

Report
on
the California Medical Malpractice Business
of
Norcal Mutual Insurance Company, SCPIE Indemnity Company,
and
The Doctors Company:
Profitability, Performance and Financial Condition

by

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Executive summary

The profitability of the medical malpractice insurance industry has increased substantially over the last five years, both in the nation as a whole and in California. The California malpractice market, however, has consistently been far more profitable than the national malpractice market. Specifically, in each of the last five years for which both California and countrywide data are available, the California market was at least 48% more profitable and as much as 75% more profitable than the national malpractice market. In addition, with only one exception the California market was more profitable throughout the period 1998-2006 than was the national market in its best year.

The three leading California malpractice insurers are Norcal Mutual Insurance Company, SCPIE Indemnity Company, both of which write primarily in California, and The Doctors Company (TDC). Norcal and SCPIE write primarily in California; TDC writes about one-third of its business in California. Together, they insure approximately two-thirds of all doctors in California. According to the Annual Statements they have filed with the California Department of Insurance, in 2006 they projected they would pay out in claims less than 29 cents of each dollar they earned in premium. They thus had more than 71 cents of the premium dollar left over for overhead--e.g., executive salaries, marketing and advertising, and lawyers and lobbyists--and profit. That profit is in addition to the profit provided by the income they earn on their investments.

In addition, both Norcal and SCPIE have consistently and substantially over-reserved in California—i.e., they have actually paid out less in California than they projected they would be paying out. For example, for claims arising in the most recent 12-year period for which Norcal's true ultimate liabilities are known, Norcal actually paid out 37% less than it

initially estimated it would pay out. Similarly, for claims arising in the most recent 10-year period for which SCPIE's true ultimate liabilities are known--12-year data for SCPIE was unavailable--SCPIE ended up paying out 32.8% less than it initially projected it would pay out. Because rates are based on the amount the insurer estimates it will pay out, not on the amount it has actually paid out, the fact that Norcal's and SCPIE's estimates of the amount they would ultimately pay out have consistently been far higher than their actual payouts means that their rates have traditionally been excessive. (Unfortunately, because TDC writes only one-third of its business in California but reports its reserves only on a national basis, its Annual Statement does not reveal how the amount it has reserved for California claims compares to the amount it has actually paid out in California.)

Notably, while SCPIE's California physicians liability business has been highly profitable, SCPIE acknowledges in its Annual 10-K Statement filed with the Securities and Exchange Commission that it has lost money on both its non-California healthcare liability business and its reinsurance business. Thus, the rates it has been charging California doctors have in effect subsidized the losses it has had on its non-California and reinsurance operations.

Surplus is the extra cushion insurers hold over and above the amount they have reserved to make their estimated future claims payments. Norcal, SCPIE and TDC all hold more surplus, as a percentage of the minimum surplus the National Association of Insurance Commissioners requires them to hold, than all but two of the ten other largest malpractice carriers; and TDC holds more surplus than any other malpractice insurer in the nation, both in absolute terms and as a percentage of the NAIC's minimum required surplus. All three carriers have substantially increased their surplus in recent years. SCPIE, for example,

increased its surplus by 20% in only two years, and both Norcal and TDC increased their surplus by almost 100% in four years.

Notwithstanding such increases in surplus, none of the three companies has issued a substantial dividend to its policyholders during the last five years. The nominal nature of the dividends issued by Norcal and TDC despite their almost 100% gains in surplus since 2002 are particularly noteworthy because both companies are owned by their policyholders, and thus owe a legal duty solely to their policyholder/owners.

Finally, although their Annual Statements show both their actual and projected claims payments declining, Norcal, SCPIE and TDC have all increased their rates substantially since 2001. They have been able to do so because their rate filings are based not on their actual experience, but rather on assumptions which are at odds with both their experience and in some cases with other data they have filed with the Department and/or the SEC.

In order to justify rates that are substantially higher than their actual experience would justify, they have assumed that they would be paying claims more quickly in the future than they have paid them in the past; they have assumed that the amount they will pay out in the future will increase substantially in the future even though it has been decreasing in the past; they have assumed that their expenses in the future will be higher than they have been in the past; and they have assumed that they would earn less on their investments than they have publicly acknowledged they are in fact earning. The difference between the assumptions the carriers made in their rate filing as to their claims experience and their actual claims experience may provide a basis for challenging their current rates as excessive.

I. Introduction

This report examines the profitability, performance and financial condition of the three largest malpractice insurers in California: Norcal Mutual Insurance Company (“Norcal”), SCPIE Indemnity Company (“SCPIE”), and The Doctors Company (“TDC”). In 2006, they together accounted for two-thirds of all malpractice business in California. Norcal wrote \$187.5 million in malpractice premium, or 28% of the total market; TDC wrote \$151.2 million, or 23%; and SCPIE wrote \$98.6 million, or 15%.

This report first analyzes the performance and financial condition of these three companies. The analysis is based primarily on the financial data contained in the Annual Statements that all three companies have filed with the California Department of Insurance (“DOI”) and the National Association of Insurance Commissioners (“NAIC”). It also draws on the commentary in the Management Discussion and Analysis (“MD&A”) sections in those Statements, as well as on the annual report – the so-called “10-K” – SCPIE has filed with the Securities and Exchange Commission. As a publicly-held stock company, SCPIE must file regular reports with the SEC. As companies owned by their policyholders, Norcal, which is a mutual company, and TDC, which is a reciprocal, do not file with the SEC.

Second, this Report analyzes the most recent rate filings of Norcal, SCPIE and TDC. Those rate filings contain the data, assumptions and calculations on which the current rates of those companies are based. The Report compares the assumptions Norcal, SCPIE and TDC made in their rate filings as to the trend in their claims payments with the actual trend. It also compares the assumptions the three companies made in their rate filings as to various factors on which their current rates are based with statements they made in their 10-K or MD&A about

these same factors. The Report concludes that because the rates these companies are currently charging are based on assumptions and projections that are far more pessimistic than their actual experience has proved to be, their current rates are excessive.

II. Annual Statement data

Insurance companies must file comprehensive financial statements with state insurance departments by March 1 each year. Those statements, known as Annual Statements, include extensive financial data for the most recent calendar year, and summary data for each of the most recent five calendar years. In particular, an insurer's Annual Statement includes data on:

- the premium it collects;
- its claims payments and projected claims payments;
- its reserves—the amount it sets aside to pay projected future claims; and
- its surplus—the extra cushion held by the insurer in addition to the amount it sets aside to pay future claims.

This section analyzes all those elements of the performance of Norcal, SCPIE and TDC based primarily on the data contained in their Annual Statements.

A. Earned premiums vs. incurred losses

The performance of property/casualty insurance companies—malpractice insurance is a type of property/casualty insurance--can be measured in several ways. One often-used metric is the incurred loss ratio—the claims payments the insurer projects it will make in the future that are covered by policies in effect in a given year, plus any changes in the amount the insurer has reserved to pay on prior years' policies, divided by the premiums the company earns in the given year. All other things equal, the lower the incurred loss ratio, the more profitable the insurer.

Notably, the denominator in the incurred loss ratio—earned premium—is a hard number, while the numerator—incurred losses—is an estimate. That estimate often turns out to be substantially inaccurate, as explained in subsection C of this section. Nevertheless, the industry uses the incurred loss ratio as its primary measure of an insurer’s performance. As a very rough rule of thumb, if a malpractice insurer’s incurred loss ratio is between 65 and 70 and its incurred loss projections are reasonably accurate, it is earning a reasonable profit. An incurred loss ratio above 70 means the insurer is likely earning an inadequate profit; a ratio below 65 means its profit is likely excessive. The following table compares the incurred loss ratios of Norcal, SCPIE and TDC to those of both the California malpractice market as a whole and the national malpractice market for each of the last nine years.¹

