Self Insurance: Does It Ever Make Sense?

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A popular question these days is what to do about the cost of malpractice insurance premiums. For many physicians, squeezed by Medicare and HMO cost cutting, malpractice costs are devouring an ever larger share of their income. Sometimes the premiums are just too expensive to afford or insurance might be unavailable at any price. An increasing number of physicians are electing to "go bare" -practice without insurance- or to self-insure in some manner. This presents the obvious risk that a lawsuit may wipe out years of savings and hard work. Many of my clients ask whether there is an alternative to conventional insurance. Can a legal plan be developed which will hold down costs without jeopardizing personal and business assets?

I'll answer that question like any good lawyer and hedge my advice. Is there a legal alternative to malpractice insurance? Maybe. It depends on the circumstances. There are important business, financial, and legal issues to resolve, but the potential payoff is high enough to at least make it worth considering. In this article we will look at the concept of self-insurance and examine the strengths and weaknesses of the strategy.

Goals of Self-Insurance

I received a call from a client - a member of a 6 physician anesthesiology group. Insurance costs for the group are roughly $400,000 per year. He asked whether it would be advantageous to drop coverage completely. Instead, they would establish a trust funded with their premium savings. The objective is to control litigation costs, limit settlement amounts and hopefully distribute a surplus back to the partners every few years. He wanted to know the ramifications of this approach.

This is an issue that is frequently raised. In this case insurance is currently available, although it is expensive and seems excessive based on the actual dollar amount of potential liability. When insurance can be purchased, but is considered costly, the analysis is different than when insurance is unavailable as a practical matter. If insurance is neither available nor affordable then certainly, asset protection is the only solution. There is no other means to minimize the risk of a disastrous financial loss. When coverage *can* be obtained but the price is steep, the issues are more complex.

Business Problems with Self-Insurance

There are a number of business problems which are created by dropping malpractice coverage. Even if the savings can be significant, in many states the obstacles to dropping traditional coverage may make it impractical to do so.

In an earlier article ("Asset Protection Strategies" MDNetGuide March 2004) we discussed the fact that hospitals, private insurers and other physicians may refuse to do business or practice with anyone without specified amounts of coverage. That might shut down your practice right there. In addition, a number of states which cap non-economic damages in a malpractice suit exclude physicians with inadequate coverage from this legal protection.

As the number of self-insured physicians increases everyone involved may be forced to develop reasonable solutions to the problem. Already we see that sometimes the hospitals and insurers can be satisfied with reasonable financial guarantees. But certainly these business problems must be carefully considered and in many cases may present a difficult hurdle to overcome.

Legal Ramifications

If it is decided that the plan is feasible from a business standpoint how well does it work legally?

Suppose ABC Medical Group pays $400,000 per year into a Liability Insurance Trust (LIT), and after three years there is a lawsuit naming one of the ABC members as a defendant, as well as ABC itself. Here are the points to consider:

<u>Attack against the LIT</u>

The first avenue of attack by a plaintiff will be against the LIT itself. That is the source of ready, available cash and *if those funds can be reached,* the plaintiff's attorney will view it as similar to an insurance policy. He can attempt to drive a settlement or litigate through trial with the knowledge that he will be paid if he wins, at least to the extent of the remaining funds. The LIT has sufficient assets to mount an appropriate legal defense, but if all of the accumulated contributions can be seized to pay for a judgment, then nothing has been accomplished by the plan. ABC might just as well have paid the insurance premiums.

If, on the other hand, the LIT is not vulnerable -if the funds cannot be reached by a successful plaintiff- the dynamic of the case and the relative leverage of the parties has certainly been altered. The attorney for the plaintiff now has no available source of payment for his claim. Under these circumstances, the administrators of the LIT determine the merit of the claim and can negotiate a reasonable settlement based on whatever standards have been established.

