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A N D

**Defense
costs data:
new
insights**

**Document! Follow up!
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Risk Management
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BY CHAD C. KARLS

Insights into Defense Cost Data



As is often the case, the most difficult part of writing an article is the first few words—the title. This article was no exception. Typically, since the author has only a few seconds to catch the reader's attention, the objective of the title is to be descrip-

tive and, perhaps, even catchy. Since you've read this far, maybe the five words above worked. Beyond the usual challenges with any title, this particular one proved especially difficult because some of the possible titles I came up with had already been used. "Defusing Defense Costs" was an early contender, until I discov-

ered that this was the title of a July 1988 *Best's Review* article. Since I'm a big fan of alliteration, I next tried "Driving Down Defense Costs," only to find that, that too, had already been used—this time, in a July 1999 *Best's Review* article. In retrospect, though, the fact that these titles were already taken worked in my favor because, had I used them, I would have violated the first objective of a title: to be descriptive.

Managing defense costs is not a new concept, as evidenced by the generationally old articles noted above. Further, managing defense costs does not necessarily mean minimizing or defusing or even driving down defense costs. In order to better manage these costs, one first needs to understand them by gleaning insights into the defense cost data—hence, the title. Only with first having a better understanding of one's defense costs can one be expected to better manage them.

If the topic of managing defense costs is at least a generation old, why would this publication allocate four pages to it when there are so many other issues facing the medical professional liability (MPL) industry? The answer, I believe, is twofold. First, while the MPL industry has enjoyed what is arguably its greatest financial success ever over the past several years, the one cost element that has increased at a noticeably higher rate than the others is the average defense cost per claim. The second reason for including this type of article now is that the proliferation of Web-based business transactions, along with advances in data mining and warehousing techniques, has made it possible to extract more granular and valuable insights from the detailed defense cost data than ever before. Armed with this information, one will be able to better manage the entire claims process, including the cost of defense.

Many articles have been written and presentations made regarding the MPL industry's impressive financial results over the latter half of the past decade. The combination of rate increases in the early part of the 2000s, coupled with the unexpected and significant decline in claims frequency has been well documented here and in other industry publications.

Frequently, the issue of claim severity has been assigned only a minor role in these discussions. Given the overall trends in claim severity during this period, this treatment seems appropriate, especially in light of the significant claim frequency decline. However, even though the overall trends in the average cost per claim have been manageable, when one deconstructs these overall trends into its components, the average indemnity per claim versus the average defense costs per claim, two distinct patterns emerge.

Higher defense costs

Since the decline in claims frequency, we have observed a notice-

ably higher trend in the average defense costs per claim, with some datasets showing year-over-year increases in the high single digits. To demonstrate this phenomenon, Figure 1 displays the cumulative trend in the calendar-year average paid indemnity per closed with indemnity (CWI) claim versus the cumulative trend in the calendar-year average paid defense and cost containment expense per closed claim for 43 MPL specialty companies since 2003. As displayed in Figure 1, while the average indemnity per CWI claim has been stable, the average defense cost per claim has risen by 30% over this time period. Further, of the 43 companies in our composite, 15 have experienced an increase in the defense cost per claim that is in excess of 7% per annum, or 50% cumulatively over this time period. Figure 2 shows a breakdown of the annual trends by company.

A few issues with the analysis captured in these figures warrant comment. First, the data underlying our analysis was taken from each of the company's 2010 statutory annual statements, which, for some companies, may have included some minor discrepancies in the data, typically in the claim count data of Schedule P (we excluded several MPL specialty companies from our analysis because the discrepancies in the data contained in their statutory annual statements seemed too significant to yield any meaningful results). Second, the trends presented were based solely on paid data, which has the benefit of not being reliant on the claims departments' case-based reserve estimates

Figure 1 Cumulative Change in Costs per Claim

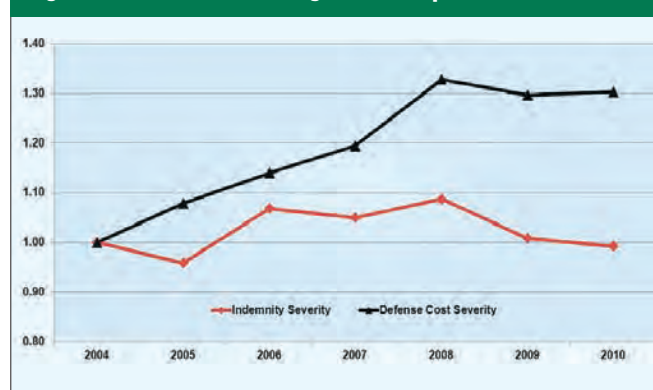
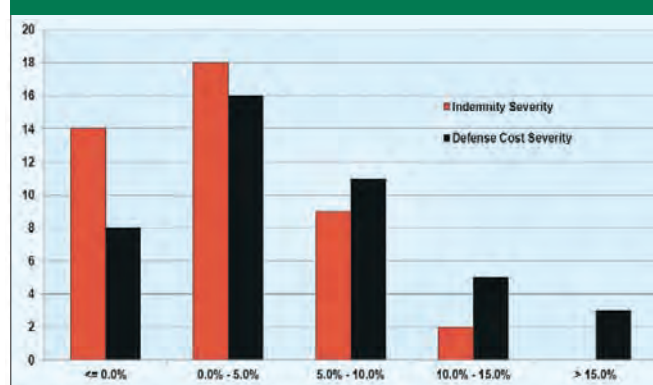


Figure 2 Per Annum Trend Rates by Company



Chad C. Karls, FCAS, MAAA, is a Principal and Consulting Actuary with Milliman.

or the actuary's case development and/or incurred but not reported estimates. However, focusing on paid data can add to the volatility of the year-by-year indications and can be a lagging indicator of current trends given the claim settlement lag in MPL. Having said that, the overall conclusion based on this data, namely, that defense costs per claim have been trending at a noticeably higher rate than their counterpart indemnity costs, is consistent with our observations from the "actuarial data" we reviewed in the course of our analyses. Further, the overall differential in these rates of approximately 450 basis points is also consistent with our more technically "clean" analyses that were done using data from the claims departments.