Figure 1

Norcal, SCPIE and TDC Loss Ratios v. all Cal. v. CW, 1998-2006

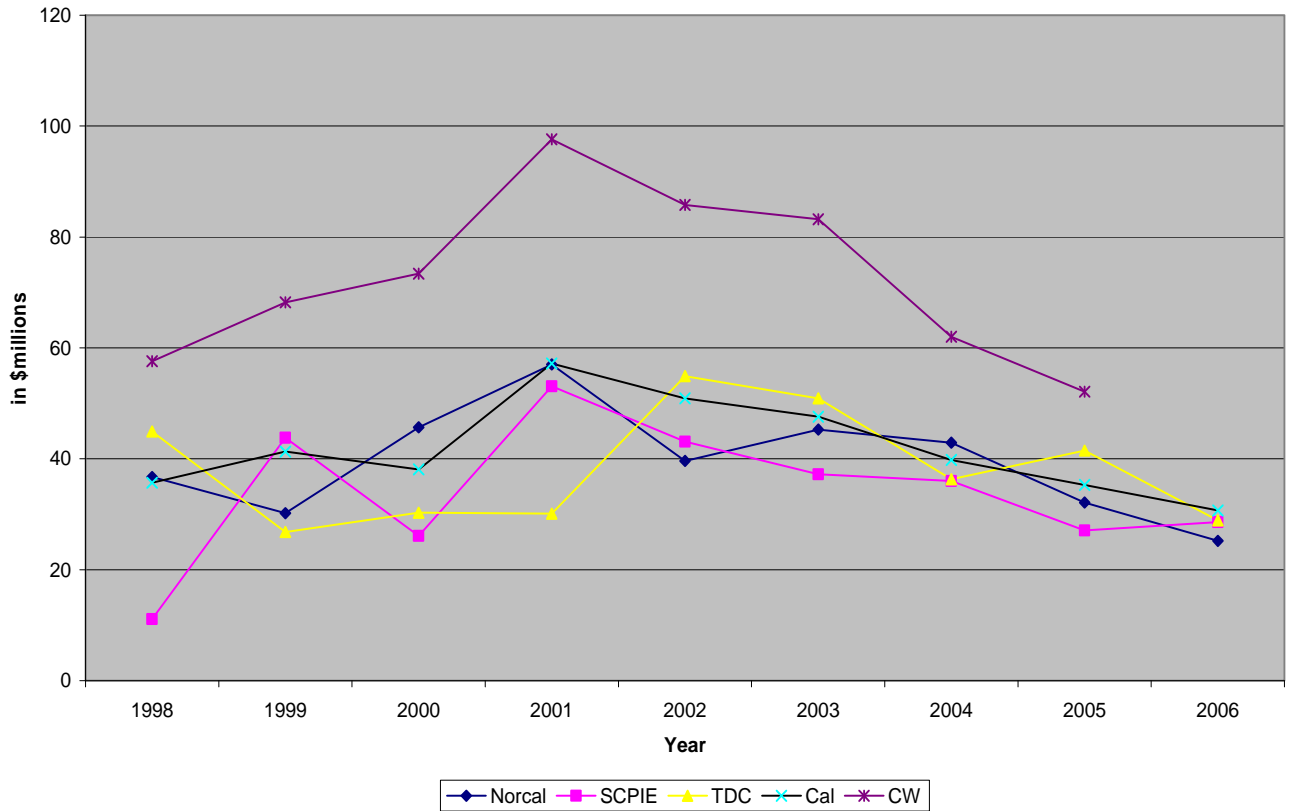
<u>Year</u>	<u>Norcal</u>	<u>SCPIE</u>	<u>TDC</u>	<u>Cal.</u>	<u>CW</u>
1998	36.7	11.1	44.9	35.7	57.6
1999	30.2	43.8	26.8	41.3	68.2
2000	45.7	26.1	30.3	38.1	73.4
2001	57.0	53.1	30.1	57.2	97.6
2002	39.6	43.1	54.9	50.9	85.8
2003	45.3	37.2	50.9	47.6	83.2
2004	42.9	36.0	36.3	39.8	62.0
2005	32.1	27.1	41.5	35.3	52.1
2006	25.2	28.6	28.9	30.7	N/A

Source: Cal. DOI Market Share Reports, 1998-2006; NAIC Report on Profitability by line by state, 1998-2005.

The following chart displays the above information graphically:

¹ The California DOI makes by line by company loss ratio data available to the public on its website for the most recent nine-year period.

Figure 2
Norcal, SCPIE and TDC Loss Ratios v. All Cal. v. CW, 1998-2006



As Figures 1 and 2 indicate, over the last five years medical malpractice loss ratios have generally declined—and thus medical malpractice insurers have become more profitable – in the nation as a whole, in California specifically, and for Norcal, SCPIE and TDC individually. The California medical malpractice market, however, has consistently been far more profitable than the national medical malpractice market, and Norcal, SCPIE, and TDC have generally been more profitable than both the national and California markets.

As is made clear in Figure 2 by the space between the top line, representing countrywide profitability, and the other four lines representing California-only business, the difference in the

profitability of the California and national malpractice markets is dramatic. In each of the last five years for which both California and countrywide data are available, for example, the California market was at least 48% more profitable and as much as 75% more profitable than the national malpractice market. Further, in all those years at least two of the three leading companies, and in 2006 all three, were even more profitable than the California market as a whole. Perhaps most strikingly, with only one exception the California market was more profitable throughout the period 1998-2006 than was the national market in its best year. Put another way, the California market in its worst year was just about as profitable as the national market was in its best year.

The 2006 results for Norcal, SCPIE and TDC are particularly noteworthy: their incurred loss ratios indicate that SCPIE and TDC projected they would pay out in claims less than 29 cents of each dollar they earned in premium, and that Norcal projected it would pay out in claims only one-quarter of each premium dollar it earned. SCPIE and TDC thus had more than 71 cents of the premium dollar and TDC almost 75 cents of the premium dollar left over for overhead--e.g., executive salaries, marketing and advertising, and lawyers and lobbyists--and profit. That profit is in addition to the profit provided by the income they earn on their investments.

It is important to emphasize that an insurer's "incurred losses" are not actual claims payments but rather are projected claims payments plus or minus any changes in reserves. A decline in an insurer's "incurred losses," therefore, can mean two things. First, it can mean that the insurer's projected claims payments for injuries occurring in a given year are less than its projected claims payments for injuries occurring in a previous year. Second, it can mean that the insurer has reduced its projected claims payments for injuries occurring in prior years. The consistent and substantial decrease in the incurred losses reported by Norcal, SCPIE and TDC

over the last five years necessarily means that during that period they reduced the amount they had initially projected they would pay out for claims covered by prior years' policies. Because their rate increases beginning in 2001 were based on those excessive projections, those rate increases were by definition excessive.

B. Written premiums vs. paid losses

The ratio of an insurer's written premiums to its paid losses is a measurement of its cash flow—the amount it collects in premium in a given year vs. the amount it pays out in claims in that same year. Because the premiums an insurer receives in a given year are used to pay for claims it pays in future years, start-up or very fast-growing companies with low paid loss ratios are not necessarily profitable, since for such companies premiums grow very fast in the early years, while the paid claims covered by those premiums grow very fast in later years.

Conversely, mature companies with high paid loss ratios are not necessarily unprofitable, since the claims they pay in a given year are covered by policies for which they have collected the premium in prior years. Nevertheless, for well-established companies like Norcal, SCPIE and TDC the paid loss ratio over time can be a relevant indicator of performance, particularly in combination with other measures.

The paid loss experience of Norcal, SCPIE and TDC is shown in Figures 3, 4 and 5 respectively.

Figure 3

Norcal

Written Premiums, Paid Losses, Number of Claims Paid, 2002-2006

Year	Written Premium (in \$millions)	Paid Losses (in \$millions)	Paid Loss Ratio	# of Claims Paid
2002	152.8	73.4	48.0%	387
2003	174.6	66.1	37.9%	369
2004	173.0	57.5	33.2%	342
2005	172.9	43.3	25.0%	311
2006	175.2	55.4	31.6%	273
Avg, 2002-2006	169.7	59.1	34.8%	336

Figure 4

SCPIE

Written Premiums, Paid Losses, Number of Claims Paid, 2002-2006

Year	Written Premium (in \$millions)	Paid Losses (in \$millions)	Paid Loss Ratio	# of Claims Paid
2002	98.7	55.1	55.8%	376
2003	99.3	37.9	38.2%	281
2004	100.3	33.1	33.0%	225
2005	104.7	27.6	26.4%	196
2006	97.1	25.3	26.1%	148
Avg, 2002-2006	100.0	35.8	35.8%	245

Figure 5

TDC

Written Premiums, Paid Losses, Number of Claims Paid Claim, 2002-2006

	Written Premium (in \$millions)	Paid Losses (in \$millions)	Paid Loss Ratio	# of Claims Paid
2003	120.4	42.3	35.1	257
2004	148.6	33.7	22.7	356
2005	153.8	37.9	24.6	223
2006	151.2	56.5	37.4	230
Avg, 2003-2006	143.5	42.6	29.7%	267

Figures 6, 7 and 8 set forth the written premium and paid losses of Norcal, TDC and SCPIE graphically.