Can a LIT be established so that it is impervious to a lawsuit attack? Generally, the answer is yes, but that is subject to a number of important qualifications. In previous articles we have discussed the Fraudulent Transfer rules which prohibit transfers of property with the intent of defeating a creditor's claim. In addition it will be very important that the powers of the Trustees and administrators are properly enumerated and

prescribed. In some ways the LIT itself may look similar to a traditional pension or profit sharing trust, but rather than retirement benefits the purpose here is to determine the validity and administer the payment of claims.

Attack against Business and Personal Assets

Although the creation of the LIT is likely to stymie a plaintiff's primary and preferred line of attack, other avenues remain open and must be defended against. Without available insurance or an attractive and reachable cash fund, the financial incentive for the plaintiff is substantially diminished. Since malpractice cases are typically expensive to pursue many of the cases without significant merit may be discouraged. However, in a case involving serious injury and clear liability, the plaintiff may still proceed with the case. His intention is to obtain a judgment which will apply to the assets of the group as well as the personal assets of one or more physician members. The group may have valuable equipment and/or substantial accounts receivable. Certainly, the individual physician may have his home and savings. All of these assets may be jeopardized by a judgment.

The plaintiff's attorney may threaten to proceed against these assets if a satisfactory settlement is not reached. A good trial lawyer can create enough uncertainty and fear of loss that he is able to achieve a favorable settlement.

In our example, although the LIT was protected, the availability of the assets of the group and the individual physicians creates a weakness in the structure that the plaintiff's attorney may be able to exploit. In order to be successful with a self insurance strategy, group and individual assets would have to be protected as well. We've written about the techniques for protecting personal assets (See MD Net Guide March 2004) and the plans for business property are discussed at http://www.rjmintz.com/equity-stripping/overview

Plugging the Holes

The legal strategy for this type of self-insurance plan therefore consists of three parts:

1. Create a LIT to be funded with contributions from the members of the practice group. Since the goal is to reduce the number of claims and to control the amount of any settlement, the LIT must be drafted so that its assets are not legally reachable in the event of a judgment.

2. Protect business assets such as equipment and accounts receivable.

3. Protect personal assets such as the family home, savings and investments.

Now it looks like the holes are plugged and a typical case will unfold in this fashion: An attorney considering filing a case first investigates to determine the amount of insurance coverage. He's informed that there is no commercial insurance and the group is self insured and pays out claims based upon the injury and the circumstances. The most likely

next move is that the attorney will then conduct a thorough investigation into the assets of the group and the individual members. He will be trying to determine whether he can get a foothold in the negotiations, some threat to apply in order to obtain a settlement. But if no available assets are located, if he determines that collection will be impossible even if he obtains a judgment, the case is likely to be dropped or settled for a minimal amount. (See "Asset Protection and Financial Privacy" MD Net Guide, May 2004 for more background on pre-lawsuit financial investigations.) We can assume that an attorney will generally not proceed with a case if there are no reachable assets.

Additional Factors to Consider

1. It is crucial that enough money is accumulated in the LIT to cover the costs of a legal defense. If the case is not defended the plaintiff will obtain a default judgment with any associated court orders requested. So there must be enough time and sufficient contributions to create an adequate defense fund. A sole practitioner may use a LIT but will have to accelerate his contributions to make sure that potential defense costs are covered as quickly as possible.

2. If the attorney for the plaintiff proceeds with the case, despite the lack of reachable and available funds and if he is successful at trial, assets accumulated in the future may be subject to the judgment. Although property and savings developed prior to the case can be protected, subsequent amounts are at least theoretically at risk.

3. Amounts contributed to a LIT will not be deductible for income tax purposes. Earnings on accumulated LIT assets such as interest income or dividends will be taxable when earned. If amounts are used by the LIT to pay litigation costs or to settle claims, a deduction would be allowed at that time. Distributions of surplus to the members would not be taxable.

Advising a Client

Would we recommend a self-insurance strategy for our clients? The business problems we discussed will make this type of plan impractical for many. Generally, those who can afford to keep their insurance coverage should do so. If insurance protection is not available or is unreasonably priced, this strategy may provide a sensible solution to the problem. If the premium savings allow a physician to continue to provide valuable medical services, this type of planning will be worth the thought and the effort which is required.