

**STATE OF RHODE ISLAND AND PROVIDENCE PLANTATIONS  
DEPARTMENT OF BUSINESS REGULATION  
233 RICHMOND STREET  
PROVIDENCE, RHODE ISLAND 02903**

<u>IN RE:ProSelect Insurance Company</u>	)	
1) Individual Medical Professional Liability	)	
Program – Rate and Rule Filing –	)	
Effective Date 9-30-05	)	
2) Partnership and Corporation Medical	)	
Professional Liability Program –	)	DBR No. 05-I-0111
Rate and Rule Filing –	)	
Effective Date 9-30-05	)	
3) Hospital Professional Liability Program –	)	
Rate and Rule Filing –	)	
Effective Date 9-30-05	)	
<u>(Filed May 9, 2005)</u>	)	

**I.  
POSITION OF PARTIES**

As detailed below, the hearings in this matter lasted four days and both the request of ProSelect Insurance Company (ProSelect) and the alternative rate calculations of the Attorney General were changed from the original positions taken by each party prior to the hearing. The following is a summary of the position of each party at the conclusion of the hearing.

**ProSelect**

On the first day of the hearing, ProSelect announced that it had amended its requested rates based upon information developed during preparation for the hearing. The final rate request of ProSelect, therefore, is an increase of 4.9% for Physicians & Surgeons and an increase of 13.5% for Hospitals and Facilities. [The filing made on May 9, 2005 had requested 7% for Physicians & Surgeons and 16% for Hospitals.]

### **Attorney General (AG)**

On the morning of the final day of the hearing the AG amended its alternative rate calculation to provide for a 3.5% decrease for Physicians & Surgeons and a 2.2% decrease for Hospitals. [The AG's statement of areas of disagreement and alternative rate calculations filed in accordance with Insurance Regulation 39(9)(b) had proposed a rate decrease of 14% for Physicians & Surgeons and a rate decrease of 14.8% for Hospitals.] The differential of 8.4 points between ProSelect's amended rates and the AG's alternative rate calculation with regard to Physicians & Surgeons is primarily due to disagreement as to the inclusion of the excess policy limits/extra contractual obligation ("XPL/ECO") provision and the manner in which the permissible loss & loss adjustment expense ("LAE") ratio is reflected in calculating the rate level indication. The differential of 15.7 points between ProSelect's amended rates and the AG's alternative rate calculation with regard to Hospitals is primarily due to disagreement as to the inclusion of the XPL/ECO provision, the manner in which the permissible loss & LAE ratio is reflected in calculating the rate level indication, and the complement of credibility. The AG did not raise an objection to approval of the Partnership and Corporation filing.

### **Rhode Island Trial Lawyers (RITLA)**

RITLA did not provide alternative rates; however, it argued that the proposed rates were excessive and that a "rate decrease in the low single digits" is warranted. In support of this argument, RITLA detailed nine areas of disagreement. The nine areas of disagreement are:

1. Loss Development – while recognizing that some actuarial judgment is necessary, RITLA argued that ProSelect had not provided any evidence as to the basis for selection.
2. Severity Trend – RITLA argued that the manner of calculation unreasonably skews the trend high and is not consistent with the Department’s Decision in Norcal Mutual Insurance Company DBR No 03-I-0218 issued November 20, 2003 (hereinafter referred to as the *Norcal Decision*).
3. Frequency Trend – RITLA argued that the National Practitioners Databank, used by ProSelect for severity but not frequency trend, should be given some weight which would result in a “moderately negative” trend rather than the zero trend used in the filing.
4. Trended Loss Ratio – RITLA takes exception to the averages selected by ProSelect for reasons similar to its criticism of ProSelect’s selection of Severity Trend.
5. Selection of Loss Ratio – In addition to the criticism of averages selected, RITLA takes exception to the selection of the loss ratio from among the averages.
6. Profit and Contingency Provision – RITLA objects to the use of a 17.83% provision rather than the 12.5% provision used last year and currently in use for ProSelect in New Jersey, Maine and Vermont.
7. XPL/ECO Provision – RITLA objects to this provision on the basis that no medical malpractice insurer in Rhode Island has actually made a payment

under the *Asermely* case. Additionally, although the provision is designed for a catastrophic event, RITLA points out that reserves for future catastrophes should be maintained in an isolated account, which is not proposed by ProSelect.

8. Off-Balancing – As a matter of public policy, RITLA does not believe that a system of debits and credits which result in a revenue loss of 19.2% is proper since the manual rate is no longer a good indicator as to the actual premium charged.
9. IRR Model – RITLA opined that ProSelect’s IRR model does not consider all sources of investment income.

RITLA did not raise an objection to approval of the Partnership and Corporation filing.

### **Rhode Island Medical Society (RIMS)**

RIMS filed a statement of its president which discusses the adverse effects of increasing medical malpractice costs balanced with the necessity for a healthy insurance market. (RIMS Exhibit 1) RIMS notes the expensive and labor intensive process involved in rate hearings and suggests that the Department and the AG consider less expensive methods of scrutiny of medical malpractice insurance rates. RIMS did not raise an objection to approval of the Partnership and Corporation filing.

## **II. TRAVEL**

This matter came to be heard before the Department of Business Regulation ("Department") as a result of three rate filings received by the Department on May 9,

2005 from ProSelect. All rates were proposed to be effective on September 30, 2005. The rates now in effect for ProSelect were approved effective September 30, 2004.