Figure 6

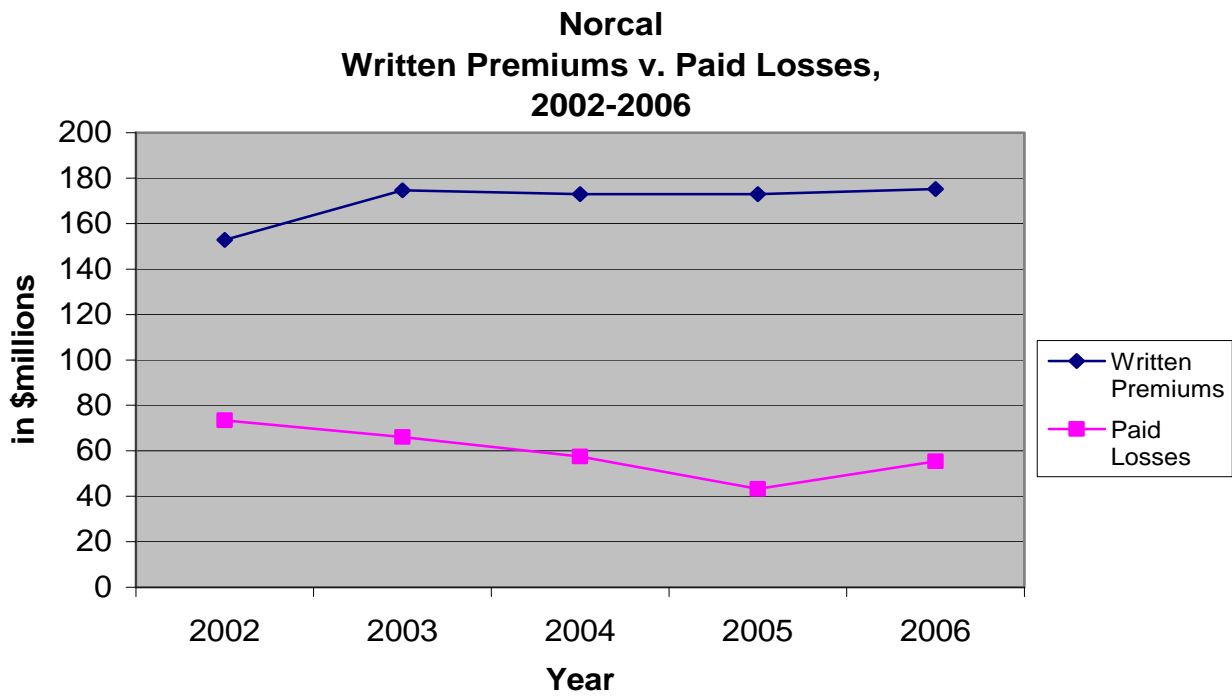


Figure 7

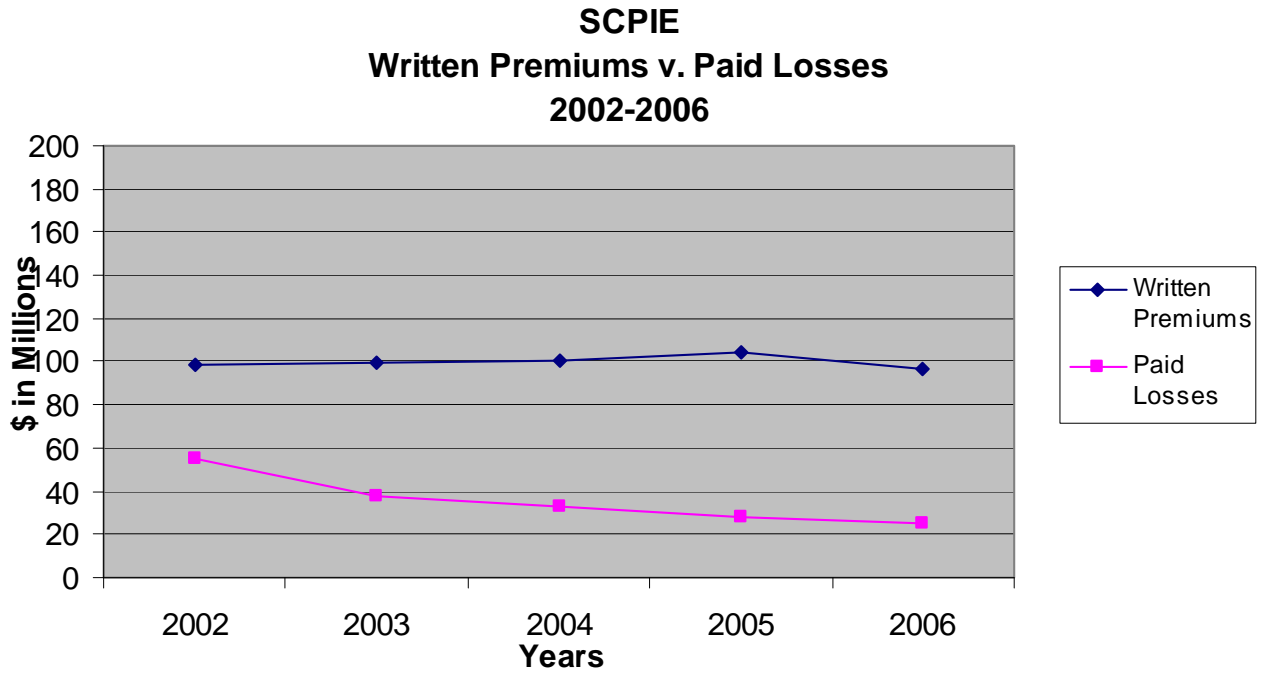
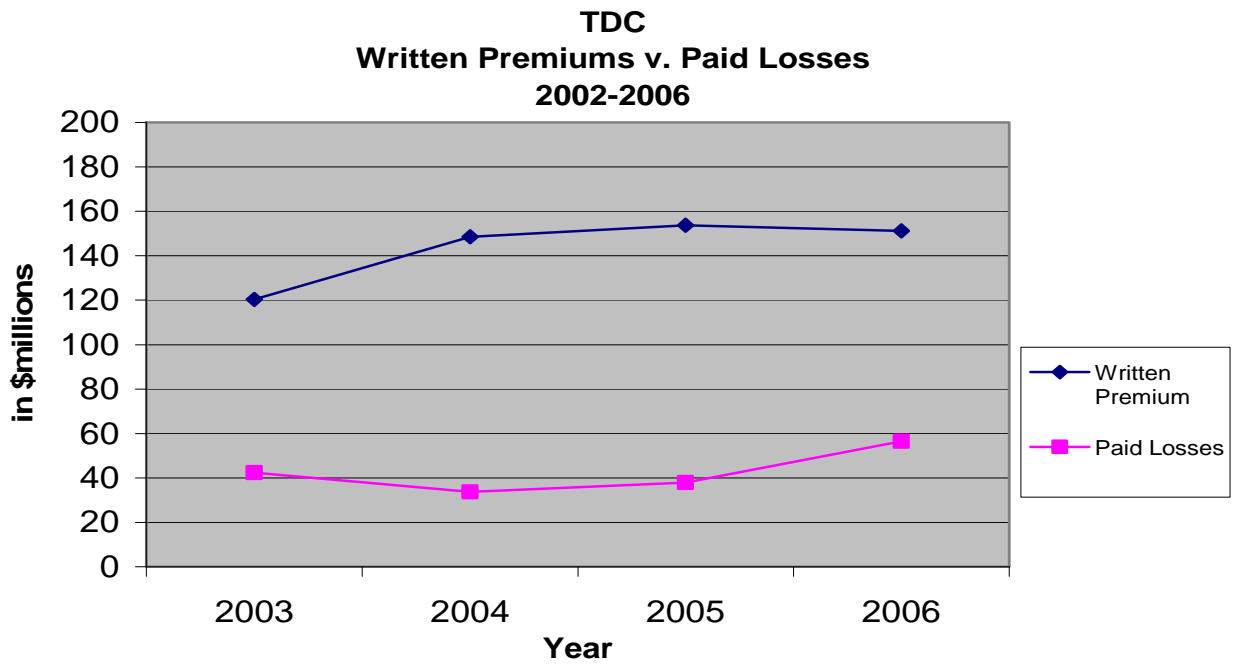


Figure 8



As the preceding tables and charts indicate, for both Norcal and SCPIE both paid losses and claims paid declined substantially over the last five years, while written premium remained essentially flat. Specifically, Norcal's paid losses declined by 25% between 2002 and 2006, while its claims paid declined by 29%. The decline in SCPIE's payouts was even more dramatic: its paid losses declined by more than 50%, and its claims paid by 60%. For the five year period as a whole, both companies paid out approximately 35 cents for each dollar they collected in premium.

TDC's paid loss experience followed a different pattern than did Norcal's and SCPIE's experience: its paid losses decreased between 2003 and 2004 and then increased over the next two years, whereas its paid claims increased between 2003 and 2004 and then decreased. Notably, TDC's paid loss ratio of 29.7% over the four-year period for which it reported was even lower than Norcal's and SCPIE's average loss ratio of approximately 35%.

C. Reserve analysis

An insurer's loss reserves are the amount it has set aside to pay claims in the future. Whether or not an insurer's reserves for policies written today are accurate can not possibly be known today. That is because the average medical malpractice claim is paid approximately 5.5 years after the claim arises, with virtually all claims being paid nine years after the claim arises. An insurer therefore can not know whether its initial estimate of its ultimate liabilities for claims arising in a given year is accurate until nine years after that year. On the other hand, as time progresses an insurer's estimates as to its ultimate liabilities for claims arising in a given year become increasingly accurate, as more information is reported to the insurer about those claims and more of those claims are paid.

Two separate sections of the Annual Statement enable us to determine the extent to which an insurer's reserve estimates have turned out to be accurate. First, Schedule P, Part 2 of the Annual Statement enables us to compare the insurer's initial estimate of its ultimate liabilities for claims arising in each year beginning with the year nine years before the Annual Statement year with the new estimate it made in the Annual Statement year of those liabilities. Thus, its 2006 Annual Statement allows us to compare an insurer's initial estimate of its ultimate liabilities for claims arising in each year from 1997 through 2005 with the estimate it made in 2006 as to its ultimate liabilities for claims arising in each of those years.

Unfortunately, Schedule P Part 2 contains the company's estimates and ultimate liabilities on a national basis only, not on a state-by-state basis. For TDC, therefore, which writes in all states and writes only about one-third of its business in California, one can not fairly draw conclusions about its California business based on Schedule P data. Norcal and SCPIE, however, have always written the large majority of their business in California.² Their Schedule P data therefore does enable us to see how accurate their estimates of their California medical malpractice payments have proved to be.

1. Schedule P data

a. Norcal's Schedule P data

The following two tables indicate the extent to which Norcal has under- or over-reserved. The first, Figure 9, compares the amount that Norcal initially estimated it would pay out for claims arising in a given year with the amount it actually paid out—as disclosed in Schedule P of the Annual Statement it filed nine years later—for claims arising in that year.

² In 2006 and prior years Norcal wrote 88 to 90% of its business in California. In 2006 SCPIE wrote 100% of its business in California. In earlier years SCPIE wrote small amounts of non-California and non-malpractice business at a loss, as explained more fully in subsection 1(b) of this section.

