

MEDICAL MANAGEMENT

Medical Practice Management Professional

A quick reference tool of important information for every healthcare professional

CICs Drop Malpractice Costs Dramatically

By Mark Sims

You receive your renewal premium notice from your medical malpractice insurance carrier, but fear opening it because you know your premiums have increased — just how much is the million-dollar question.

Physicians in high-risk specialties in particular have seen their premiums increase by 100% or even 200% over the previous year. Indeed, soaring premiums on medical malpractice insurance are a national crisis, invading the practice of medicine, threatening access to quality care and prompting widespread public outcry. Physicians and the insurance industry place the blame on the growing number of out-of-control litigant awards.

In response, many state legislators have implemented tort reform to restrict these type of awards in their respective states. Their primary vehicle: *non-economic damage caps*, which limit the awards a patient can receive for intangible injuries, such as pain and suffering.

Since 1975, 19 states have implemented these caps on non-economic damages at various levels ranging from \$250,000 to \$1 million. In an attempt to cope with the emerging crisis, the push to impose caps has reached the federal level, with a number of legislative proposals to institute reforms including the most salient feature, a \$250,000 nationwide cap. Yet, how soon this will happen, if at all, remains to be seen.

What is a CIC?

What is being seen, however, is a new twist on an old self insurance plan that might be the saving grace for physicians nationwide. Although in existence since the 1970's, physicians all over the country are beginning to more closely evaluate how a Captive Insurance Company (CIC) can help them maintain reasonable malpractice protection.

Essentially, a CIC is a corporation qualified by a regulatory authority to operate as a licensed insurance company for specific and limited purposes — to provide malpractice insurance for its owners. As an owner-controlled entity, a CIC operates much the same as any insurance company.

In the simplest form, a CIC is an organized plan of self-insurance, with re-insurance to cover large claims, that calculates risk, issues policies, collects premiums, pays expenses and establishes reserves to pay future claims.

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The majority of CICs are formed and domiciled in the international jurisdictions because of the high cost to form them in the United States. For example, capitalizing a medical malpractice CIC in the US would require a minimum investment of \$1 million, whereas the cost can be as little as \$50,000 in the international jurisdictions.

Why are captives formed?

CICs reduce the direct cost of insurance for their owners by eliminating various expenses associated with commercial policies. CIC owners control their company, how claims are handled and how reserves are invested. The owners decide whether a claim is to be settled or fought in court. Right now it is up to your commercial carrier to make these decisions.

Over a period of time, the reserves that accumulate in your CIC can become quite sizeable. These reserves and the income from this asset directly benefits the CIC owners by offering the company’s owners tax reduction and asset protection strategies not available with commercial carriers.

As a matter of fact, you do not know what your commercial carrier is paying for re-insurance, sales and marketing, administrative and overhead costs, and yes profits. Don’t forget, your commercial carrier is in the business to make a profit.

How can a CIC save me money?

Premium dollars paid to your commercial malpractice insurance carrier are allocated as follows:

- reserve account to pay future claims;
- re-insurance costs (*they do not take all the risk*);
- sales and marketing costs;
- administrative and overhead costs;
- profit (*yes, they make money*).

Some 60-70% of the premium dollars you pay are actually set aside for the purpose you pay them: the payment of future claims liabilities. A CIC sets aside the same amount of money in reserves and substantially reduces many of the policy expenses.

With your own CIC, you will pay for

Step one in starting a CIC requires complete financial, insurance picture

Interested in seeing if a Captive Insurance Company is right for you? The first step is to develop a business plan to see how this program could work in your practice. To begin that process, your advisor/consultant will need complete insurance and financial documentation, which includes the following data:

- ⇒ Name of insured(s); group and/or practice name (if applicable); addresses; telephone and fax numbers; contact person(s); email/website or both. CVs on all physicians.
- ⇒ History of medical malpractice insurance coverage for a minimum of five years, including premium history. (If possible, preferably 10 years history.)
- ⇒ Information and history of the medical practice including financial information and risk management policies and procedures.
- ⇒ Loss history (loss run) for a minimum of five years, unless physician(s) have been in practice for a shorter time frame.

The loss data must contain:

- i) Full details on all paid losses, separated into indemnity and expense as well as information on losses in excess of \$50,000.
- ii) Full details on open and pending claims, a description of the loss(es), changes in reserves, defense posture, as well as remarks covering losses in excess of \$50,000.
- ⇒ Current risk management procedures. If a manual or other printed material exists, your consultant will most likely need to review it as well as a description of hiring practices for both physician(s) and technical personnel.
- ⇒ Future plans, if any, for increasing staff or any change in venue or method of conducting the practice.
- ⇒ Coverage requirements.

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reinsurance costs to pay for any catastrophic claim. For example, each physician would have a \$100,000 deductible.

Any claim over that deductible will be paid by a reinsurance company. These are the same reinsurance companies that are re-insuring your commercial policy now.

You will not pay sales and marketing costs or commissions with a CIC. You will not be marketing your company by sponsoring some sports stadium and you will not be putting your name out on a shingle in New York City.

You will be eliminating at least 30% of the costs you are currently paying with your commercial carrier, while at the same time you will be building up your reserves in your CIC. Keep in mind that those reserves are there to pay the high deductible claim – \$100,000 for example – and to build up the profit of the CIC to benefit its

You will not pay sales and marketing costs or commissions with a CIC...you will be eliminating at least 30% of the costs you are currently paying with your commercial carrier.

owners, just like a real insurance company operates and performs.