In accordance with the provisions of R.I. Gen. Laws § 27-9-10 and 42-6-8, on May 20, 2005, the Director of the Department designated Elizabeth Kelleher Dwyer, Deputy Chief of Legal Services and Paula M. Pallozzi, Chief Property & Casualty Insurance Rate Analyst, as Co-Hearing Officers in this matter. A prehearing conference was held on June 1, 2005 at which time deadlines for discovery, motions to intervene, prefiled testimony and statements pursuant to Insurance Regulation 39(9)(b) were set and the public hearing was scheduled for July 26, 2005. The Order Appointing Hearing Officers was sent to RIMS, RITLA and the Hospital Association of Rhode Island (“HARI”) and each sent representatives to the prehearing. These organizations were requested to file motions to intervene as soon as possible if they intended to intervene.

Motions to Intervene were filed by RIMS on June 23, 2005 and RITLA on June 27, 2005. Neither ProSelect nor the AG objected to the motion of RIMS, however, ProSelect did object to the motion of RITLA. On July 14, 2005 the Department held a hearing on RITLA’s motion to intervene. After briefing and argument the Department issued an order granting RITLA’s motion to intervene. Data requests were submitted by the Department, the AG and RITLA, to which ProSelect responded.

Pursuant to R.I. Gen. Laws § 27-9-10 and 42-35-9 through 18, notice of the filing and of the hearing thereon was duly published on June 23, 2005 in *The Providence Journal*. Although not required by statute, to assure the wide notification of the hearing, the notice was sent electronically to the “interested parties” list maintained by the

Insurance Division pursuant to R. I. Gen. Laws § 42-35-3 and was posted on the Department's website.

On July 26, 27, 28 and 29, 2005 the public hearing in this matter was held. Hearing Officers Elizabeth Kelleher Dwyer, Esq. and Paula M. Pallozzi were assisted by consulting actuaries Ted Zubulake and Debbie Stein. The following made appearances on behalf of the parties:

ProSelect – Daniel Crocker, Esq.

Attorney General – Genevieve Martin, Esq.

Jodi Nourse Bourque, Esq.

RITLA - Miriam Weizenbaum, Esq.

Jay Angoff, Esq.<sup>1</sup>

RIMS - Brian Lamoureux, Esq.

ProSelect offered as witnesses Stephen Langlois and Thomas Ghezzi. The AG offered as witnesses Anthony Grippa and Michael Ileo.

During the hearing the following exhibits were admitted into evidence: ProSelect Exhibits A through Z, AG Exhibits 1 through 22, Department Exhibit 1, RIMS Exhibit 1 and RITLA Exhibits 1 through 4. On July 26, 2005, upon opening the hearing, the Department asked for public comment on the filing. Public comment was offered by Ann Rhodes of Rhode Island for Healthcare. Ms. Rhodes indicated that she was a healthcare consumer advocate and that the impact on the patient, doctors and hospitals of increased medical malpractice rates should be taken into consideration. She commented on the “ripple effect” that medical malpractice premiums have to the health system and opined

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<sup>1</sup> Mr. Angoff was admitted *pro hac vice* by the Providence County Superior Court for purposes of this hearing.

that the causes of malpractice premium increases are not an increase in legal awards since only two jury awards for medical malpractice have been issued in Rhode Island since 2003 and both of those were for \$200,000. She also referred to a study issued by the Center for Justice and Democracy in New York in July of 2005 which indicated that while national medical malpractice rates increased 120% between 2000 and 2004 claim payments only increased by 5.7%. A full copy of her statement was admitted into evidence as Public Comment Exhibit 1.

As discussed in detail below, after consideration of all of the evidence submitted, the Department determined that ProSelect's proposed rate increases for physicians & surgeons and hospitals are excessive. With regard to hospitals, the Department determined the rate level indication to be negative. The Department also noted, however, that ProSelect's selected loss trend rate is lower than that previously approved in the *Norcal Decision* and lower than that selected by Norcal in the upcoming proceeding *In re Norcal* DBR No. 05-I-0142 filing. In addition, the Department noted that ProSelect's selected target rate of return is different than the target rate of return previously approved in the *Norcal Decision* and that selected by Norcal in the upcoming proceeding *In re Norcal* DBR No. 05-I-0142 filing.

These facts caused concern to the Department that the application of only the specific data and information presented in the ProSelect proceeding could lead to inconsistent outcomes among malpractice carriers and could adversely impact the medical malpractice insurance market in Rhode Island.<sup>2</sup> The Department, therefore, issued an order on August 22, 2005 indicating that testimony regarding the profit &

contingencies margin (including the selection of a target rate of return, and the assumptions and calculations that are applied to convert the target return to a profit & contingencies margin), and the claim frequency and claim severity loss trend rates from the upcoming proceeding *In re Norcal* DBR No. 05-I-0142 would be considered in this filing and ProSelect would be allowed to intervene in the *In re Norcal* DBR No. 05-I-0142 proceedings with regard to these issues to offer evidence and/or differing positions than presented by the filer.

On September 1, 2005 ProSelect filed a motion requesting that the Department reconsider this order and indicating that it did not wish to have evidence in the upcoming proceeding *In re Norcal* DBR No. 05-I-0142 considered in conjunction with the filing. By this Decision, the Department accedes to ProSelect's request and will consider only the information presented by ProSelect in rendering this Decision.<sup>3</sup>

### **III. JURISDICTION**

The Department has jurisdiction in this matter pursuant to R.I. Gen. Laws §§ 27-9-10 and 42-62-13. The hearing was conducted in accordance with the provisions of the Administrative Procedures Act, R.I. Gen. Laws §§ 42-35-1 *et seq.*

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<sup>2</sup> As of the date of this Decision, Norcal and ProSelect are the only monoline competitive carriers actively writing in the Physicians and Surgeons market and ProSelect is the only monoline competitive carrier writing in the Hospital Liability market in Rhode Island.