Figure 9
Norcal
Initial Incurred Loss Estimates v. Incurred Losses Reported After 9 Years
(\$000's omitted)

<u>Year</u>	<u>Initial Estimate of Incurred Loss For Year</u>	<u>Reported Incurred Loss 9 Years Later for Year</u>	<u>Difference in Dollars</u>	<u>Difference in Percentage</u>
1986	61,994	22,859	-39,135	-63.1
1987	70,938	34,942	-36,996	-50.7
1988	71,333	32,676	-38,657	-54.2
1989	75,886	39,919	-35,967	-47.4
1990	88,510	52,405	-36,105	-40.8
1991	91,228	56,533	-34,695	-38.0
1992	95,195	66,885	-28,310	-29.7
1993	104,228	77,947	-26,281	-25.2
1994	116,137	81,129	-35,008	-30.1
1995	130,594	88,810	-41,784	-32.0
1996	158,889	111,869	-47,020	-29.6
1997	154,304	102,257	-52,047	-33.7
Totals	1,219,236	768,231	-451,005	-37.0

As the table indicates, Norcal has consistently and substantially over-reserved: for the most recent 12 years for which Norcal's true ultimate liabilities are known, Norcal actually paid out 37% less than it initially estimated it would pay out. (Said another way, Norcal initially reserved 58.7% more than it ultimately ended up paying out.) Because rates are based on the amount the insurer estimates it will pay out, not on the amount it has actually paid out, the fact that Norcal's estimates of the amount it would ultimately pay out have consistently been far higher than its actual payouts means that its rates have traditionally been excessive.

Unlike the true liabilities for claims arising in 1997 and earlier years, true ultimate liabilities for claims arising in 1998 and later years are not known. Nevertheless, Schedule P of the 2006 Annual Statement sets forth Norcal's 2006 estimate of its ultimate liabilities for claims

arising in those years. Because they are based on more complete data than Norcal's initial estimates, they are more accurate than Norcal's initial estimates of its liabilities for claims arising in those years, although not as accurate as its reported liabilities for claims arising in 1986-1997 shown in the previous table. Accordingly, Figure 10 sets forth the estimates Norcal made in each year between 1997 and 2005 of the amount it would ultimately pay out for claims arising in that year along with the revised estimate it made in 2006 as to the amount it would ultimately pay out for such claims.

Figure 10

**Norcal
Initial Incurred Loss Estimates v. 2006 Incurred Loss Estimates
(\$000's omitted)**

Year	Initial Estimate of Incurred Loss for Year	2006 Estimate of Incurred Loss for Year	Difference in Dollars	Difference in Percent
1998	148,344	99,392	-48,952	-33.0
1999	154,510	124,987	-20,523	-14.1
2000	159,450	149,664	-9,786	-6.1
2001	166,129	179,972	13,843	8.3
2002	177,858	163,429	-14,429	-8.1
2003	181,482	147,209	-34,273	-18.9
2004	170,244	144,582	-25,662	-15.1
2005	159,835	150,420	-9,415	-6.3
Totals:	1,317,852	1,159,655	-149,197	-11.3

As Figure 10 indicates, for eight of the most recent nine years Norcal's 2006 estimate of the amount it will eventually pay out is less than the amount it initially estimated it would pay out. Further, Norcal's 2006 estimate of its ultimate liabilities for all claims arising during the period 1998-2005 is 11.3% less than its initial estimates were. (Said another way, Norcal initially reserved 12.9% more than it now believes it will ultimately pay out.) While based on incomplete data, the difference between Norcal's current estimates of its ultimate liabilities for claims

arising after 1997 and its initial estimates of those liabilities is further evidence that Norcal's rates are excessive.

b. SCPIE's Schedule P data

For claims arising in the ten most recent years for which substantially all claims have been paid—1988 through 1997³—SCPIE, like Norcal, has consistently and substantially over-reserved. Specifically, as Figure 11 indicates, for claims arising during that 10-year period SCPIE ended up paying out 32.8% less than it initially projected it would pay out. Put another way, SCPIE initially projected it would pay out 48.9% more than it ultimately paid out.

Figure 11

**SCPIE
Initial Incurred Loss Estimates vs. Incurred Losses Reported After 10 Years
(\$000's omitted)**

Year	Initial Estimates of Incurred Loss For Year	Reported Incurred Loss 9 Years Later for Year	Difference in Dollars	Difference in Percentage
1988	121,905	78,511	-43,394	-35.6%
1989	122,679	72,317	-50,362	-41.1%
1990	118,157	75,350	-42,807	-36.2%
1991	117,981	90,345	-27,636	-23.4%
1992	131,059	89,251	-41,808	-31.9%
1993	134,700	96,047	-38,653	-28.7%
1994	136,749	91,938	-44,811	-32.8%
1995	140,962	81,782	-59,180	-42.0%
1996	130,573	94,431	-36,142	-27.7%
1997	111,354	79,602	-30,752	-27.9%
Totals:	1,266,119	849,574	-415,545	-32.8%

³ Data for claims arising in 1986 and 1987, which was available for Norcal, was not available for SCPIE.

For claims arising in 1998 and future years, with respect to which SCPIE’s ultimate liabilities are still unknown, SCPIE’s current estimate of its ultimate liabilities is essentially the same as the net effect of its initial estimates, as Figure 12 indicates.

Figure 12

**SCPIE
Initial Incurred Loss Estimates vs. 2006 Incurred Loss Estimates
(\$000’s omitted)**

Year	Initial Estimate of Incurred Loss for Year	2006 Estimate of Incurred Loss for Year	Difference in Dollars	Difference in Percent
1998	146,152	137,834	-8,318	-5.7
1999	152,201	152,305	104	0.1
2000	162,305	186,906	24,601	15.2
2001	241,067	263,297	22,230	9.2
2002	259,136	261,944	2,808	1.1
2003	147,397	140,209	-7,188	-4.9
2004	111,457	105,136	-6,321	-5.7
2005	93,530	85,835	-7,695	-8.2
Totals:	1,313,245	1,333,466	20,221	1.5

The estimates shown in Figure 12, however, include the amount SCPIE added to its reserves to cover greater-than-expected liabilities on two types of business it entered in 1996 that have nothing to do with its California physicians liability business and that it is no longer writing: healthcare liability insurance outside of California, including hospital liability, and the reinsurance business.

While SCPIE’s California physicians liability business has been extraordinarily profitable, SCPIE acknowledges in its 10-K that it has lost money on both non-California healthcare liability and reinsurance. For example, SCPIE states in its 10-K that “From 1996 to 2001, the Company significantly expanded its healthcare liability insurance products into markets outside California. This expansion was not successful.” 10-K at 23.

It states further that it had an underwriting loss on its reinsurance business of \$13.8 million in 2004, \$31.3 million in 2005, and \$11.2 million in 2006. Id. at 41. It also notes that it has suffered “significant losses” in its assumed reinsurance operations from the World Trade Center terrorist attack. Id. at 9. And it discloses that “The Company is obligated to assume certain policy obligations of Highlands Insurance Company (Highlands) in the event Highlands is declared insolvent by a court of competent jurisdiction and is unable to pay these obligations. The coverages principally involve workers compensation, commercial automobile and general liability.” Id. at 70.

Thus, SCPIE acknowledges in its 10-K, “The cumulative deficiencies which have emerged for reserves held over the past four years relate entirely to the Company’s non-core healthcare liability and assumed reinsurance reserves which are now in run-off.” Id. at 14. The over-all equivalence between SCPIE’s initially estimated liabilities and its currently estimated liabilities on its business as a whole thus means that it significantly over-reserved on its core California physicians liability business. Looked at another way, the rates it has been charging California doctors have subsidized the losses it has had on its non-California and reinsurance operations.

2. Note 25

a. Norcal’s Note 25

A second source for determining the accuracy of an insurer’s reserves is Note 25 in the Note to Financial Statements section of the Annual Statement. In that Note, entitled “Changes in Incurred Losses and Loss Adjustment Expenses,” the insurer is required to disclose the extent to which it increased or reduced its reserves for claims arising in prior years during the Annual Statement year. In Note 25 in its 2005 Annual Statement, Norcal states as follows:

Reserves for incurred losses and loss adjustment expenses attributable to insured events of prior years (report years 1994 through 2005) have decreased by \$181.5 million from \$492.3 million in 2005 to \$310.8 million in 2006 as a result of payments and re-estimation of unpaid losses and loss adjustment expenses on the Medical Malpractice line of insurance. The decrease is generally the result of ongoing analysis of recent loss development trends. Original estimates are increased or decreased as additional information becomes known regarding individual claims.

Norcal is thus saying that it now believes its ultimate liability for claims arising between 1994 and 2005 is \$181.5 million, or 37%, less than it believed it was last year.

b. SCPIE's Note 25

Similarly, SCPIE provided as follows in its Note 25:

Reserves for incurred losses and loss adjustment expenses attributable to insured events of prior years have decreased by \$9.4 million from \$343.9 million at December 31, 2005 as a result of payments and re-estimation of unpaid losses and loss adjustment expenses principally for pooled California medical malpractice insurance and assumed reinsurance. This decrease is the result of ongoing analysis of recent loss development trends. Estimates will be increased or decreased, as additional information becomes known regarding individual claims.

SCPIE is thus saying that it now believes its ultimate liabilities on prior years' policies are \$9.4 million, or 3%, less than it believed they were last year.

This 3%, however, substantially understates the extent to which SCPIE reduced its reserves on its California medical malpractice business alone, for the reasons explained in the previous section. Because SCPIE increased its reserves for its non-California business, the amount by which it reduced its reserves for its California physicians liability business alone necessarily exceeds 3%.

D. Surplus analysis

The surplus of an insurance company is the amount it holds over and above the amount it has reserved to make its estimated future claims payments. A company increases its surplus

when it earns a profit and does not distribute that profit to its shareholders (in a stock company) or policyholders (in a mutual company). The purpose of surplus is to ensure that the company will be able to pay claims even if the amount it has reserved to pay them proves to be too low. Accordingly, the NAIC has established a formula, based on the risk assumed by the insurer and the quality of the assets it holds, that produces a minimum required surplus for each insurer, called the authorized control level, or ACL. As a practical matter, insurers must hold at least 200% of the ACL level of surplus, and typically hold substantially more than that.

