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MYTHBUSTER!

Medical Malpractice Mismanagement – Why Some Major Insurers Have Pulled Out of the Market

It's a common theme: insurance companies are abandoning policyholders, leaving states or pulling out of the market altogether because jury verdicts are too high and are costing insurers too much money. The solution, they say, is to limit what judges and juries are allowed to give injured patients.

Yet insurance insiders know that jury verdicts aren't to blame. Rather, the collapse of many medical insurance companies has been directly brought on by the mismanaged underwriting practices of the industry as a whole.

As one insider recently put it, "The [medical malpractice insurance] market is in chaos.... Throughout the 1990s ... insurers were ... driven by a desire to accumulate large amounts of capital with which to turn into investment income. Regardless of the level of ... tort reform, the fact remains that if insurance policies are consistently underpriced, the insurer will lose money."¹ Or as the head of a leading medical malpractice insurer put it, "I don't like to hear insurance-company executives say it's the tort [injury-law] system – it's self-inflicted."²

The mismanaged underwriting practices of the following companies, which have left thousands of policyholders high and dry, have wreaked havoc on the nation's health care professionals:

ST. PAUL

In 2001, one of the country's largest medical malpractice insurance companies, St. Paul, pulled out of the medical malpractice insurance market, creating significant supply and demand problems in states like Nevada and West Virginia.

According to a June 24, 2002 *Wall Street Journal* front-page investigative article, St. Paul, with 20% share of the national market, pulled out after mismanaging its underwriting and reserves.³ In the 1980s, the company set aside too much money for malpractice claims. So, using a tricky accounting method, in the 1990s the company "released" \$1.1 billion in reserves, which flowed through its income statements and appeared like big profits. Seeing these profits, many new, smaller carriers came into the market. Everyone started slashing prices to attract customers. From 1995 to 2000, rates fell so low that they became inadequate to cover malpractice claims. Many companies collapsed as a result. St. Paul eventually pulled out, creating problems for doctors in many states.

Even after getting out of the medical malpractice business, St. Paul's problems continued to demonstrate that poor business practices, not medical malpractice insurance, have really been at the heart of the company's downfall. In May 2002, the company was placed on credit watch with negative implications,⁴ and in July 2002, St. Paul had its ratings lowered again by Standard and Poor's due to its handling of asbestos and other environmental claims.⁵

In May 2002, the Nevada Attorney General's office filed an administrative complaint against St. Paul in connection with its decision to pull out of the medical malpractice market.⁶ The complaint cites St. Paul for alleged unlawful business practices, unauthorized policy modifications, payment of commissions to unlicensed agents, unlawful policy cancellations and nonrenewals and failure to return unearned premium payments.

A group of Charleston surgeons have sued St. Paul for "grossly poor management" that led St. Paul to drop malpractice coverage.⁷ The case is still pending.

PHICO

In November 2001, Pennsylvania regulators filed a civil fraud suit against the Pennsylvania Hospital Insurance Co. (Phico), which filed for bankruptcy in December. The company's board was allegedly misled about the adequacy of Phico's premium rates and funds set aside to pay claims. According to the *Wall Street Journal*, "On the way to becoming the nation's seventh-largest malpractice insurer, the company had suffered mounting losses on policies for medical offices and nursing homes as far away as Miami."⁸

More specifically, the suit accuses Phico officials of "fundamentally unsound" financial practices.⁹ Regulators claim that company officials and directors knew "the strategy of offering low prices in highly competitive and unfamiliar markets was fraught with risk" yet "pushed for still higher dividends as the premium volume increased."¹⁰ The state also alleges that Phico's chairwoman and two other directors engaged in self-dealing when they pressed for dividends despite knowing that the company's surplus was "declining drastically and significant strengthening of loss reserves was required."¹¹

A Pennsylvania court placed the company into liquidation in February 2002 after an insurance department investigation revealed that the extent of Phico's insolvency made rehabilitation "futile" – as of June 30, 2001, Phico had been under-reserved by more than \$250 million for losses and loss-adjustment expenses.¹²