<sup>3</sup> ProSelect took the position that the Decision must be issued no later than 30 days after August 29, 2005, on the basis that this date was the "close of the hearing." The Department did not make any order on August 29, 2005 that the hearing was closed and upon consideration of the evidence determined that it wanted additional evidence to consider. The Department did not, therefore, consider the hearing "closed" on August 29, 2005.



#### **IV. ISSUES**

1. What Judgments and Assumptions are Appropriate in Assessing ProSelect's Rate Level Needs?
2. Is a Rate Decrease Justified for Hospitals?
3. What are ProSelect's Rate Level Needs?

#### **V. DISCUSSION**

1. What Judgments and Assumptions are Appropriate in Assessing ProSelect's Rate Level Needs

By its nature, the actuarial determination of an insurance company's rate level need is subject to a considerable amount of actuarial judgment. In determining its rate level need, ProSelect makes numerous assumptions and judgments. The AG stated that while it does not necessarily agree with each of the assumptions and judgments ProSelect makes in arriving at its selected trended ultimate loss and ALAE ratios – before credibility considerations - it finds the selected ratios to be reasonable. However, the AG takes issue with other aspects of ProSelect's calculation of its rate level indications, including the complement of credibility, the provision for expenses, and the profit & contingencies provision. RITLA also questions certain of ProSelect's assumptions and judgments.

The Department does not agree with some of the assumptions and judgments made by ProSelect. A discussion of these issues and the Department's decision and reasoning follows.

#### **Loss Development Factors**

In general, the Department finds ProSelect's selected loss development factors to be reasonable. However, the Department is concerned that ProSelect has not provided

strong rationale for its particular judgments and that ProSelect does not seem to have been consistent in making its selections. As a result, the Department finds that a systematic approach to selecting development factors is appropriate in this instance. The Department also believes that averages other than those considered by ProSelect should be considered as a means to achieve an appropriate balance between responsiveness and stability. As respects both the incurred loss development method and the paid allocated loss adjustment expense (“ALAE”) development method, the Department accepts an average of the following average development factors: (1) Simple Average of Middle 3 of Latest 5 (non-contiguous), (2) Volume Weighted Average of Latest 3, and (3) Volume Weighted Average. The Department finds the tail factors selected by ProSelect to be reasonable. The Department finds ProSelect’s method of selecting loss development factors from among those indicated based on the ProMutual and ProSelect data to be reasonable. As discussed later, the Department rejects ProSelect’s use of the paid development method for estimating ultimate losses.

### **Loss Trend**

ProSelect’s selected loss trend rate of 6.3% per annum is based upon (a) a selected frequency trend rate of 0%, and (b) a selected severity trend rate of 6.3%. ProSelect selects a 0% frequency trend rate based on a review of its countrywide physicians & surgeons and hospital claim frequency experience over the period 1993 through 2004. That experience shows a generally increasing trend over the period 1993 through 1998/1999 and a somewhat decreasing trend between 1998/1999 and 2004. However, the data has not been developed and, therefore, the Department is of the view that the seemingly downward trend does not portray an accurate picture of ProSelect’s

claim frequency pattern. The Department accepts ProSelect's selection of a 0% frequency trend rate.

ProSelect selects a 6.3% claim severity trend rate based on insurance industry physicians & surgeons data obtained from the National Practitioners Databank ("NPD"). The Department recognizes that ProSelect's own loss experience is not sufficiently credible for claim severity trend, and while it also recognizes the limitations of the NPD data the Department accepts, for this filing, the use of the NPD industry data as the basis for selecting the claim severity trend rate.

However, the Department takes issue with the manner in which ProSelect calculates an indicated loss trend rate. ProSelect performs an exponential regression analysis of the Rhode Island data and of the insurance industry Countrywide data that is contained in the NPD data base, each spanning the period 1996 through 2004. It then selects an arithmetic average of the two indicated trend rates. The Department also takes issue with ProSelect's reliance upon unlimited NPD data when its analysis of its rate level needs is on a basic limit basis (i.e., claims capped at \$1 million). At the Department's request, ProSelect provided the NPD data reflecting a capping of claims at \$1 million.

The Department accepts ProSelect's selection of a 0% frequency trend rate based on ProSelect's Countrywide data.

As respects the claim severity trend rate, the Department finds use of NPD insurance industry data that reflects a capping of claims at \$1 million and the following manner of selecting the severity trend rate to be a more appropriate way of calculating an indicated severity trend rate.

- Based on the Countrywide data, determine a severity trend based upon a weighted average of the arithmetic averages of the exponentially fitted trends over the following periods: 1996-2002, 1997-2002, 1998-2002 (weight of 3.0); 1996-2003, 1997-2003, 1998-2003, 1999-2003 (weight of 2.0); and 1996-2004, 1997-2004, 1998-2004, 1999-2004, 2000-2004 (weight of 1.0).
- Based on the Rhode Island data, determine a severity trend based upon a weighted average of the arithmetic averages of the exponentially fitted trends over the following periods: 1996-2002, 1997-2002, 1998-2002 (weight of 3.0); 1996-2003, 1997-2003, 1998-2003, 1999-2003 (weight of 2.0); and 1996-2004, 1997-2004, 1998-2004, 1999-2004, 2000-2004 (weight of 1.0).
- Determine the arithmetic average of the severity trend rate based on the NPD Countrywide data and the severity trend rate based on the NPD Rhode Island data.
- The result is an indicated severity trend rate of 4.6% per year.

Although the indicated severity trend rate of 4.6% calculated in this manner is less than ProSelect's selected severity trend rate of 6.3%, the Department accepts ProSelect's selected severity trend rate of 6.3% as reasonable.

### **Premium Trend**

Based on the data provided by ProSelect, the Department accepts ProSelect's implicit exclusion of premium trend to be appropriate.