There are two major reasons why an insurer might need to hold an unusually large surplus. First, an insurer needs an unusually large surplus if it routinely under-reserves--sets aside less money to pay claims than it ultimately pays out for those claims--since in that case the insurer must invade its surplus to pay such claims. Second, if an insurer writes most of its business in states which have enacted no limits on compensation, it may feel that it must hold a large surplus because it could potentially be liable for aberrationally large claims. Norcal and SCPIE, however, write most of their business in California, which has limited compensation in medical malpractice cases to a greater extent than any other state. Moreover, as Figures 9 and 11 indicate, Norcal and SCPIE have historically over-reserved, not under-reserved. One would therefore expect them to hold less surplus than malpractice insurers which have under-reserved, or which write most of their business in states other than California. One would also expect TDC, which writes one-third of its business in California – far more than it writes in any other state – to hold less surplus than insurers which write little California business. In fact, however, Norcal, SCPIE and TDC each hold substantially larger surpluses than do most malpractice insurers. Specifically, as Figure 13 indicates, Norcal, SCPIE and TDC hold more surplus, as a percentage of the NAIC's minimum required surplus, than all but two of the ten other largest

malpractice carriers; and TDC holds more surplus than any other malpractice insurer in the nation, both in absolute terms and as a percentage of the NAIC's minimum required surplus.

Figure 13

Norcal, SCPIE and TDC Surplus v. Other Leading Malpractice Carriers' Surplus, 2006

<u>Company</u>	<u>Actual surplus (in \$millions)</u>	<u>Minimum required surplus (in \$millions)</u>	<u>Ratio of actual surplus to minimum required surplus</u>
TDC	657.4	70.3	935.2%
Med Pro	645.9	72.0	897.0%
HCI	521.9	173.5	300.8%
Pro Mutual	504.7	151.6	333.0%
Med Assurance	429.1	69.9	613.8%
Norcal	398.9	57.6	692.5%
ISMIE	293.9	63.7	461.8%
MAG Mutual	251.1	35.4	709.4%
AP Capital	233.8	46.1	507.8%
Pro National	231.7	60.2	385.2%
State Volunteer	217.4	35.3	616.8%
FPIC	200.4	30.4	659.2%
SCPIE	164.4	24.1	682.2%

In addition, the surpluses of Norcal, SCPIE and TDC each reached an all-time high in 2006, as Figure 14 indicates.

Figure 14

Norcal, SCPIE, TDC: Actual Surplus v. Minimum Required Surplus, 2002-2006

	<u>Norcal</u>			<u>SCPIE</u>			<u>TDC</u>		
	<u>Actual Surplus</u>	<u>MRS</u>	<u>Actual ÷ MRS</u>	<u>Actual</u>	<u>MRS</u>	<u>Actual ÷ MRS</u>	<u>Actual</u>	<u>MRS</u>	<u>Actual ÷ MRS</u>
2002	204.2	67.4	303%	155.8	61.9	252%	341.4	69.8	489%
2003	246.0	58.3	422%	140.2	46.3	303%	350.2	81.1	432%
2004	309.1	60.0	515%	136.5	38.0	359%	405.6	81.0	501%
2005	336.7	58.5	576%	145.6	29.9	487%	503.2	69.1	728%
2006	398.0	57.6	691%	164.4	24.1	682%	656.0	70.3	933%

Norcal, SCPIE and TDC all substantially increased their surplus over the past five years.

SCPIE's, for example, was up 20% in only two years, and was 6% higher than its previous record-high surplus of \$155.8 million, set in 2002. The increase in SCPIE's surplus, however, was dwarfed by the increase in Norcal's and TDC's surplus: both companies almost doubled their surplus in four years.

Figures 15, 16 and 17 graphically set forth the difference between the actual surplus of each company and the NAIC's minimum required surplus for each company for each of the last five years.

Figure 15

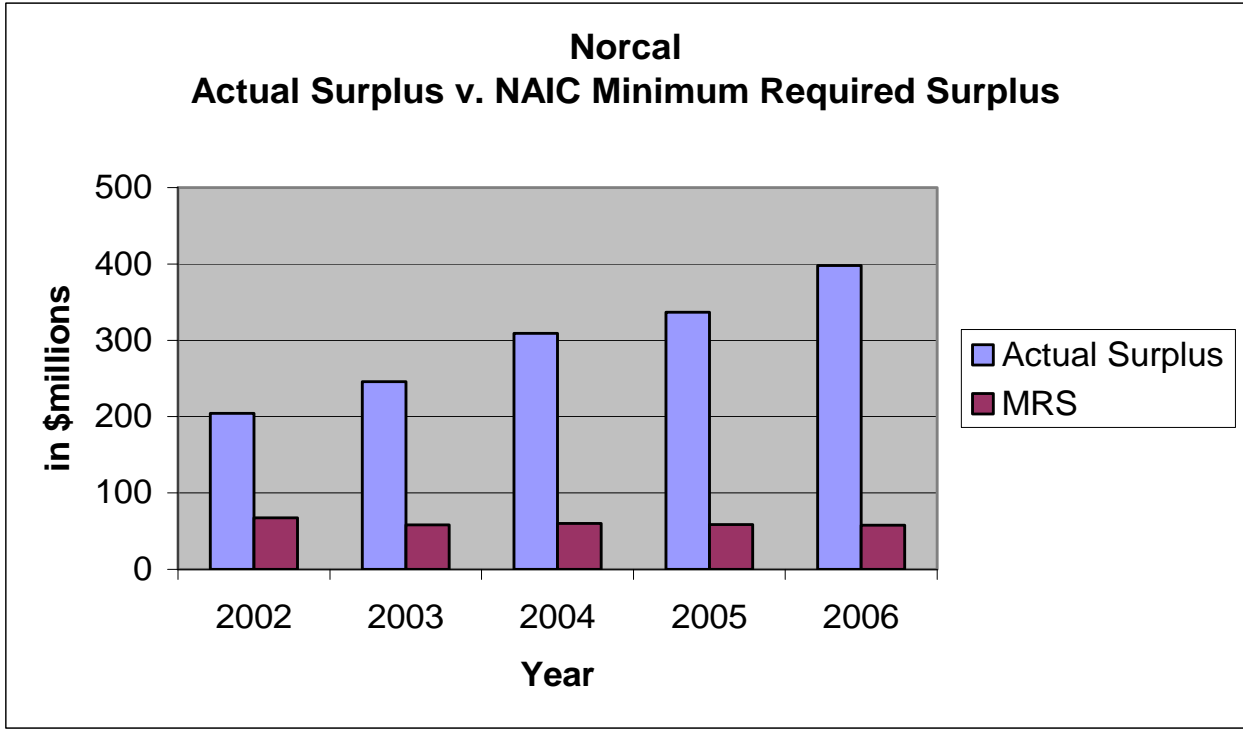


Figure 16

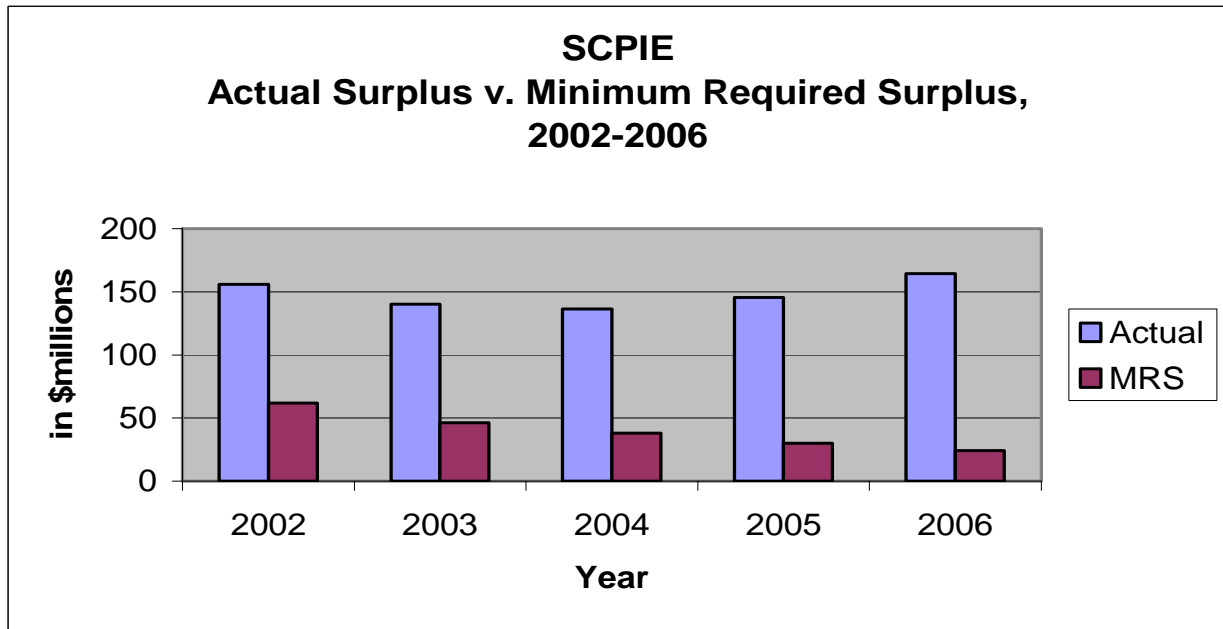
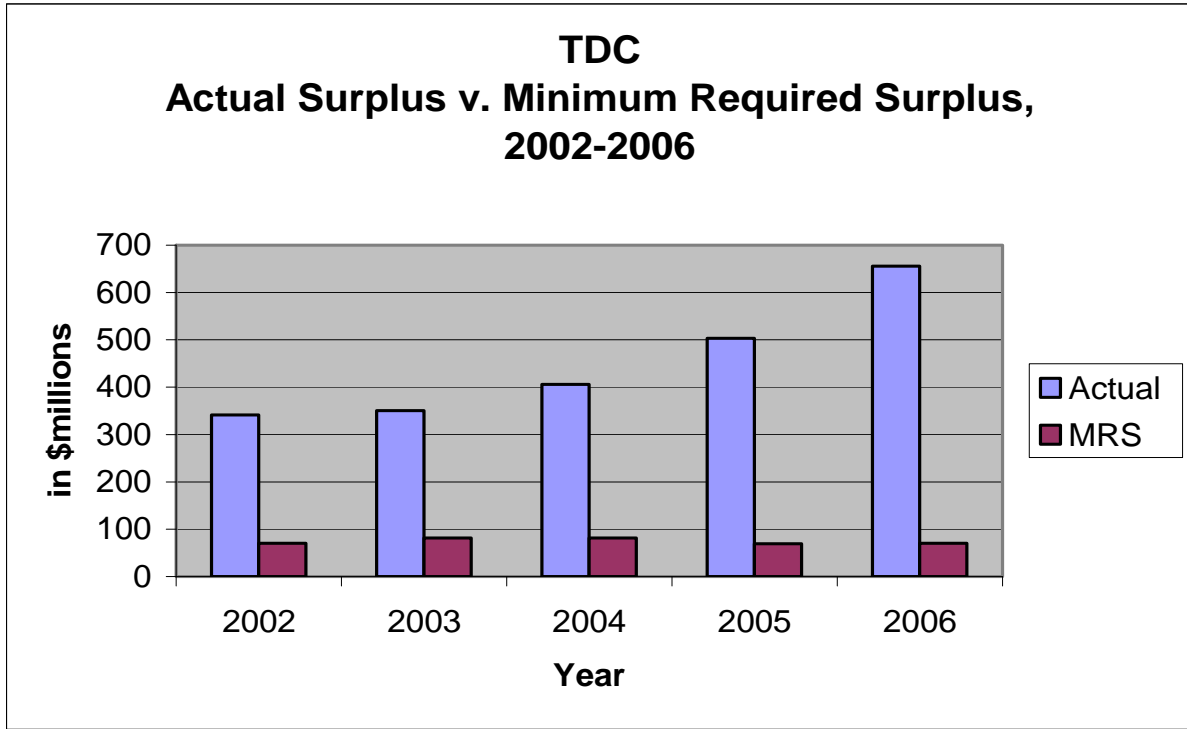


