



Claims-Made Malpractice Insurance

By Brian S. Kern, Esq. (2005)

Claims-Made Malpractice Insurance: Evolution and Risks

Medical malpractice insurance companies throughout the nation have experienced significant problems by offering occurrence-based coverage, and have now either ceased offering them, or are simply marketing claims-made policies more aggressively. Although most professional liability policies have historically been written on a claims-made basis, New Jersey carriers began offering occurrence coverage to physicians more than twenty-five years ago, and, until recently, have enjoyed great success. But while the New Jersey tort system continues to shy away from meaningful reform, the inherent difficulties in offering occurrence-based policies have finally been realized.

Occurrence-based policies cover claims relating to incidents that occurred during the years the policy is in force, regardless of the date when a potential lawsuit is filed. So, for example, an occurrence policy purchased for 1999 covers any claim that alleges malpractice to have occurred during 1999, regardless of when the lawsuit is filed, be it in 1999, 2001, or 2005. This makes it difficult for insurance companies to account and reserve for any single year of coverage. This difficulty is exacerbated by New Jersey's discovery rule, which effectively extends the two-year statute of limitations for a plaintiff to file a claim (except for minors), by the number of years it takes for alleged negligence to be "discovered." Since occurrence policies are designed to cover this infinite period of time, pricing is difficult and significant company resources are tied up in reserve funds, explaining the continued shift towards the more quantifiable claims-made policies.

Irrespective of any statute of limitations, claims-made policies cover only those claims made during the policy period. Thus, coverage is determined not by the date when the incident occurred, rather, by the date that the claim is made. To trigger coverage, a claim must be filed after a policy's retroactive date, and before a policy's termination date.

The retroactive date of a claims-made policy is that date on which the policy first becomes effective. When a claims-made policy is renewed each year, the retroactive date remains the same. However, if a claims-made policy is *not* renewed, all coverage under the policy ends when the policy expires. This allows insurers to more accurately account and reserve for any claims incurred by each policy. To prevent a lapse in coverage, prior-acts can be bought from a new insurer, which should provide coverage back to the original retroactive date. A second option is to purchase extended reporting coverage,

also known as a tail, from the previous insurer. Since the cost of a tail is based on the rates at the time it is purchased though, its cost will reflect changes in a medical practice, the tort environment, and even claim activity.

When purchasing a claims-made policy, the goal is to avoid the necessity of buying a tail, but this cannot always be achieved. The cost of tail coverage is based either on a percentage of the prior year's premium or on a percentage (or multiple) of the "mature" rate. When a dramatic rate increase results from either claim activity or an increase in exposure, the cost of a tail will usually increase proportionately. An understanding of the pricing of a tail is critical, as funds must be available to purchase one if necessary. Tail payments are required to be made in full, and generally cannot be financed through the carriers.

Other long-term factors are important to consider when choosing between claims-made and occurrence coverage. Most insurance companies not only exclude coverage beyond state lines, but also refuse to pick up prior coverage from other states. Consequently, occurrence-based policies are advisable for physicians who may be thinking about relocating to another state, or perhaps just uncertain about the future.

Because the insurance market in New Jersey is still precarious, it is also important to choose a company that has a long-term commitment to the state, is financially solvent and has a long-term commitment to its policyholders. Several companies have left the New Jersey market in recent years, while others are showing continued signs of dissatisfaction with its laws. Yet another company has begun canceling select policyholders after only two years in existence, forcing some claims-made policyholders to immediately purchase tails.

There are countless other considerations as well as additional ways to maximize the benefits and reduce the risks of claims-made coverage, especially for large groups. We strongly advise that specialized accountants and insurance agents be consulted before these decisions are made.

The Advantages of Claims-Made Medical Professional Liability Insurance Policies

In an article appearing in the inaugural issue of *Physician Advocate*©, we outlined the evolution and risks associated with claims-made medical professional liability coverage. This follow-up article highlights the advantages and disadvantages of claims made policies.

