

Patient Access Crisis: The Role of Medical Litigation

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Witness:

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Testimony:

Mr. Chairman and Members of the Committee:

My name is Jay Angoff and I am a lawyer from Jefferson City, Missouri, and a former insurance commissioner of Missouri and deputy insurance commissioner of New Jersey. I appreciate the opportunity to testify here today.

Background

Today's medical malpractice insurance crisis is the third such crisis in the last thirty years. The first was in the mid 1970's, and the second was in the mid 1980's. Some states enacted limits on liability--so-called "tort reform"--in response to one or both of those previous crises. But whether or not a state enacted such limitations, malpractice rates rose during the mid-80's, fell during the 90's, and are rising sharply today. The tort system therefore can not be the cause of these periodic insurance crises, and thus enacting tort reform can not reasonably be expected to avert future insurance crises.

For example, during my 1993-98 tenure as insurance commissioner of Missouri, both the number of medical malpractice claims filed and the number of medical malpractice claims paid out decreased: according to the data the medical malpractice insurance companies filed with our department, the number of new medical malpractice claims reported decreased from 2,037 in 1993 to 1,679 in 1998, and the number of medical malpractice claims paid out decreased from 559 in 1993 to 496 in 1998. See Exhibits 1 and 2. As might reasonably be expected, medical malpractice insurance rates in Missouri decreased during that time.

After I left the insurance department, the number of malpractice claims paid continued to decrease: from 496 in 1998 to 439 in 2001. And the number of malpractice claims filed decreased even more dramatically: from 1,679 in 1998 to 1,226 in 2001. Moreover, the average payment per claim rose by less than 5%--from \$161,038 to \$168,859--far less than either general or medical inflation.

Unexpectedly, however, malpractice insurance rates rose sharply last year in Missouri--by an average of almost 100% in little over a year, according to a Missouri State Medical Society survey--just as they did in the rest of the country, and just as they did in 1986 and 1975. Insurance rates going up while insurance claims are going down--and Missouri is just one of many states where this phenomenon is occurring--doesn't seem to make sense. But it does make sense, for four reasons.

Causes of Insurance Crises

First, malpractice insurers make money not by taking in more in premiums than they pay out in claims, but by investing the premiums they take in until they pay the claims covered by those premiums. Investment income is particularly important for malpractice

insurers because they invest their premiums for about six years, since they don't pay malpractice claims until about six years after they have occurred; insurers pay other types of insurance claims much more quickly. When either interest rates are high or the stock market is rising, a malpractice insurer's investment income more than makes up for any difference between its premiums and its payouts. Today, on the other hand, stocks have crashed and interest rates are near 40-year lows. The drop in insurers' investment income today can therefore dwarf the decrease in their claims payments, and thus create pressure to raise rates even though claims are going down.

Second, just as people buy insurance to insure themselves against risks that they can't afford to pay for or choose not to pay for themselves, insurance companies buy insurance—called re-insurance—for the same reason. For example, an insurer might buy reinsurance to pay an individual claim to the extent it exceeds a certain amount, or to pay all the insurer's claims after its total claims exceed a certain amount. The re-insurance market is an international market, affected by international events, and the cost of re-insurance for commercial lines was already increasing prior to the terrorist attacks. After those attacks, not surprisingly, it increased far more, due to fears related to terrorism (and completely unrelated to medical malpractice).

Third, insurance companies use a unique accounting system—called statutory accounting principals, or SAP--rather than the generally accepted accounting principles (GAAP) used by most other companies. Under this system, insurers increase their rates based on what their “incurred losses” are. “Incurred losses” for a given year, however, are not the amount insurance companies have paid out in that year—although that would be its non-insurance, common-sense meaning—but rather are the amount the insurer projects it will pay out in the future on policies in effect in that year. These projections are, by definition, a guess, under the best of circumstances, i.e., under the assumption that an insurer has no business reason to either overstate or understate them.