Figure 17



While surplus is necessary to protect policyholders, at some point additional surplus serves no practical purpose—it is no longer “used and useful for providing insurance.” See *20th Century Ins. Co. v. Garamendi*, 8 Cal.4th 216 (1994). This is particularly true if a company has routinely over-reserved and does a substantial amount of its business in a state which strictly limits the amount it can pay out, as TDC does. It is even more true if a company has routinely over-reserved and writes exclusively or almost exclusively in such a state, as Norcal and SCPIE do. Based on the three leading companies’ actual surplus to minimum surplus ratio, their declining claims payments and projected claims payments, and their having consistently over-reserved, only part of their collective \$1.2 billion surplus as of year-end 2006 can reasonably be characterized as “used and useful for providing insurance.”

E. Dividend analysis

On line 16 of the Five Year Historical Data pages of the Annual Statement insurers disclose the dividends to policyholders they have issued in each of the last five years. Figure 18 sets forth those dividends, both in dollars and as a percentage of surplus.

Figure 18

Norcal, SCPIE, TDC: Dividends Issued to Policyholders, 2002-2006

	<u>Norcal</u>			<u>SCPIE</u>			<u>TDC</u>		
	<u>Surplus</u> <u>(in \$mils.)</u>	<u>Dividend</u> <u>(in \$mils.)</u>	<u>Dividend</u> <u>as % of</u> <u>surplus</u>	<u>Surplus</u> <u>(in \$mils.)</u>	<u>Dividend</u> <u>(in \$mils.)</u>	<u>Dividend</u> <u>as % of</u> <u>surplus</u>	<u>Surplus</u> <u>(in \$mil)</u>	<u>Dividend</u> <u>(in \$mils)</u>	<u>Dividend</u> <u>as % of</u> <u>surplus</u>
2002	204	9.9	4.8%	156	0	0%	341	0	0%
2003	246	0	0%	140	0	0%	350	0	0%
2004	309	0.0	0%	137	0	0%	406	0	0%
2005	337	12.0	3.6%	146	0	0%	503	0	0%
2006	398	11.7	2.9%	164	0	0%	656	21.0	3.2%

As Figure 18 indicates, although both Norcal and TDC almost doubled their surplus between 2002 and 2006, TDC issued a dividend—which amounted to 3.2% of its surplus—only in 2006, and as a percentage of surplus Norcal’s 2006 dividend of 2.9% was smaller than the dividend it issued five years earlier. SCPIE, which due to its losses on its reinsurance and non-California business increased its surplus to a lesser extent than did Norcal and SCPIE, issued no dividend in any year.

The nominal dividends issued by Norcal and TDC despite their almost 100% gains in surplus over four years are particularly noteworthy because both companies are owned by their policyholders, and thus owe a legal duty solely to their policyholder/owners: as TDC states on its website in explaining the advantages to doctors of being insured by TDC rather than a stock

company, TDC "does not have the divided loyalties of stockholders versus policyholders." www.thedoctors.com/whychoose/carrier/carrier.asp. To be sure, the decision of the Board of Directors as to whether to issue a policyholder dividend, and as to the size of that dividend, has traditionally been protected by the business judgment rule, and thus has been immune from challenge in the absence of fraud or extraordinary circumstances. However, the extent to which Norcal and TDC have increased their surplus since 2002, the fact that they owe a legal duty solely to their policyholder/owners, and the lack of any apparent rational basis for retaining their current level of surplus could potentially place their failure to issue more than a nominal dividend outside the protection of the business judgment rule.

Moreover, in opposing a petition challenging its most recent rate increase, TDC argued that the petition should be denied because, being owned by its insureds, TDC's sole purpose "is to provide its member insureds with the lowest cost insurance consistent with maintaining adequate reserves and surplus." TDC Answer and Opposition to Petition for Hearing, File No. 03-6211, before the Insurance Commissioner of the State of California, Nov. 10, 2003, at 3. Because TDC's reserves are redundant and its surplus is far beyond adequate, based on the standard articulated by TDC in its most recent rate filing its rates should be reduced.⁴

III. Rate filing data

Despite the data Norcal, SCPIE and TDC have filed in their Annual Statements showing both their actual and projected claims payments declining, each company has increased its rates substantially since 2001. Specifically, Norcal raised its rates by 8.25% for 2001, 4.9% for 2002,

⁴ TDC also argued that its proposed 9.8% rate increase should be granted because it needed a rate increase in order to build up its surplus, which had declined from \$383 million as of year-end 2001 to \$333 million as of June 30, 2003. As of year-end 2006, however, TDC's surplus had increased to \$656 million. It therefore currently has no need to build up its surplus. To the contrary, even if 40% of that surplus were distributed to its policyholders, it would still have more than the surplus it had in 2001.

13.0% for 2003, 2.91% for 2004, and 1.6% for 2005; SCPIE raised its rates by 10.6% for 2001, 8.4% for 2002, 9.9% effective October 2003, and 6.5% for 2005; and TDC raised its rates by 5.3% for 2001, 7.8% for 2002, 6.1% for 2003, and 9.8% for 2004. These three companies have been able to raise their rates to this extent because their rate filings are based on assumptions, not on their actual experience. This section explains some of the methods used both by insurers in general and by Norcal, SCPIE and TDC in particular to obtain rate increases when the underlying data does not justify a rate increase. In addition, it points out how the three companies' actual experience both before and after they filed for rate increases demonstrates the invalidity of some of the assumptions they have made in their rate filings. It also notes how some of the disclosures that SCPIE has made in its 10-K statement, and that Norcal and SCPIE have made in their MD&A's, contradict some of the statements the companies have made in their rate filings.

A. How insurers purport to justify unreasonably high rate increases

1. By assuming an unreasonably high loss development factor.

Loss development is the process by which the ultimate liability for claims arising in a given year is estimated. The actuary estimates this ultimate liability by looking at the payments for claims arising in prior years that were made in different periods. He then assumes that the claims arising in the current year will follow the same payout pattern as did those arising in prior years. The actuary can produce unreasonably high developed losses by assuming a faster payout pattern for the year for which the insurer seeks a rate increase than the actual payout pattern for claims arising in prior years justifies.

2. By assuming an unreasonably high trend factor.

The trend factor, which is applied to fully developed losses, is the assumed rate at which the ultimate liabilities for claims arising in the year for which the insurer seeks a rate increase will exceed the ultimate liabilities for claims arising in prior policy years. Actuaries determine the trend factor by looking at the rate at which the frequency and severity of claims have been increasing or decreasing in the past. The actuary can produce an unreasonably high trend factor--and thus an unreasonably high rate--by heavily weighting those years during which claims payments were increasing substantially, while giving little weight to years in which claims payments were decreasing.

3. By assuming unreasonably high expenses

Insurers purport to justify unreasonably high rates both by passing through unreasonably high expenses to their policyholders, and by assuming that their expenses will increase even though they have not in fact been increasing.