### **Selection of Trended Ultimate Loss and ALAE Ratio**

Separately, using the incurred loss development method and the paid loss development method, ProSelect selects a trended ultimate loss and ALAE ratio based upon four averages that it calculates – each of the averages based on selected years. The

Department is concerned that ProSelect has not provided strong rationale for its particular selections. As a result, the Department finds a systematic approach to determining the Selected Trended Ultimate Loss and ALAE Ratio to be appropriate in this instance.

The Department rejects consideration of the results of the paid loss development method. The Department finds the paid loss development method unreliable for the more recent years because of the sensitivity of the results to small changes in the amount of paid losses. The Department also finds the paid loss development method not to be as reliable as the incurred loss development method for the more mature years.

The Department finds the following manner of determining the Selected Trended Ultimate Loss and ALAE Ratio to be more appropriate.

- Assign a “responsiveness weight” to years 2004 back to 1996 of 9 for 2004, 8 for 2003, 7 for 2002, etc.
- Assign a “stability weight” to years 2004 back to 1996 equal to the percentage of the estimated ultimate losses and ALAE reported/occurred/paid (maximum of 100%).
- Assign a “premium weight” to years 2004 back to 1996 equal to the “on level earned premium.”
- Normalize the product of the three (3) weights.
- Apply the normalized weights to the trended ultimate loss and ALAE ratios by year.

The Department notes that by introducing a “premium weight” this approach departs from the approach in the *Norcal Decision*. The Department finds consideration

of a “premium weight” necessary in this filing because of the growth rate experienced by ProSelect.

This manner of determining the Selected Trended Ultimate Loss and ALAE Ratio produces a ratio of 65.0% for Physicians & Surgeons and 89.5% for Hospitals. As these values are very close to the ratios selected by ProSelect of 66.5% for Physicians & Surgeons and 90.0% for Hospitals under the incurred loss development method, the Department accepts ProSelect’s Selected Trended Ultimate Loss and ALAE Ratios derived under the incurred loss development method as reasonable.

#### **Unallocated Loss Adjustment Expense (“ULAE”) Percentage**

ProSelect judgmentally selects a ULAE percentage that is based on its historical countrywide experience. The Department finds the selected percentage to be reasonable.

#### **Credibility of ProSelect’s Loss Experience**

This issue concerns the credibility of the estimates of ProSelect’s ultimate trended incurred loss and ALAE ratio for years 1996-2004 as the basis for projecting ProSelect’s ultimate loss and ALAE ratio for year 2005. Both ProSelect and the AG consider ProSelect’s data not to be fully credible and adjust for this.

ProSelect selects a full credibility standard of 1,082 claims, and the AG accepts this standard as being reasonable. The Department, however, finds this standard not to be appropriate as it does not recognize the variation in claim size. Consistent with its decision in the *Norcal Decision*, the Department finds 683 claims a reasonable full credibility standard subject to an adjustment that recognizes the variability of claim costs. The credibility standard and adjustment that the Department selects are based on a published actuarial paper titled, “An Introduction to Credibility Theory.” The 683 is

lower than the 1,082 claim standard selected by ProSelect. The lower standard recognizes the uncertainty in the assumption of rate adequacy that underlies the use of trend as the complement of credibility. The 683 is adjusted by multiplying by a factor equal to the sum of unity and the square of a selected coefficient of claim size variation. The Department's selected coefficient of claim size variation is presented in the Department's exhibits. The Department's calculated full credibility claim standard is 1,500 claims.

The AG finds ProSelect's manner of estimating its ultimate number of incurred claims for purposes of determining credibility to be inappropriate. The Department agrees with the AG and accepts the AG's estimate as reasonable.

The Department accepts in principle ProSelect's manner of determining the complement of credibility, which is to consider the prior rate level indication, less the approved rate increase, adjusted by loss trend. However, as respects this filing, the Department does not accept ProSelect's consideration of its prior rate level indication.

The Department's reason is that while the Department accepted ProSelect's prior proposed rate changes as being reasonable, it did not make a finding on the full amount of rate level indication that had been calculated by ProSelect. Therefore, the Department finds the consideration of loss trend only and not the prior rate level indication to be appropriate. This is also the position of the AG.

In applying the complement of credibility both ProSelect and the AG take into consideration the rate level off-balance resulting from changes in ProSelect's premium modifications. While they each do so in a different way, the Department finds the two

approaches to be mathematically equivalent, and, therefore, accepts ProSelect's calculations as reasonable.

### **Adjustment Due to Proposed Change in Provision for Expenses and Profit**

After applying the complement of credibility the AG also includes an adjustment to reflect the "proposed change in provision for expenses and profit." While ProSelect does not make a similar, explicit adjustment, it implicitly reflects changes in its selected expense and profit provisions through the manner in which it calculates its rate level indication. The two ways of considering changes in the expense and profit provisions differ, not only in approach, but in the result. Under the AG's approach the effect of the change in expense and profit provisions is applied to the rate level indication after credibility has been considered. Under ProSelect's approach, essentially, the effect is applied to the rate level indication before credibility has been considered; Pro-Select does not reflect the effect in the complement of credibility.

In principle, the Department finds the AG's approach to be appropriate. For example, if Pro-Select increased the amount of commissions that it pays by 2 percentage points, then this increase should be fully reflected in ProSelect's final (i.e., after credibility considerations) rate level need, and not simply reflected in ProSelect's rate level need before consideration of credibility.