Insurers do, however, have reasons for inflating or understating their estimates of “incurred losses.” Insurance companies who are thinly capitalized—who have very little cushion, called “surplus” in the insurance industry, beyond the amount they estimate they must pay out in claims—will often understate their “incurred losses” on the reports they file with insurance departments so that they can show a higher surplus on those reports. (It's the job of insurance department auditors to ferret out insurers who are doing this.) At other times, however—like today—insurers overstate their incurred losses to justify a rate increase. In addition, because increasing their “incurred losses” lowers their income, they also have tax reasons for inflating those estimates. Today, insurers' incurred loss estimates have increased dramatically because they are seeking to recoup the money they have lost on investments—not because the amount they have actually paid out in the past has risen substantially (to the contrary, in Missouri it has actually decreased). When it becomes apparent that the insurers' current loss estimates are too high, insurers will be able to use the amount they estimated they would pay out but did not in fact pay out to reduce premiums or increase profits, or both. This is one reason premiums fell during the 1990's: the “incurred loss” estimates insurers made in the mid-1980's to justify their rate increases during the 1985-86 insurance crisis turned out to be wildly inflated, enabling insurers to use the difference between what they estimated they would pay out and what they actually ended up paying out to both reduce premiums and increase their profits in the 1990's. These same phenomena will inevitably occur after this insurance crisis.

The final factor contributing to periodic spikes in insurance rates is the insurance industry's exemption from the antitrust laws under the McCarran-Ferguson Act. Unlike virtually all other major industries, insurance companies may agree among themselves to raise prices or restrict coverage, as well as to engage in other anti-competitive activities, with the exception of boycotts, that would otherwise violate the antitrust laws. When times are good—i.e., when investment income is high—the industry's antitrust exemption would seem to be irrelevant. Far from raising prices in concert, insurance companies compete for market share by cutting price. When times are bad, however—and they could hardly be worse than they are today, when both the stock market and the bond market are producing low or negative returns—the antitrust exemption for the insurance industry allows insurers to collectively raise their prices without fear of prosecution. In other industries, fear of such prosecution prevents such collective increases.

The extent to which insurers today are acting in concert to raise price has not yet been determined. Evidence from the mid-1980's insurance crisis, however, supports the conclusion that insurance companies both have collectively raised prices and have used such collective increases to pressure legislators to enact tort reform. For example: In December 1984 the Insurance Information launched an advertising campaign which it characterized as an "effort to market the idea that there is something wrong with the civil justice system in the United States." Maher, I.I.I. Launches New Ad Campaign, *National Underwriter*, Dec. 21, 1984, at 2.

In June 1985 former GEICO Chairman John Byrne told the Casualty Actuaries of New York that they should quit covering doctors, chemical manufacturers, and corporate officers and directors since "it is right for the industry to withdraw and let the pressure for reform build in the courts and in the state legislatures." *Journal of Commerce*, June 18, 1985, at 10A.

In November 1985, the Insurance Information Institute sent a kit on the "civil justice crisis" to insurance executives and agents urging them to tell their policyholders and the media that "insurers have no recourse but to cut back on liability insurance until improvements in the civil justice system will create a fairer distribution of liability, reduce the number of lawsuits, and create a climate in which insurance can operate more predictably."

The famous *Time* Magazine cover story announcing the arrival of the insurance crisis appeared in January 1986.