It isn't just the actuaries who've noted that defense costs are trending at a rate that is higher than expected. Many senior management teams have also noted this and have frequently attempted to answer the all-important question, why? Why are defense costs increasing? The discussion that ensues typically includes some reasonable and rational hypotheses: Expert witness fees are going up. The cases are medically and legally more complex. We need more experts per case. More motions are being filed. All of these suggestions seem plausible, and may in fact be contributing to the increased costs, but what is typically missing from these discussions is any comprehensive and systematic way to measure and quantify these hypotheses. The primary reason for this lack

Figure 3 Components of Defense Costs

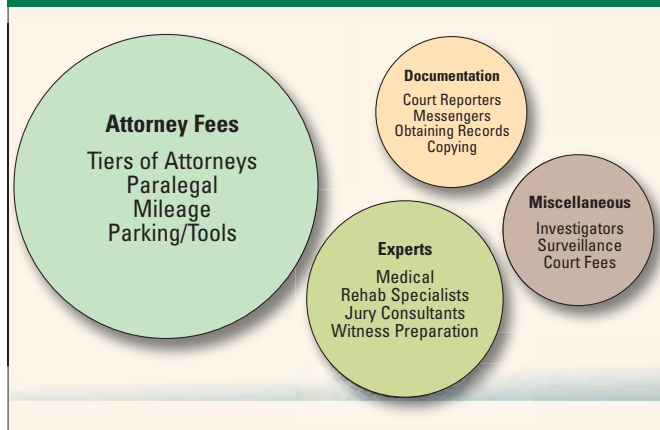
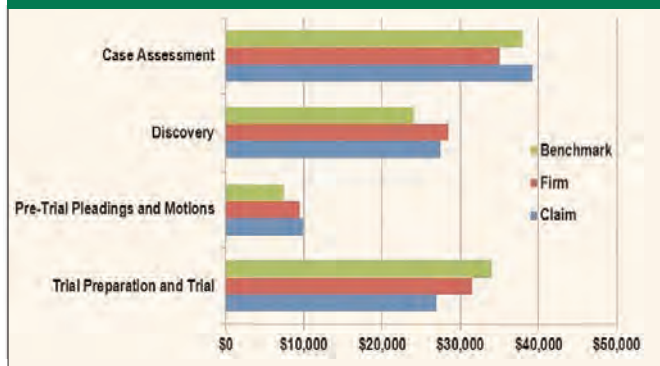


Figure 4 Defense Costs by Claim Phase



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of quantitative ability is the dearth of detailed data that exists at most companies concerning defense costs.

Extracting the details


Defense costs in an MPL setting primarily take the form of attorney fees, expert witness fees, document retrieval and copying expenses (e.g., medical records, court reporters, etc.), and miscellaneous costs (e.g., surveillance, court animation, etc.) (Figure 3). Within each of these categories, the data can be broken down into more granular components. For example, the defense attorney fees are not only a multiple of the billing rate and the number of hours spent on the case; they are also a function of the distribution of the hours by type of legal professional working on the case—paralegal, associate, or partner.

Defense costs can also be assigned to a particular phase of the claim, which might be categorized as case assessment, discovery activities, pre-trial pleadings and motions, or trial preparation and trial. Likewise, within each of these phases of the claim, various events occur; witnesses are deposed, motions are filed, for example. Keeping track of the costs and associated activities at this sort of granular level can be difficult, if not overwhelming, for a particular claim, let alone for a company's complete inventory of open claims, which can total several hundred or even thousands of claims, all at various stages of maturity.

While the task of monitoring an open claim inventory in a much more systematic and detailed manner may seem daunting, the good news is that the data to do it already exists, even if companies are not currently collecting or using this data. The bad news is that the data is not available in a neat and orderly package. The data I am referring to is the painstakingly detailed, line-by-line description of the services rendered by the defense attorney firms. Within this unstructured, text-based data lies a wealth of detailed information that can be extracted to better understand and ultimately better manage a company's claims process.

Benchmarking the costs

Once this detailed data is collected, scrubbed, normalized, and stored in a data warehouse environment, management will have the ability to quickly and easily track and benchmark its open claims inventory on a variety of levels including at the invoice level, by defense firm, by the phase of the claim, etc. For example, Figure 4 displays the hypothetical costs by claim phase for a particular claim, versus those same statistics for all of the claims handled by the particular defense firm, as well as a benchmark using all claims closed since 2007.

Being able to monitor the open claims inventory in a detailed and real-time fashion, using the wealth of information that is contained in the defense attorney invoices, can enhance a company's ability to better manage every aspect of its claims process, not just its defense costs. 

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Joseph G. LoPorto
Insurance Asset Management
212.493.7245
joseph.loporto@bbh.com
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