RELIANCE

In October 2001, a Pennsylvania court placed Reliance into liquidation "after concluding that it was insolvent by \$1.05 billion as of March 31 and would run out of cash to pay claims before the end of 2001."¹³

In June 2002, the Pennsylvania Insurance Commissioner filed suit against directors of the defunct Reliance Insurance Co., alleging breach of fiduciary duty and negligence. From 1998 through the first half of 2000, the company's directors allowed more than half a billion dollars in dividend and other payments to be distributed to holding companies of which Reliance directors were major shareholders. According to an August 2002 Insurance Information Institute *Insurance Issues*

Update, the Commissioner charged the executives with “draining cash from the company to support their ‘lavish lifestyle.’”¹⁴

As reported by the Insurance Information Institute, “[a]ccording to the last publicly available financial data, filed in June 2001, Reliance’s liabilities exceeded assets by about \$1.2 billion. Every state has been affected by the insolvency, but those most severely impacted are California, New York and Texas.”¹⁵

FRONTIER INSURANCE CO.

In March 2001, the company stopped writing new and renewal business because of mismanaged underwriting and pricing of medical malpractice policies in the early and mid-1990s.¹⁶ Frontier’s CEO and president, Harry W. Rhulen said, “The problem really was we lacked the underwriting controls and infrastructure to properly do that type of business.”¹⁷

According to *BestWire* (March 20, 2001),

Rhulen said the company started writing med-mal in New York, where the business did turn a profit. Medical malpractice in New York is different than any other states, because the insurance department sets the rates, Rhulen said. “We weren’t competing based on rates, like in any other state,” he said. The company believed medical malpractice was a profitable line because of the long-tail nature of the claims.

However, the company expanded the business to competitive medical malpractice states, such as Florida and Texas, where many companies were doing “cash-flow underwriting” – underpricing premiums with the expectation that lost revenue would be made up through investments. “That’s where we really got ourselves in trouble,” Rhulen said. “We didn’t realize companies were intentionally writing at a very significant underwriting loss... we priced to that level, but reserved to our historic profitable levels (from New York business).”

In the early days, as much as 50% of the company’s business was medical malpractice. That percentage was later dropped down to as low as 25%, but the losses from the medical malpractice business began to outweigh the rest of the company’s business and dragged the bottom line into the red. “When you’re writing \$100 million in premium at a 150 combined ratio, you’re losing \$50 million a year. To make up that profitability... it’s almost impossible,” Rhulen said.¹⁸

In August 2001, Frontier entered voluntary rehabilitation, allowing the New York Insurance Department to take control of the insurer.¹⁹ As of October 2002, the Department was still attempting to rehabilitate the company.²⁰

MIXX

In May 2002, the seventh-largest medical malpractice insurer in the United States announced that it would shut down operations after losing \$200 million in a little more than a year, leaving 17,000 policyholders in 24 states without replacement coverage.²¹ As explained by *Medical Economics* in September 2002, “MIIX achieved much of its out-of-state growth by offering low premiums to gain a share of what had become a highly competitive market. In a rush to sign up new policyholders, MIIX may also have taken on an unhealthy amount of high-risk business.”²²

And according to a June 2, 2002 *New York Times* investigative article, the company “performed well enough through much of the 1980’s and early 90’s. But by the end of the decade it was in trouble after it embarked on a rapid national expansion and went public at the height of the stock market boom.”²³

Notes

¹ Charles Kolodkin, Gallagher Healthcare Insurance Services, “Medical Malpractice Insurance Trends? Chaos!” (September 2001), found at <http://www.irmi.com/expert/articles/kolodkin001.asp>.

² Quotation of Donald J. Zuk, chief executive of Scpie Holdings Inc., a leading malpractice insurer in California, from Christopher Oster and Rachel Zimmerman, “Insurers’ Missteps Helped Provoke Malpractice ‘Crisis,’” *Wall Street Journal*, June 24, 2002.