Because of McCarran-Ferguson courts have also consistently been forced to dismiss cases involving either price-fixing among insurers or any other type of collusion falling short of a complete refusal to deal on any terms. See, e.g., *Ohio AFL-CIO v. Insurance Rating Board*, 451 F.2d 1178 (6th Cir. 1971); *Fleming v. Travelers Indem. Co.*, 324 F.Supp. (D. Mass. 1971). And while the attorneys-general of 19 states challenged certain insurer activity under the boycott exception to McCarran in the aftermath of the last insurance crisis, they did not challenge the recommending of rates by the Insurance Services Office (ISO), an insurance industry consortium. The attorneys general explained that "the rate-recommendation function of ISO, although anticompetitive and illegal in any other industry, is not a part of the Attorneys Generals' cases because the insurance industry has a special exemption from the antitrust laws that covers this conduct." Office of the Attorney-General of West Virginia, Fact Sheet on the Multi-state Prosecution of

Antitrust Violations in the Insurance Industry, March 22, 1988, at 7. Whether any anti-competitive activity that insurers may currently be engaging in is immune from prosecution under McCarran or actionable under the boycott exception to McCarran will likely be determined in the aftermath of the current crisis.

#### How to Prevent Future Insurance Crises

What, then, can be done to reduce medical malpractice insurance rates in the short run, and to prevent periodic medical malpractice insurance crises from occurring in the future just as they have occurred in the past? First, Congress should repeal the McCarran antitrust exemption, so that insurers could no longer act in concert to raise prices without fear. A second solution is to give doctors automatic standing to challenge rate increase proposals filed by medical malpractice insurers with state insurance departments. Some malpractice insurers are today owned by doctors, and many doctors have the quaint idea that those doctor-owned insurers are somehow different than other insurers. When doctors own insurance companies, however, they act like insurance executives, not doctors; and they are just as affected by poor investment performance and high reinsurance costs as are other insurers, and just as likely to inflate their incurred loss estimates and take advantage of their antitrust exemption as are other insurers. By hiring an independent actuary at a cost of a few thousand dollars to point out the unreasonableness or irrationality of an insurer's "incurred loss" estimate on which its rate increase request is based, a state medical association could save its members hundreds of thousands or even millions of dollars in the aggregate.

Third, the states could change their laws to make it easier for insurance commissioners to prevent excessive rate increases. In many states, for example, medical malpractice insurers can raise their rates at will, without getting approval of the insurance commissioner. In other states the insurance commissioner may disapprove a rate only if he first finds that the market is not competitive; by the time the commissioner makes such a finding, however, the damage has already been done.

Fourth, states can authorize and provide start-up loans for new malpractice insurers which would compete with the established insurers. In Missouri, the legislature created such a company to write workers compensation insurance in 1993, when workers comp rates were increasing dramatically even though workers comp claims were not, and that company has been a success: it charged rates that were based on experience rather than inflated "incurred loss" estimates, which forced the other insurers to do the same; it paid back its loan from the state well ahead of schedule; and it now is a significant player in the workers comp market. The key to its success is the fact that it competed with the established insurers for all risks, including the most profitable; the established carriers had sought to limit its mission to insuring only the worst risks. If a state establishes a new medical malpractice carrier and authorizes it to compete with the established carriers for all doctors' business then that insurer should help drive medical malpractice rates down just as the Missouri state-authorized workers comp insurer has helped drive workers comp rates down.

Finally, there is the California 20% solution. In 1988, California voters narrowly approved a ballot initiative, Proposition 103, which not only repealed California's antitrust exemption for insurance companies and gave both doctors and consumers automatic standing to challenge insurers' proposed rate increases, but also mandated that insurance companies roll back their rates. The California Supreme Court upheld

substantially all of Proposition 103, including the rollback, modifying it only to the extent necessary to permit insurers to avoid the rollback if they could demonstrate that they would be unable to earn a fair rate of return if their rates were rolled back. Few insurers could prove this, and as a result medical malpractice premiums in California fell sharply in the years immediately after Prop 103 was enacted, and even today are lower than they were in the year before Prop 103 was enacted. While a mandatory rollback sounds--and is--extreme, what California tells us is both that it is constitutional and that it works. Some doctors argue that what has caused rates to fall in California is a law limiting the non-economic damages that injured people can recover that the California Supreme Court held constitutional in 1984. But in the first full year after the law was upheld, premiums rose by 35%. Premiums did not begin to fall until Prop 103 was enacted in 1988 and declared constitutional a year later. See Exhibits 3 and 4.