A claims-made policy, unlike its occurrence counterpart, provides only temporary protection, and can completely terminate at the end of a policy period. If a claims-made is not renewed, a policyholder must secure extended reporting coverage, or a "tail." This tail can be quite costly to purchase, and often must be paid in full within thirty days of the policy expiration date. A few carriers offer only short-term tails, and should be avoided wherever possible, since the protection will expire and ultimately leave the physician

without *any* coverage. The statute of limitations is often misunderstood to be two years in New Jersey, but is misleading, as the two-year time limit does not begin to run until the time that a patient “discovers” negligence. Thus, the actual time period within which a claim can be filed is virtually unlimited.

However, claims made policies do provide substantial advantages. One major advantage is that claims-made coverage is portable. As long as a claims-made policy is renewed each year, and continually provides for coverage back to the initial retroactive date, then a physician is free to move from company to company. In this volatile insurance market, the benefits of being able to transfer freely from a financially precarious insurance company to a financially strong one cannot be understated. And given today’s unstable market, replete with start-up and un-rated insurers, occurrence coverage should be carefully scrutinized.

The principle economic benefit of a claims-made policy is that the premium during the first years of coverage is substantially less than a comparable occurrence policy. By switching from an occurrence to a claims-made policy, a physician could save as much as 75% of premium in the first year. Thereafter, claims-made premiums will increase by a fixed percentage in each of the next four years, reaching the same level as an occurrence policy in year five. For example, an occurrence policy that costs \$10,000 annually could be priced on a claims-made basis at \$2,500, \$4,500, \$8,500, \$9,500, and \$10,000 in years one to five. Some companies price the mature claims-made policy below the occurrence even after five years.

The savings that a physician can realize from a claims made policy should be invested annually into a “Tail Investment Account” in the name of the medical entity. Since the deposits into this account are not tax deductible, it could create taxable income and charges for any additional federal or state taxes incurred as a result of the premium savings. However, a properly structured S Corporation may minimize the overall tax impact, and the balance would be invested into marketable securities, bonds, saving accounts, etc. Depending upon the rate of return and length of time the money is invested, this account should achieve positive growth. Any realized gains would be included in the taxable income of the entity and subject to taxes annually. The longer the duration of the practice, and, in turn, the length of time the funds earn interest, the greater the value of the account. When it becomes time to purchase a tail, instead of withdrawing money from the account, the practice can borrow against the fund, or use collateral such as receivables to facilitate the loan. Alternatively, the practice can simply use its current income to fund the tail, all the while leaving the tail investment account in tact.

Ideally, a tail will never actually have to be purchased, and all the money accumulated in the tail savings account will become a personal retirement bonus. Tails are generally free in the event of death, disability, or upon permanent retirement from medicine. Qualifying for a free tail at retirement usually entails additional requirements though; typically that a physician maintain a claims-made policy with the same company for the five consecutive

years leading up to retirement. Often a minimum age must be attained as well, such as 55 years.

Depending on your entity type and the strategies implemented to address the premium savings, the distributions from the tail investment account to the shareholders could be tax-free. This model can work with proper planning, insight, and understanding of the issues, as well as self-discipline in investing the premium savings along with a reasonable rate of return. Claims-made policies can play an integral role in a comprehensive estate and/ or retirement plan too, and many of our clients have saved tens of thousands of dollars by taking the time to educate themselves to the risks versus potential rewards.

These strategies may not be useful for physicians who intend to either stop practicing for any length of time prior to retirement, or are considering moving out-of-state. Otherwise, as occurrence policies become increasingly more expensive, or simply unavailable from financially solid carriers, switching to a claims-made policy is not necessarily problematic, and can present considerable investment opportunities, as well as potential relief from a financially unstable carrier.

As always, it is critical to consult with independent professionals prior to making any coverage decisions.

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