However, as respects this filing, the Department has two concerns with the AG's approach and calculations. First, because of the circumstances of ProSelect's last rate filing – the fact that appropriate expense and profit provisions were not determined for that filing - it is not evident to the Department that the AG's adjustment for a change in the expense and profit provisions is appropriate (since there are no provisions against



which changes, if any, can be measured). Second, the Department is not certain how the AG's selected permissible loss ratio was determined, and whether it is appropriate to be used in calculating this adjustment.

Because of these two concerns, and because, as discussed later, the Department finds ProSelect's expense and profit provisions to be reasonable, the Department does not accept the AG's adjustment for "proposed change in provision for expenses and profit."

### **XPL/ECO Provision**

ProSelect has requested a 4% provision for this potential liability. This provision actually refers to two separate types of risks. The risk addressed by XPL is the risk that a court would find the insurer liable in excess of its policy limits. The risk addressed by ECO is the risk that a court would find ProSelect liable outside of the insurance contract. An example of ECO liability is "bad faith" conduct of an insurer.

In the *Norcal Decision* the Department was first presented with a request to include this provision in rates. At that time the AG objected to this provision arguing the risk under *Asermely v. Allstate*, 728 A.2d 461 (1999) was predicated on a finding of bad faith and the insurer should not be allowed to include an amount in rates which anticipates its own bad faith conduct. The Department disagreed that *Asermely* required a finding of bad faith conduct and found that *Asermely* did pose a risk of liability in excess of policy limits. The only evidence before the Department in the *Norcal Decision* with regard to the amount of the provision was Norcal's experience in California with regard to extra contractual liability. Although the Department noted that the *Asermely* risk was significantly different from the California bad faith experience, since both involved

liability outside of the insurance policy, the Department relied upon Norcal's California bad faith experience to establish a 4% provision.

In this case, the AG again argues that *Asermely* requires a finding of bad faith and the insurer should not be allowed to collect a provision in anticipation that they will be found to have breached its contract in bad faith. Additionally, the AG argues that there is no data to support the requested 4% provision and that if an amount were allowed for this risk it should be included in losses rather than as a separate provision. RITLA argues that since the *Asermely* case was decided there has not been a verdict under *Asermely* and that, without any verdict, there is no experience upon which to base such a provision.

As in the *Norcal Decision* the Department again rejects the AG's contention that *Asermely* requires a finding of bad faith. In fact, the *Asermely* court upheld the lower courts grant of summary judgment finding that as a matter of law the insurer had not acted in bad faith. The language upon which ProSelect bases its assertion of a risk in excess of policy limits is, as pointed out by RITLA, *dicta*. In *Asermely*, after reviewing the lower court's grant of summary judgment, the Supreme Court stated:

We shall take this opportunity to promulgate a new rule to guide the trial courts in deciding these issues...It is not sufficient that the insurance company act in good faith. An insurance company's fiduciary obligations include a duty to consider seriously a plaintiff's reasonable offer to settle within the policy limits. Accordingly, if it has been afforded reasonable notice and if a plaintiff has made a reasonable written offer to a defendant's insurer to settle within the policy limits, unless it can show that the insured was unwilling to accept the offer of settlement. The insurer's duty is a fiduciary obligation to act in the best interests of the insured. *Even if the insurer believes in good faith that it has a legitimate defense against the third party, it must assume the risk of miscalculation if the ultimate judgment should exceed the policy limits.*

*Id.* at 464. (emphasis added.)

The Department continues to believe, as expressed in the *Norcal Decision* that *Asermely* presents a unique risk that the insurer, even if it acts in good faith, could be liable in excess of policy limits. RITLA is correct, however, that, contrary to the conclusion in the *Norcal Decision* the risk is actually lessened where the insurance policy provides the insured with consent to settle. It would appear that, in accordance with the language quoted above, if the insurer were willing to settle but the insured refused to do so under the consent to settle provision, the insurer would not be liable. However, this fact does not remove the risk. Even if the insured has the right to prevent a settlement by withholding his or her consent, this does not remove the risk that both the insurer and insured may in good faith refuse to settle and the insurer would be liable in excess of policy limits.

As noted above, the XPL/ECO provision in the *Norcal Decision* was based upon Norcal's California bad faith experience. ProSelect disclosed in discovery that it had also had experience with liability in excess of policy limits. ProMutual had experienced unexpected liability in excess of policy limits in Massachusetts, when the Massachusetts Supreme Court held that single occurrence limits were actually per person limits. The policy language has since been amended and the liability no longer exists in Massachusetts; however, during the period in which that liability existed ProSelect suffered losses at 3.3% for Physicians & Surgeons and 0.9% for Hospitals.<sup>4</sup>

The Department also notes that three years have passed since the *Norcal Decision* and the *Asermely* risk has not yet materialized. As time passes without such liability, the need for a provision in the rates decreases. RITLA argued that, in addition to the fact that

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<sup>4</sup> ProSelect's witness indicates that the more favorable hospital experience was based upon a Massachusetts law which limits the liability of charitable organizations.

the *Asermely* liability was established by *dicta*, the *Asermely* language contains a number of variables, including what is meant by “reasonable notice,” and that it is unclear what the Supreme Court would do when confronted with such a case. RITLA’s counsel was correct when he argued that the *Norcal Decision* was not intended to establish an indefinite 4% provision regardless of the actual experience. The Department believes that the ProSelect Massachusetts experience, the vagueness of the *Asermely* decision and the continued passage of time without an *Asermely* claim, all support the modification of the 4% provision. For this case, the Department will allow a 2% provision for the XPL/ECO liability. The Department further notes that continued passage of time and any further development with regard to *Asermely* will be taken into account in the establishment or elimination of this provision in the future.

### **Expenses**

The AG finds ProSelect’s general expense provision of 6.68% to be higher than what is suggested by ProSelect’s historical experience, and instead finds a provision of 6.28% to be reasonable based on ProSelect’s historical experience. ProSelect’s selected general expense provision is based on management’s budget expectations. The Department finds ProSelect’s selected general expense provision to be reasonable.