³ Christopher Oster and Rachel Zimmerman, “Insurers’ Missteps Helped Provoke Malpractice ‘Crisis,’” *Wall Street Journal*, June 24, 2002.

⁴ “S&P downgrades The St Paul and subsidiaries,” *Insurance Day*, July 18, 2002; Sheryl Jean, “St. Paul Cos.’ rating falls,” *Saint Paul Pioneer Press*, July 17, 2002.

⁵ *Ibid.*

⁶ “Late News,” *Business Insurance*, June 3, 2002; “Nevada Complaint Blames St. Paul Cos. For Med-Mal Crisis,” *BestWire*, May 31, 2002; Brendan Riley, “Nevada moves against St. Paul Cos. in docs’ insurance crisis,” *Associated Press*, May 30, 2002.

⁷ Mary Massingale, “Judge delays proceedings in surgeons’ lawsuit against insurer,” *Associated Press*, August 30, 2002; Lawrence Messina, “West Virginia Judge Refuses to Dismiss Malpractice Insurance Suit,” *Charleston Gazette*, July 9, 2002; Lawrence Messina, “Charleston, W. Va. Surgeons Demand Refund from Insurer,” *Charleston Gazette*, July 8, 2002; “Surgeons file brief seeking refund from insurer,” *Associated Press*, July 8, 2002.

⁸ Christopher Oster and Rachel Zimmerman, “Insurers’ Missteps Helped Provoke Malpractice ‘Crisis,’” *Wall Street Journal*, June 24, 2002.

⁹ Lawrence Messina, “Medical insurer bankrupt,” *Charleston Gazette*, December 20, 2001.

¹⁰ Tim Darragh, “Past business ties cloud regulators’ tasks,” *Morning Call*, April 21, 2002.

¹¹ *Ibid.*

¹² David Wenner, “Pennsylvania Medical Malpractice Insurer Declared Insolvent,” *Patriot-News*, February 24, 2002; Lori Litchman, “Court Places Insurer Into Liquidation,” *Pennsylvania Law Weekly*, February 11, 2002; “Pennsylvania’s Phico Placed In Liquidation,” *BestWire*, February 4, 2002.

¹³ Dudley Price, “Business failure will cost state a lot,” *News and Observer*, June 4, 2002; Lori Litchman, “Court Places Insurer Into Liquidation,” *Pennsylvania Law Weekly*, February 11, 2002.

¹⁴ Ruth Gastel (ed.), “Insolvencies/Guaranty Funds,” *III Insurance Issues Update* (August 2002).

¹⁵ *Ibid.*

¹⁶ “Rhulen: Frontier Will No Longer Bear Risk, But Legacy Will Live On,” *BestWire*, March 20, 2001.

¹⁷ *Ibid.*

¹⁸ *Ibid.*

¹⁹ “Frontier Enters Rehabilitation; Frontier Insurance Co.,” *Best’s Review*, October 1, 2001; “Updates,” *Business Insurance*, September 3, 2001; Joseph P. Fried, “Albany Seizes Insurance Company; Seeking to Rescue It From Insolvency,” *New York Times*, August 31, 2001.

²⁰ “Court Orders Segregation of Amount Liquidated From Trust Fund,” *New York Law Journal*, October 31, 2002.

²¹ Berkeley Rice, “How a malpractice insurer grew too big too fast,” *Medical Economics*, September 23, 2002; Susan Warner, “Practicing Without A Net,” *New York Times*, June 2, 2002; “Northeast Zone: MedMal Insurer Halting in N.J.,” *Insurance Chronicle*, May 13, 2002; “MIIX Reorganization Spotlights National Med-Mal Woes,” *BestWire*, May 10, 2002.

²² Berkeley Rice, “How a malpractice insurer grew too big too fast,” *Medical Economics*, September 23, 2002.

²³ Susan Warner, “Practicing Without A Net,” *New York Times*, June 2, 2002.