#### What Insurers Themselves Say About Insurance Crises

To be sure, the current sharp and apparently irrational increases in insurance rates have created pressure to enact limitations on liability, based on the understandable rationale that if the amount injured people can recover from insurance companies is limited, insurance companies will pay out less money to such people, and they will pass at least some of those savings on to policyholders. I have explained that such limitations do not make sense because the other factors which cause insurance rates to fluctuate, such as investment income and the cost of reinsurance, have a much greater impact on the premium dollar than could any plausible limitation on the amount injured people could recover.

In addition, Missouri and many other states did enact such limitations after the insurance crisis of the mid-1980's, or the insurance crisis of the mid-1970's, yet rates are rising today in those states just as they are rising in states that did not enact such limitations--even if, as in Missouri, litigation is decreasing, not increasing.

But perhaps the best evidence that litigation does not cause insurance rates to rise--and conversely, that limiting litigation will not cause insurance rates to drop--is what two of the biggest medical malpractice insurance companies said themselves after the last insurance crisis. Florida reacted to that crisis by limiting non-economic damages for all injuries to \$450,000, and limiting liability in four other respects. After the law was passed, the insurance commissioner required all medical malpractice insurers to refile their rates to reflect the effect of the five major limitations on liability the state had just enacted. In response, Aetna Casualty and Surety conducted a study, attached as Exhibit 5, that concluded that none of those limitations would reduce insurance rates. In particular, Aetna concluded that the \$450,000 cap on non-economic damages would have no impact on Aetna's claims costs "due to the impact of degree of liability on future losses, the impact of policy limits, and the actual settlement reached with the plaintiff."

The St. Paul Fire and Marine Insurance Company--which at the time was the largest malpractice insurer in the nation--conducted a similar study, attached as Exhibit 6. That study analyzed 313 claims it had recently closed and found that 4 of those 313 claims would have been affected by the limitations enacted in Florida, "for a total effect of about 1% savings." The St. Paul further explained that the 1% savings estimate probably overstates the savings resulting from the new restrictions. And it specifically emphasized that "the conclusion of the study is that the noneconomic cap of \$450,000, joint and

several liability on the noneconomic damages, and mandatory structured settlements on losses above \$250,000 will produce little or no savings to the tort system as it pertains to medical malpractice.”

What the Aetna and St. Paul studies may really be telling us--since they prepared those studies to justify their refusal to reduce their rates after limitations on liability were enacted--is that even if such limitations might reduce the amount insurers pay out, insurers don't pass on any savings to policyholders. More important, however, even if they did pass on any such savings, they would be insignificant compared to the other factors affecting malpractice rates. Perhaps that is why after the last insurance crisis the chairman of the Great American West Insurance Company told an audience of insurance executives that tort reform "will not eliminate the market dynamics that lead to insurance cycles," and warned them that "we must not over-promise--or even imply--that insurance cycles will end when civil justice reform begins." See "Don't Link Rates to Tort Reform, Insurance Executive Warns Peers," *Liability Week*, Jan. 19, 1988, at 1.

#### Conclusion

In conclusion, over the long run the medical malpractice insurance industry is substantially more profitable than the insurance industry as a whole: during the 10-year period 1991-2000, according to the National Association of Insurance Commissioners, its return on net worth has been more than 40% greater than the industry average, and its loss ratio has been 6 percentage points lower than the industry average, i.e., it has paid out in losses six cents less on the premium dollar than have all property/casualty insurers. See Exhibit 7. Despite this long-run above-average profitability, however, medical malpractice insurance rates, for the reasons I have described, fluctuate substantially--both up and down. The reforms I have outlined can both reduce those fluctuations and, particularly if the insurance industry's antitrust exemption is repealed, reduce the level of malpractice rates over the long run. In contrast, limitations on liability have been demonstrated to do neither.

I would be happy to answer any questions the committee may have.