4. By assuming an unreasonably low investment yield

In order for a rate to be neither excessive nor inadequate, the rate must be set at a level that will enable the insurer to earn a fair rate of return after taking into consideration its investment income. Like the trend factor, the investment yield the insurer assumes in its rate filing is dependent on the number of years the actuary considers in calculating it and the weight he gives to each of those years. Further, just as is the case with trend, the average investment yield during the last five years has been substantially lower than the average investment yield over the last 10 years. Unlike trend, however, in connection with which using more recent data produces a lower indicated rate increase, using an insurer's recent, lower investment yield

produces a higher indicated rate increase. To justify unreasonably high rate increases, therefore, actuaries rely on old data for trend, but on recent data for investment yield.

5. By assuming an unreasonably high federal income tax rate

In their rate calculations insurers often assume they pay the statutory tax rate – 35% – rather than their effective tax rate. This has the effect of reducing the income allegedly produced by their current rates and thus of increasing the rate increase they allegedly need in order to obtain an after-tax fair rate of return.

B. How SCPIE, Norcal, and TDC have sought to justify their current rates

1. Loss development

SCPIE's most recent rate increase was a 6.5% increase approved on October 15, 2004 and implemented in 2005. In its rate filing purporting to justify that increase, SCPIE calculated five different loss development factors based on five different types of averages of prior years' payout patterns. SCPIE Rate Filing No. 04-3735, filed May 19, 2004, Exh. 6, Sheet 7. For the three most recent years it analyzed in its rate filing, however—2001, 2002, and 2003—it selected a loss development factor which is far higher than any of the five averages it has calculated.

Norcal followed a similar process in its most recent rate filing, which was approved on July 21, 2004 and implemented in 2005. Specifically, Norcal calculated loss development factors based on two different average—a straight average of the most recent three years and a weighted average of the last three years—but then selected loss development factors that substantially exceeded both averages. Norcal Rate Filing No. 04-2368, filed March 29, 2004, Exh. 5, Exh. 6.1 Sheet 1.

The use of unreasonably high loss development factors in the rate calculation has the effect of producing excessive rates, since rates are based on losses that have been both developed

and trended. If the loss development factor is excessive, therefore, rates will be excessive, even if a reasonable trend factor is applied to those losses. If the trend factor is also unreasonably high—as SCPIE’s, Norcal’s, and TDC’s all are, as discussed in the following section--then rates will be doubly excessive.

2. Trend

In its most recent rate filing SCPIE assumed a 3% trend factor. SCPIE Rate Filing, Actuarial Memorandum at 4. The only way SCPIE could purport to justify a trend factor as high as 3% was by disregarding its claims data for the most recent three years—all of which show substantially lower losses than the three years before that—and choosing as the initial years for calculating the trend 1991 and 1992, in each of which SCPIE’s losses were unusually low. Had SCPIE included the claims data it had for 2001 through 2003 in its analysis, and had it used a more recent year as its starting point for calculating trend, it would necessarily have calculated a substantially lower trend factor. For example, if it had used 1998 as its starting point and had included 2001 through 2003 data, its trend would have been -1.9%. Typically, all other things equal, one point of trend makes a difference of at least 5% in the proposed rate. Simply changing the trend factor from 3% to -1.9% would therefore have resulted in SCPIE seeking a substantial rate decrease rather than a 6.5% increase.

Notably, although in its rate filing SCPIE purported to demonstrate that its claims payments were increasing, and thus that a positive 3% trend was justified, in its 2006 10-K it trumpeted the fact that its claims payments were decreasing, and in particular that claim frequency had declined “markedly.” 10-K at 4. It acknowledged, for example, that its incurred losses and loss adjustment expenses—i.e., defense lawyers fees—together declined by 12.5% between 2004 and 2006--from \$99.3 million in 2004 to \$90.5 million in 2005 to \$86.9 million in

2006. Id. at 4. It also disclosed that its claim frequency declined by 36.5% over the last four years. Id. at 14. Based on the disclosures it made in its 10-K, therefore, SCPIE's current rates are clearly excessive.

Norcal also unreasonably inflated its trend factor in its most recent rate filing. Specifically, Norcal used a 3.5% trend factor, which it broke out further into a 4.0% severity trend and a -0.5% frequency trend. Norcal Rate Filing at Exh. 8, Sheets 1-3. The only way Norcal could justify a severity trend as high as 4.0% was to weight heavily the early years of the last 10 years and give little weight to the more recent years. If Norcal had given equal weight to the three most recent years – during which claim severity declined by 23% -- Norcal would have had a 2.3% severity trend. Rate Filing Exh. 8, Sheet 3. Had it given greater weight to its more recent experience than to its earlier experience—as it did in calculating several other factors in its rate filing—then its severity trend would have been flat or even slightly negative. Notably, in its MD&A Norcal acknowledges that its trend has been negative in the last two years. Norcal MD&A at 12.

TDC's most recent rate increase was a 9.8% increase approved on November 17, 2003 and implemented in 2004. In its rate filing purporting to justify that increase TDC selected a severity trend of 7% and a frequency trend of -1.9% after calculating separate trends for the last 10 years of data and the last five years of data. TDC Rate Filing No. 03-6211, filed Sept. 8, 2003, at Exh. 8, pages 1-2. The frequency trend TDC used in its rate filing, however, was substantially higher than the frequency trend resulting from either of the two methods it used to calculate trend. Id. at Exh. 8, Page 1.

Perhaps most strikingly, in its MD&A TDC discloses that its frequency trend has been substantially more negative than the frequency trend it used in its rate filing. Specifically, its MD&A includes the following chart setting forth claims per 100 doctors:

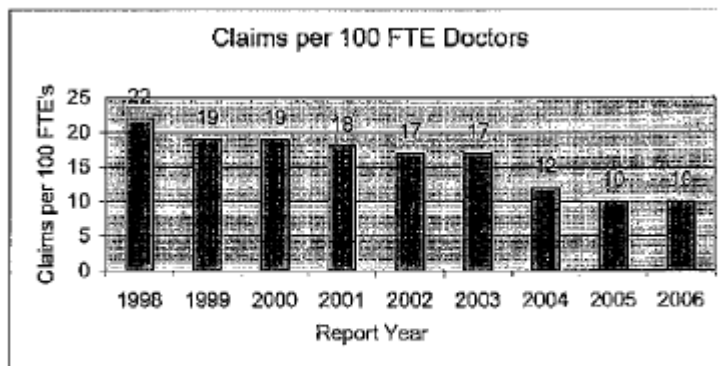


Table 4

TDC MD&A at 15. The chart indicates that TDC's frequency declined from 22 to 17, or by 22.7%, between 1998 and 2002, which were the most recent five years for which data was available when TDC filed for its most recent rate increase. The 22.7% decrease in frequency between 1998 and 2002 equates to an annual trend of more than -5% per year—almost three times the -1.9% TDC used in its rate filing. Moreover, in the four-year period after 2002 TDC's frequency declined even more dramatically—from 17 to 10, or at an annual rate of about 12%.

To be sure, the data in TDC's MD&A is countrywide data, not California-only data. With respect to frequency, however, insurers typically consider both in-state data and countrywide data. Moreover, California data is by far the largest component of TDC's countrywide data, and the difference between the frequency trend it discloses in its MD&A and the trend it uses in its rate filing is so great that it can not credibly be attributed solely to declines in frequency in TDC's non-California business.

TDC's MD&A also discloses a lower severity trend than TDC used in its rate filing. Specifically, although TDC used a 7% trend in its rate filing, in its MD&A TDC says that its

severity trend was 6.1% for the ten-year period ending in 2005, and 5.1% for the five-year period ending in the same year. TDC MD&A at 16.

Due to these favorable trends, TDC notes in its MD&A, 2006 was the most profitable year in its 31-year history. Id. at 19.

3. Expenses

In its rate filing, SCPIE assumed that its expenses would increase at the rate of 14.48% a year. SCPIE Rate Filing at Exh. 8, Sheet 6. The only way SCPIE could justify such an assumption was by looking at only the three most recent years of data available at that time—2001, 2002 and 2003—during which its expenses were aberrationally high. Had SCPIE followed the same approach it followed with trend and loss development—heavily weighting earlier years, and giving little or no weight to more recent years—its expense trend would have been substantially lower. Notably, in its 10-K SCPIE discloses that for the most recent three year period for which data is now available—2004, 2005, and 2006—its payments for agent’s commissions and other marketing expenses were essentially flat, varying only from 20.3% to 20.9%. 10-K at 4. SCPIE’s actual expenses as disclosed in its 10-K are thus substantially lower than those SCPIE assumed in its rate filing.

4. Investment yield

In its rate filing, TDC assumes a 4.5% investment yield. TDC Rate Filing at CA-RA5. In fact, however, as TDC discloses in its MD&A, its fixed income return over the period 2002-2006 averaged 5.1%, while its return on its equity investments averaged 10.0%. TDC MD&A at 22. TDC’s use of a 4.5% investment yield in its rate filing thus means that it assumed it would earn substantially less on its investments than it actually earned, and therefore that it obtained a substantially higher rate increase than was necessary for it to earn a fair rate of return. Notably,

although the loss development and trend factors TDC used in its rate filing were based to a large extent on ten-year old data, the investment yield it used in its rate filing was based exclusively on the most recent five years of data, during which interest rates were at historic lows.

5. Effective tax rate

In its rate filing, TDC projects that it will be paying federal income tax at the rate of 35%. TDC Rate Filing at Exh. 17. In its MD&A, in contrast, TDC discloses that its effective tax rate in 2005 was 33.7%, and that its effective tax rate in 2006 was 19.3%. TDC Rate Filing at 24.