ProSelect treats all expenses as being premium variable. The Department finds that some expenses should be treated as fixed, and notes that Mr. Ghezzi said that he agrees that some of ProSelect’s expenses are fixed in nature. However, the AG does not raise this as an issue and no evidence was provided to support the selection of a fixed expense provision. Therefore, and based on the Department’s belief that such a consideration would not have a significant effect on the rate level indications, the

Department accepts ProSelect's treatment of all expenses as being premium variable in this filing.

### **Profit & Contingencies**

There was considerable testimony on the issue of the profit & contingency provision. The AG takes issue with ProSelect's selected target after-tax return on equity of 8.1% and with the manner in which ProSelect converts this target return into a profit & contingency provision. While the AG finds the Internal Rate of Return (IRR) approach for conversion reasonable, it takes issue with the structure of ProSelect's IRR model and certain of the assumptions that Pro-Select makes in applying the model.

ProSelect's 8.1% target return is based on a methodology referred to as the Capital Asset Pricing Model (CAPM) and certain assumptions concerning risk free rates, the expected market return, and the relative riskiness of medical malpractice insurance (as measured by the selection of a "beta coefficient"). The AG finds the CAPM approach reasonable – although acknowledges that other methods could be used that could produce higher or lower results – but finds that to be consistent with the beta coefficient that was selected the risk free yield should be based on 30 day Treasury Bills, which are currently yielding 3.23%. According to the AG, doing so reduces the target after-tax return to 7.84%. Further, the AG argues that the after-tax investment yield used in the model should be 2.9%, not 2.6%. The Department did not accept Mr. Ghezzi as an expert in selecting target rates of return and ProSelect did not present any other witness as an expert to argue its position on this issue. However, in response to a question, Dr. Ileo stated that he does not find ProSelect's 8.1% target to be unreasonable.

As respects the structure of ProSelect's IRR model, Dr. Ileo has concerns with ProSelect's model, the most significant of which is the model's failure "to properly consider investment income, most notably with respect to surplus." This concern is also raised by RITLA. However, Dr. Ileo caveats his concern by stating that due to time constraints he did not complete a full evaluation of ProSelect's IRR model. The Department questioned Mr. Ghezzi on this issue – asking him whether investment income on the equity supporting the operation of the company is reflected in the calculation of the target rate of return. Mr. Ghezzi answered "Absolutely, yes."

The AG also takes issue with several assumptions used in applying the model related to the timing of premium receipt and expense outflows, and whether the XPL/ECO provision should be reflected as an expense or as a loss. But based on testimony presented by both Dr. Ileo and Mr. Ghezzi, the Department finds that the issues raised by the AG are not material to the calculation of the rate level indications.

A material assumption with which the AG takes issue is the amount of capital needed for Year 1 under the IRR model. The AG finds that ProSelect's use of a 1 to 1 premium to surplus ratio results in an excessive amount of surplus; it finds that a 2.5 to 1 reserve to surplus ratio results in an appropriate surplus level for Year 1. ProSelect finds that a 1 to 1 premium to surplus ratio results in a reasonable surplus level in Year 1 considering the surplus requirements of regulators and rating agencies. ProSelect uses a 2.5 to 1 reserve to surplus ratio beginning in Year 2; the AG agrees with this assumption for those years.

Primarily for reasons of materiality and the uncertainty surrounding Dr. Ileo's views on the structure of ProSelect's IRR model, the Department accepts ProSelect's IRR

model, ProSelect's assumptions regarding the timing of cash inflows and outflows – including the loss payment pattern, ProSelect's assumed investment yields, and ProSelect's target after-tax return of 8.1% as reasonable for this filing. However, the Department agrees with the AG that ProSelect's use of a 1 to 1 premium to surplus ratio for Year 1 of the model produces an excessive level of assumed surplus. In the Department's view, ProSelect's basis for basing the needed first year surplus on an assumed 1 to 1 premium to surplus ratio is not compelling. The Department acknowledges ProSelect's arguments for a medical malpractice insurer to operate at a premium to surplus ratio of 1 to 1. However, in selecting a 1 to 1 premium to surplus ratio for purposes of applying the IRR model, Pro-Select does not recognize that the company is an on-going concern and that the surplus supporting the claim reserves arising from insurance policies written by ProSelect in other years (i.e., other than the policy year under consideration) also contribute to meet the surplus level required by regulators and rating agencies. Therefore, the Department accepts the AG's use of a reserve to surplus ratio of 2.5 to 1 for Year 1 and for all subsequent years. The Department also accepts, for this filing, the application of the 2.5 to 1 reserve to surplus ratio in Year 1 to the unearned premium reserve as well as the loss and LAE reserve. The result is a profit & contingency provision of 9.6% for Physicians & Surgeons and 6.4% for Hospitals.

### **Other Issues**

The AG is of the view that ProSelect's rates for the All Other Facilities classification are excessive. This is based on what Mr. Grippa referred to as the "dramatic difference" in the on-level loss ratios between other facilities and hospitals.

The Department finds that a comparison of loss ratios, alone, is not sufficient evidence of the degree to which the rates for this class of business may be excessive. The Department orders ProSelect to provide a separate analysis of the rates for this class at its next rate filing.

The AG is of the view that the Department should take the position (on all filings, not just the ProSelect filing) that the effect of schedule rating should be excluded from the calculation of all rate level indications. The AG's position is based on its belief that schedule rating is primarily a marketing tool and the degree to which it is used is at the full discretion of the company. RITLA also raised the concern that allowing a wide range of schedule rating debits and credits undermines the value of manual rates. The Department will take these views under advisement.