What happens to CIC profits?

In the event the captive insurance company is no longer needed at some point in the future, a transfer of ownership can be arranged allowing the practice to recoup capital investment and recover any unused portion of premium deposits, provided your loss experience has been favorable.

This return of capital is taxed at long-term capital gains tax, which is currently 15%, and distributed to the CIC owners.

Some physicians and physician groups have been able to establish millions in reserves in their CICs. Consider that for years, approximately 50% of U.S. hospitals have been able to

hire physicians away from their practices because they have formed a CIC to manage their malpractice insurance for the their staff physicians.

How can a CIC work for me?

The following is a very conservative illustration of how a CIC could work in a typical medical group.

Practice stats:

- 6-member physician group.
- \$150,000 annual premium.
- \$90,000 in reinsurance premiums.

Operating CIC:

- Each physician has a \$100,000 deductible (to be paid out of the CIC).
- A claim paid out in year 5 and year 8. The actual claim is not for \$100,000 and \$150,000 respectively, that is the most that would come from the reserves in the CIC. The claim could be for \$3,000,000; the reinsurance company pays the other \$2,900,000. This is what the reinsurance premium is for and the purpose of the reinsurance for your CIC.
- No increase in premiums (not realistic).
- Reserves earning 7% (conservative).

(CICs, continued on page 5)

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“Captive” Malpractice Insurance Company

Examples with a Captive Insurance Company

| | | |
|---|-------------|-----------|
| MY-OWNCO CIC Insurance Premium | \$150,000 | \$175,000 |
| Re-Insurance Premium | \$ 90,000 | \$ 90,000 |
| | | |
| MY-OWNCO CIC Account | \$ 60,000 | \$ 85,000 |
| MY-OWNCO CIC Annual Operating Costs | \$ 20,000 | \$ 20,000 |
| | | |
| MY-OWNCO CIC Reserve Account (after expenses) | \$ 40,000 | \$ 65,000 |
| MY-OWNCO CIC Reserve Account Earnings @7% | \$ 2,800 | \$ 4,500 |
| | | |
| MYOWNCO CIC Reserve Account | \$ \$42,800 | \$ 69,500 |

MYOWNCO CIC:

- ? Retains a pre-determined portion of risk and re-insures the rest
- ? Negotiates the rates that are charged to the policyholders
- ? Retains some of the underwriting profits
- ? Retains the investment income
- ? Helps control claims
- ? Profits and income may be returned to owners at a capital gains rate

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“Captive” Malpractice Insurance Company — A \$40k Reserve Example

| Year | Captive Insurance Premium | Reserve Account Increase | Reserve Account Investment Income | Reserve Account Balance at Beginning of Year | Med-Mal Claims Paid | Net Reserve Account Balance at Year End |
|--------------|---------------------------|--------------------------|-----------------------------------|--|---------------------|---|
| 1 | \$150,000 | \$40,000 | \$2,800 | \$0 | \$0 | \$42,800 |
| 2 | \$150,000 | \$40,000 | \$5,796 | \$42,800 | \$0 | \$88,596 |
| 3 | \$150,000 | \$40,000 | \$9,001.72 | \$88,596 | \$0 | \$137,598 |
| 4 | \$150,000 | \$40,000 | \$12,431.84 | \$137,598 | \$0 | \$190,030 |
| 5 | \$150,000 | \$40,000 | \$9,102.07 | \$190,030 | \$100,000 | \$139,132 |
| 6 | \$150,000 | \$40,000 | \$12,539.21 | \$139,132 | \$0 | \$191,671 |
| 7 | \$150,000 | \$40,000 | \$16,216.96 | \$191,671 | \$0 | \$247,888 |
| 8 | \$150,000 | \$40,000 | \$9,652.15 | \$247,888 | \$150,000 | \$147,540 |
| 9 | \$150,000 | \$40,000 | \$13,127.80 | \$147,540 | \$0 | \$200,688 |
| 10 | \$150,000 | \$40,000 | \$16,846.74 | \$200,668 | \$0 | \$257,514 |
| Total | \$1,500,000 | \$400,000 | \$107,514 | | \$250,000 | \$257,514 |

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(CICs, continued from page 3)

As you can see, at the end of 10 years with two claims, your CIC is showing a net profit of \$267,617. This money could be paid out to the owners and taxed at a favorable tax rate. With your commercial carrier at the end of 10 years, the physicians would receive nothing.

There is no doubt medical malpractice insurance is expensive with rates predicted to go even higher. It is a fact that premium dollars paid to your commercial malpractice insurance carrier are allocated as the carrier sees fit and policyholders do not share in profits or investment income.

Premium dollars paid to your CIC are allocated in an efficient and cost effective manner. The policyholders/owners are able to share in profits or investment income. Keep in mind that profits from a CIC may be distributed to the owners at a capital gains rate instead of ordinary income tax rates and that translates into a substantial tax savings for you.

Mark Sims is co-founder and president of Heritage Advisory Group, a financial consulting firm in Indianapolis. His areas of expertise include employee benefits, income and estate tax reduction, investments, asset protection, retirement and pension plans. His articles have appeared in Orthopedics Today and Strategic Orthopedics. He can be reached at 812-339-7450 or at msims@hadvisorygrp.com.

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