IV. How Proposition 103 can be used to bring down malpractice rates

A. How Proposition 103 has been used in the past

Like the insurance codes of almost all other states, the California insurance code provides that malpractice and other property/casualty insurance rates may not be “excessive, inadequate, or unfairly discriminatory.” Ins. Code sec. 1861.05(a).

Unlike other states, however, California enables private parties to challenge proposed insurance rate increases. Specifically, Ins. Code section 1861.05, enacted by the voters in 1988 as part of Proposition 103, both authorizes the commissioner to disapprove rates if he finds them excessive and authorizes “a consumer or his or her representative” to seek a hearing on any proposed rate increase. Ins. Code secs. 1861.05(a), 1861.05(c)(1), (3). The commissioner must hold such a hearing if the proposed rate increase exceeds 15%. Ins. Code sec. 1861.05(c)(3). He has discretion to hold such a hearing if the proposed increase is 15% or less. Ins. Code sec. 1861.05(c)(1).

To date doctors have not challenged malpractice insurance rates as excessive. However, a consumer group, the Foundation for Taxpayer and Consumer Rights (“FTCR”), has filed several such challenges. Those challenges have had mixed results. For example:

* In November 2002 FTCR petitioned for a hearing on SCPIE’s proposed 15.6% increase. FTCR argued, among other things, that SCPIE used unreasonably high loss development and trend factors, that it had historically over-reserved, and that the 15% return SCPIE acknowledged it would be earning if its proposed rate increase were approved was unreasonably high. The commissioner held a hearing as required by section 1861.05(c)(3), rejected FTCR’s arguments on loss development and trend but accepted part of its rate of return argument and one of its other arguments, and reduced SCPIE’s rate increase from 15.6% to 9.9%. In the Matter of the Rate Application of American Healthcare Indemnity Company and SCPIE Indemnity Company, File No. PA-02025379, Sept. 22, 2003.

* In November 2003, FTCR petitioned for a hearing on TDC’s proposed 9.8% increase. However, it did not explain the basis for its challenge, as it was required to do by the Department’s regulations, 10 Cal Code Reg. 2643.1. The Department therefore rejected the petition, declined to hold a hearing, and approved TDC’s 9.8% increase as proposed. In the Matter of the Rate Application of The Doctors Company, an Interinsurance Exchange, Decision Denying Petitioner’s Request for Hearing, File No. PA 03033334, Nov. 17, 2003.

* In May 2004 FTCR challenged Norcal’s proposed 4.3% increase on multiple grounds, including the grounds that its loss development and trend factors were unreasonably high. The Department rejected FTCR’s petition and declined to hold a hearing, but nevertheless reduced the proposed rate increase from 4.3% to 1.6%. In the Matter of the Rate Application of Norcal

Mutual Insurance Company, Decision Denying Petitioners' Request for Hearing, File No. PA 04037956, July 22, 2004.

The Department's decisions in these cases may or may not have been reasonable when decided. The loss experience of SCPIE, Norcal and TDC after those decisions were rendered, however, makes clear that the assumptions on which the companies based their rate filings were unduly pessimistic. In addition, all three companies have now acknowledged that their true experience has been far more favorable than their actuaries had projected it would be. As noted in the previous section, for example, Norcal disclosed in its 2006 MD&A that its trend has been negative in the last two years. Norcal MD&A at 12. Similarly, TDC disclosed in its 2006 MD&A that its frequency declined by more than 22% between 1998 and 2002, and by 12% a year after 2002. TDC MD&A at 15. Further, in its 2006 10-K SCPIE disclosed that its incurred losses and loss adjustment expenses together declined by 12.5% between 2004 and 2006, and that its claim frequency declined by 36.5% over the last four years. SCPIE 2006 10-K at 14.

Thus, whether or not the Department's decisions approving the three leading carriers' current rates were reasonable when those rates were filed, it is clear that today those rates are excessive.

B. How Proposition 103 could be used in the future

While the results of the 1861.05 intervention process in the past have been mixed, section 1861.05 can be used to substantially reduce malpractice rates in the future. That is because 1861.05 provides not only that excessive rates may not be approved, but also that excessive rates may not "remain in effect." Absent such language, an insurer could argue that the commissioner's approval of a rate bars any future challenge to it. The "remains in effect" language, however, would seem to foreclose that argument.

Both doctors and consumer groups may therefore wish to consider petitioning the commissioner to hold hearings on whether malpractice rates in effect today are excessive. The commissioner has no authority to order insurers to refund excessive premiums that doctors have already paid, but he does have the authority to reduce those rates prospectively. And the courts have authority to order retrospective relief. Doctors therefore may wish to file an action in Superior Court seeking refunds of excessive premiums they have paid. On its face, section 1861.10(a) would seem to authorize any person—not just policyholders—to file such actions, since it provides that “any person” may “enforce any provision of this article.” However, the court of appeal held in Farmers Ins. Exchange v. Superior Court, 137 Cal. App. 4th 842 (2006), that notwithstanding its plain language section 1861.10(a) authorizes a person to challenge a violation of Proposition 103 only before the commissioner. To challenge such a violation in court, therefore, a person must do so under the Unfair Competition Law as amended by Proposition 64, and thus must be an injured party. Only doctors, therefore, may challenge excessive malpractice insurance rates in court.

To try to defeat such a challenge insurers would seek to rely on Walker v. Allstate Indem. Co., 77 Cal. App. 4th 750 (2000), in which the court agreed with the defendant insurers that rates once approved by the commissioner could not be overturned by a court. However, the year after the court of appeal decided Walker the Supreme Court repudiated the statutory interpretation argument on which the Walker holding is premised. State Comp. Ins. Fund v. Superior Court, 24 Cal. 4th 930, 936-39 (2001) (“SCIF”). In addition, the court in Walker never construed the language “or remains in effect” in sec. 1861.05. It therefore never addressed the argument made in this Report: that an insurer’s true experience after a rate increase has been approved may

reveal that the rate in effect is excessive, and that the language “or remain in effect” authorizes a challenge in exactly that situation.

Moreover, in 2004 the court of appeal decided Donabedian v. Mercury Ins. Co., 116 Cal. App. 4th 968 (2004), which like the Supreme Court in SCIF rejected the statutory interpretation argument on which Walker relied. Donabedian specifically held that private parties could challenge unlawful rating factors under the UCL. Notably, while Donabedian concerned rating factors rather than rates, and did not expressly overrule Walker, it rejected its logic. In addition, the court of appeal followed Donabedian and rejected the Walker reasoning in another unlawful rating factor case, Poirer v. State Farm Mut. Auto Ins. Co., 2004 WL 2325837. In contrast, no court has extended the Walker holding. The continuing authority of Walker is therefore in doubt, and thus doctors may well have the ability to obtain refunds of excessive rates they have already paid by filing an action in Superior Court.

Finally, whether malpractice rates are challenged in the future by consumer groups or by doctors, and whether they are challenged before the commissioner or in court, it is essential that the party challenging the rate have the ability to cross-examine the company’s actuary. Although the Department did hold a hearing in the SCPIE case, there apparently was both no oral argument and no cross-examination of SCPIE’s actuary. Such cross-examination can demonstrate both the unreasonableness of an actuary’s assumptions and the extent to which assumptions he has made have proved to be overly pessimistic in the past, and can bring out his biases.

V. Conclusion

Both their loss ratios and the change in their reserves--the difference between their projected payments for claims arising in prior years and their actual payments for those claims--indicate that the rates the leading California malpractice insurers are currently charging are excessive. Specifically, in none of the last three years has any of the three leading companies projected that it would pay out in claims more than 43% of each premium dollar it earned; and in 2006 all three companies projected they would pay out less than 30% of each premium dollar they earned. In addition, for claims arising in years for which substantially all claims have now been paid, the amount they actually paid out turned out to be far less than the amount they initially reserved to pay out. This combination--low projected loss ratios for claims arising in the current year, plus the release of reserves allocated to pay claims arising in prior years that in fact were not paid--has enabled each of the three companies to increase its surplus to an all-time high. The surpluses of the three companies now amount to a combined \$1.2 billion, and exceed the surpluses of virtually all other comparably-sized malpractice carriers in the nation.

The carriers obtained approval for their current rates by making assumptions that have been proved to be invalid, and that in some cases are contradicted by other data they have filed with the Department and/or the SEC. In most states, the commissioner's approval of a rate bars any challenge to it, whether or not the assumptions on which the rate increase was based turn out to be accurate. In California, however, section 1861.05 of the Insurance Code provides that "No rate shall be approved or remain in effect which is excessive, inadequate, unfairly discriminatory or otherwise in violation of this chapter." The "remain in effect" language would appear to support an argument that even though the commissioner approved Norcal's, SCPIE's, and TDC's rates as non-excessive in the past, events that have occurred since that approval--e.g., their

paying out less than they projected in their rate filing that they would pay out--have revealed that the rate is in fact excessive. Their current rates therefore could be challenged as excessive.

Challenging the surplus held by Norcal, SCPIE and TDC is more difficult than challenging their rates because, while there is a law prohibiting excessive rates, there is no law prohibiting excessive surplus. On the other hand, insurers are not entitled to a fair rate of return on all their surplus, but only on that surplus which is “used and useful for providing insurance.” 20th Century Ins. Co. v. Garamendi, 8 Cal. 4th 216, 309 (1994). This is particularly true if a company has routinely over-reserved and does a substantial amount of its business in California, as TDC does, since California has strictly limited the amount malpractice insurers can pay out. It is even more true if a company writes exclusively or almost exclusively in California and has also routinely over-reserved, as Norcal and SCPIE have. Only part of the total \$1.2 billion in surplus currently held by Norcal, SCPIE and TDC therefore can reasonably be characterized as “used and useful for providing insurance.”