a doctor to cover or  
12 contribute 100% of net practice income.

13       24. I was asked in 2002 to assist Pan American Life Insurance Company with filing  
14 DBIC's supplemental disability insurance policy for approval in the state of Louisiana. My  
15 contact at Pan American was San J. Llull. I assisted in preparing certain documents necessary to  
16 the approval of the product as requested by the Office of the Commissioner of Insurance. I have  
17 attached a copy of the letter from Tangel Ayo (attached as Exhibit 5), the Compliance Examiner  
18 in the Insurance Department. Also attached is a copy of the letter I prepared and sent to Pan  
19 American for response to the Department (attached as Exhibit 6). Also attached are the three  
20 forms prepared and sent to Pan American for use with the letter in response to the Department's  
21 request (attached as Exhibit 7). Although I do not have a copy of the final approval of this  
22 product, I believe that it was approved by the Louisiana Insurance Department. I have spoken  
23 with San Llull at Pan American and he confirms that the product was approved, but no marketing  
24 of the product ever occurred. . I have also received a fax copy of the final approval Pan American  
25 received from Louisiana's Insurance Department (attached as Exhibit 16).

26       25. I have reviewed the Active Disability Claims report (attached as Exhibit 8),  
27 prepared for purposes of this Declaration, and am aware that DBIC currently has 37 of its  
28 certificateholder insureds approved for disability claim benefits, with a total monthly disability

1 claim benefit of \$222,162.95 due these insureds, the next payment due on the 25th of November,  
2 2004.

3 26. I have reviewed the Active Long Term Care Claims report (attached as Exhibit 9),  
4 prepared for purposes of this Declaration, and am aware that DBIC currently has one of its  
5 certificateholder insureds approved for long term care claim benefits, with a total long term care  
6 claim benefit of \$6,691.67 per month, the next payment due this insured on the 25th of November,  
7 2004.

8 27. I have reviewed a Disability Claims Pending Approval report (attached as Exhibit  
9 10), prepared for purposes of this Declaration, and am aware that DBIC has seven (7) of its  
10 certificateholder insureds pending approval of claims for disability benefits, which, if approved as  
11 submitted, would result in total monthly disability benefits of \$67,333.33 due these insured  
12 claimants.

13 28. I have reviewed a Medical Savings Claims Pending Approval report (attached as  
14 Exhibit 11), prepared for purposes of this Declaration, and am aware that DBIC has six (6) of its  
15 certificateholder insureds pending approval of claims for medical savings reimbursement benefits,  
16 which, if approved as submitted, would result in total medical savings reimbursement benefits of  
17 \$28,878.51 due these insured claimants.

18 29. I have reviewed a Disability Claims History report (attached as Exhibit 12),  
19 prepared for purposes of this Declaration, and am aware that DBIC has paid to 31 of its current  
20 and former certificateholder insureds, none of these insureds being currently on claim, total  
21 disability claim benefits of \$3,119,762.91.

22 30. I have reviewed a Long Term Care Claims History report (attached as Exhibit 13),  
23 prepared for purposes of this Declaration, and am aware that DBIC has paid to two (2) of its  
24 previous certificateholder insureds total long term care claim benefits of \$98,475.02.

25 31. I have reviewed the Medical Savings Claims History report (attached as Exhibit  
26 14), prepared for purposes of this Declaration, and am aware that DBIC has paid to former and  
27 current active certificateholder insureds a total of \$1,107,497.23 in medical savings claim benefits.

28