### **Overall Rate Level Indications**

Based upon the resolution of these issues the overall rate level indications are:

Individual Medical Professional Liability Program: +2.3%

Hospital Healthcare Facility Medical Professional Liability Program: -1.3%

The Department's calculations are presented in the attached exhibits.

#### **2. Is a Rate Decrease Justified for Hospitals?**

ProSelect requested an increase of 13.5% in rates for hospitals. As noted above, the adjustments made by the Department result in a negative indication for hospitals of – 1.3%. However, the Department does not believe that the negative indication necessarily demonstrates that the current hospital rates are “excessive” because the negative indication calculated by the Department is based on the data and information presented in the ProSelect proceeding, As noted previously, ProSelect's selected loss trend rate and



target rate of return are not consistent with those approved by the Department in the *Norcal Decision* nor those selected by Norcal in the upcoming proceeding *In re Norcal* DBR No. 05-I-0142 filing. As such the Department rejects ProSelect's request for an increase in hospital rates and orders that the rates approved effective September 30, 2004 remain in effect.

3. What are ProSelect's Rate Level Needs?

As detailed in the analysis above, the Department finds that rates that are not excessive, inadequate or unfairly discriminatory can only be calculated by making adjustments to ProSelect's proposals. In addition to the issues resolved as indicated above, the Department finds that the following alterations to ProSelect's requests are necessary:

- The Department finds that an overall rate level increase of 2.3% for ProSelect's Individual Medical Professional Liability Program will result in rates that are not excessive, inadequate or unfairly discriminatory. The Department orders that ProSelect is authorized to issue medical malpractice insurance in Rhode Island based on established rates in accordance with the attached rate calculations.
- The Department rejects ProSelect's request to increase rates for the Hospital Healthcare Facility Medical Professional Liability Program. The Department orders that ProSelect is authorized to issue medical malpractice insurance for hospitals and healthcare facilities in Rhode Island based on rates approved by the Department effective September 30, 2004.

- The Department approves the Partnership and Corporation Medical Professional Liability Program filing, which does not include a request for an increase in rates, as filed.

## **VI. FINDINGS OF FACT**

1. On May 9, 2005 ProSelect filed requested rate increases for three lines of business. In accordance with the provisions of R.I. Gen. Laws § 27-9-10 and 42-6-8, the Director of the Department designated Elizabeth Kelleher Dwyer, Esq. and Paula M. Pallozzi as Co-Hearing Officers in this matter. Notice of the filing and of the hearing thereon was published on June 23, 2005 in *The Providence Journal*. On July 26, 27, 28 and 29 2005 public hearings were held with regard to this request. The Department asked for public comment and one witness appeared to offer public comment.

2. Both ProSelect and the AG changed their original rate level indications. The final requests from those parties was – ProSelect +4.9% for Physicians & Surgeons and +13.5% for Hospitals ; AG -3.5% for Physicians & Surgeons and –2.2% for Hospitals. All rates are proposed to be effective on September 30, 2005. The rates now in effect for ProSelect were approved effective September 30, 2004.

3. RITLA requested a “moderate decrease” but did not propose any specific numbers. RITLA indicated that it had nine points of contention with the filing which are summarized in the Travel section of this Decision.

4. RIMS did not take a position with regard to the specific numbers, however, filed an Exhibit RIMS 1 outlining its position on medical malpractice rates and the effect on the healthcare industry.

5. The findings and recommendations in this Decision are based upon judgments and assumptions used by the Department in order to ascertain the appropriate rate relief. Insurers should not rely solely on the findings in this filing for future rate requests since conditions and situations may change depending on the data and other information provided by the filer. Clearly, the Department could have reached a different decision had the parties presented the Department with more credible and relevant data and other information for consideration. It is important to note that the Department relied on and accepted the data contained in the filing without independent audit.

6. With regard to loss development factors: (a) the Department finds ProSelect's consideration of ProSelect and ProMutual data to be appropriate. (b) the Department finds that a systematic approach to selecting development factors from each of these two data sets is appropriate and alternative averages should be considered as a means to achieve an appropriate balance between responsiveness and stability. The Department accepts an average of the following average development factors: (1) Simple Average of Middle 3 of Latest 5 (non-contiguous), (2) Volume Weighted Average of Latest 3, and (3) Volume Weighted Average. The Department accepts the tail factors selected by ProSelect. (c) the Department accepts ProSelect's method of selecting one set of development factors from those that result from this systematic approach to selecting loss development factors from each of the two data sets.

7. With regard to loss trend, the Department accepts ProSelect's selection of a 0% frequency trend rate and a +6.3% severity trend rate.

8. Based on the data provided by ProSelect, the Department accepts ProSelect's implicit exclusion of premium trend to be appropriate.

9. With regard to determining the Selected Trended Ultimate Loss and ALAE Ratios, the Department rejects ProSelect's use of the Paid Loss Development Method, and accepts ProSelect's selected ratios of 66.5% for Physicians & Surgeons and 90.0% for Hospitals that are based on the Incurred Loss Development Method.

10. The Department accepts ProSelect's Unallocated Loss Adjustment Expense ("ULAE") Percentage.

11. With regard to the credibility of ProSelect's loss experience, the Department finds 1,500 claims a reasonable full credibility standard. The Department finds the AG's estimation of the ultimate number of incurred claims for purposes of determining credibility to be appropriate. The Department finds the consideration of loss trend only and not the prior rate level indication to be appropriate. The Department accepts ProSelect's manner of considering the change in the rate level off-balance resulting from changes in ProSelect's premium modifications.

12. The Department does not accept the AG's adjustment for "proposed change in provision for expenses and profit."

13. The Department accepts that there is a risk under *Asermely* which justifies a provision for XPL/ECO. Neither the Norcal "bad faith" experience nor the ProSelect Massachusetts experience is a perfect match to the risk under *Asermely* in Rhode Island. However, the passage of time since the *Asermely* decision as well as consideration of the Massachusetts experience leads to the conclusion that the 4% provision approved in the Norcal Decision is no longer appropriate. Therefore, the Department finds a 2% provision for XPL/ECO to be appropriate. Continued passage of time and any further

development with regard to *Asermely* will be taken into account in the establishment or elimination of this provision in the future.

14. The Department accepts ProSelect's expense provisions, and their treatment as premium variable, to be reasonable.

15. The Department accepts ProSelect's IRR model, ProSelect's assumptions regarding the timing of cash inflows and outflows – including the loss payment pattern, ProSelect's assumed investment yields, and ProSelect's target after-tax return of 8.1% as reasonable for this filing. However, the Department finds the use of a reserve to surplus ratio of 2.5 to 1 for Year 1 and for all subsequent years to be appropriate. The Department also accepts, for this filing, the application of the 2.5 to 1 reserve to surplus ratio in Year 1 to the unearned premium reserve as well as the loss and LAE reserve.

16. Any conclusion of law which is also a finding of fact is hereby adopted as a finding of fact.

## **VII. CONCLUSIONS OF LAW**

1. The Department of Business Regulation has jurisdiction in this proceeding in accordance with R.I. Gen. Laws §§ 27-9-10 and 42-62-13.

2. The Director of the Department of Business Regulation, through her Co-Hearing Officers, Elizabeth Kelleher Dwyer, Esq. and Paula M. Palozzi have jurisdiction in this proceeding to conduct the hearing for purposes of considering whether ProSelect's proposed rate increases are excessive, inadequate or unfairly discriminatory.

3. All of the procedural prerequisites for the conduct of the hearing of this matter have been duly complied with.

4. ProSelect's requests for rate relief were filed at the Department of Business Regulation in accordance with the applicable statutes and regulations pertaining thereto.

5. An overall rate level change of +2.3% for ProSelect's Individual Medical Professional Liability Program, 0.0% for ProSelect's Hospital Healthcare Facility Medical Professional Liability Program, and 0.0% for ProSelect's Partnership and Corporation Medical Professional Liability Program will result in rates that are not excessive, inadequate or unfairly discriminatory.

6. The rate level change for ProSelect's Individual Medical Professional Liability Program and the Partnership and Corporation Medical Professional Liability Program shall be effective on September 30, 2005.

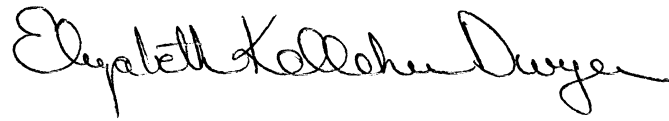
7. Any finding of fact which is also a conclusion of law is hereby adopted as a conclusion of law.

## **VIII.**

### **RECOMMENDATIONS**

In accordance with the Findings of Fact and Conclusions of Law set forth above, we find that the rate level change of +2.3% for ProSelect's Individual Medical Professional Liability Program, 0.0% for ProSelect's Hospital Healthcare Facility Medical Professional Liability Program, and 0.0% for ProSelect's Partnership and Corporation Medical Professional Liability Program will result in rates that are not excessive, inadequate or unfairly discriminatory.

September 22, 2005

A handwritten signature in black ink, reading "Elizabeth Kelleher Dwyer". The signature is written in a cursive style with a large initial "E".

Elizabeth Kelleher Dwyer, Co-Hearing Officer

September 22, 2005

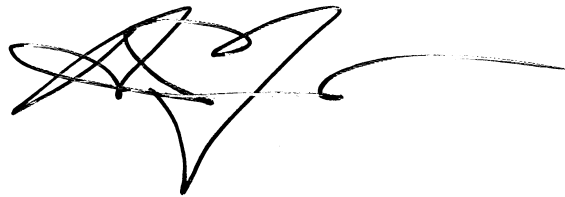
A handwritten signature in black ink, reading "Paula M. Palozzi". The signature is written in a cursive style with a large initial "P".

Paula M. Palozzi, Co-Hearing Officer

**ORDER AND DECISION**

I, A. Michael Marques, Director of the Department of Business Regulation and Insurance Commissioner of the State of Rhode Island, having read the Findings of Fact, Conclusions of Law, and Recommendations of the Co-Hearing Officers in this matter and having satisfied myself as to their validity, do hereby adopt and accept the Findings of Fact, Conclusions of Law and Recommendations of the Co-Hearing Officers.

ENTERED AS AN ADMINISTRATIVE ORDER OF THE DEPARTMENT OF BUSINESS REGULATION THIS 23<sup>rd</sup> DAY OF SEPTEMBER, 2005.

A handwritten signature in black ink, appearing to be 'A. Michael Marques', with a long horizontal flourish extending to the right.

A. Michael Marques  
Director and Insurance Commissioner  
Department of Business Regulation

**THIS DECISION CONSTITUTES A FINAL DECISION OF THE DEPARTMENT OF BUSINESS REGULATION PURSUANT TO RHODE ISLAND GENERAL LAWS TITLE 42, CHAPTER 35. AS SUCH, THIS DECISION MAY BE APPEALED TO THE SUPERIOR COURT SITTING IN AND FOR THE COUNTY OF PROVIDENCE WITHIN THIRTY (30) DAYS OF THE DATE OF THIS ORDER. SUCH APPEAL, IF TAKEN, MAY BE COMPLETED BY FILING A PETITION FOR REVIEW IN SAID COURT.**