INSURANCE
DEPARTMENT OF BANKING AND INSURANCE
OFFICE OF SOLVENCY REGULATION

Medical Malpractice Liability Insurance
Corporate Governance

Adopted New Rules: N.J.A.C. 11:27-12

Proposed: March 3, 2008 at 40 N.J.R. 1067(a)

Adopted: February 26, 2009 by Steven M. Goldman, Commissioner, Department of Banking and Insurance

Filed: February 26, 2009 as R. 2009 d. 101, with substantive and technical changes not requiring additional public notice and comment (see N.J.A.C. 1:30-6.3).

Authority: N.J.S.A. 17:1-8.1, 17:1-15e, 17:23-20 et seq., 17:29AA-1 et seq. and 17:32-1 et seq.

Effective Date: April 6, 2009.

Expiration Date: June 6, 2010

Summary of Public Comments and Agency Responses:

The Department of Banking and Insurance (Department) timely received written comments from the following:

1. CNA Insurance Companies;
2. The American Insurance Association;
3. NJ Physicians;
4. MDAdvantage Insurance Company of New Jersey;
5. The Medical Protective Company;
6. The Property Casualty Insurers Association;
7. State Farm Fire and Casualty Company and State Farm General Insurance Company;

8. Guy Carpenter and Co., LLC; and

9. The Reinsurance Association of America

COMMENT: Several commenters objected to the proposed new rules as being inconsistent with existing law, specifically N.J.S.A. 17:27A-4d. The commenters stated that this statute requires independent boards of directors and committees of boards of directors be established, but allows that the requirement would not apply to a domestic insurer if the person controlling the insurer is an entity having a board of directors and committees thereof that substantially meet the requirements of the statute. The commenters generally stated that for companies with foreign or alien parents, the governance complications could be quite extreme. One commenter stated that because of this conflict, any domestic insurer that avails itself of the exemption set forth in N.J.S.A. 17:27A-4d(5) would be in violation of the rules. Several commenters also stated that to ensure fairness, such an exemption should not carve out any particular line of insurance, which would be the result under the rule as proposed.

RESPONSE: Upon review, except as discussed more fully below, the Department has determined that no change is required. N.J.S.A. 17:27A-4d(5) provides that the requirement for independent boards of directors and committees of boards of directors may be satisfied if the person controlling the insurer is an entity having a board of directors and committees thereof that substantially meet the requirements of the statute. The Department, however, does not believe that compliance in that manner with respect to the provision of medical malpractice liability insurance would achieve the goal of the rule as set forth in the proposal Summary and this notice of adoption. These rules apply solely to entities writing medical malpractice liability insurance.

The Insurance Holding Company Act at N.J.S.A. 17:27A-4d applies only to domestic insurers that are members of an insurance holding company system. Not all domestic or foreign insurers are members of an insurance holding company system. Such non-member insurers would not be subject to any of the requirements of the Insurance Holding Company Systems Act in New Jersey or their state of domicile, assuming such state had similar requirements. Moreover, in New Jersey healthcare providers are required to maintain minimum levels of medical malpractice liability insurance. As was noted in the proposal Summary, the impact upon residents of this State that results when the availability or affordability of medical malpractice liability insurance becomes strained can be exacerbated by the volatility in rates that has existed with respect to the provision of this line of insurance. Thus, the effects of volatility in and the cyclical nature of the rates for medical malpractice liability insurance have far reaching implications with respect to public health.

The management of an insurer carries out the goals and policies established by the board of directors and one of the board functions is to oversee management. When the board is not sufficiently independent from management, management may pursue actions primarily for their own or for stockholders' benefit which may not be in the best interest of policyholders. For example, a management bonus could be provided for premium growth, resulting in over expansion. The Department had experience with a medical malpractice liability insurer that expanded into other states without adequate familiarity with or experience in the market in those states. The expansion resulted in short-term economic benefits to management, but ultimately had adverse results for the New Jersey medical malpractice liability insurance market. Another example would be where an insurer was losing business because other insurers were reducing rates and the insurer's management could be influenced to also cut rates, which could leave the

insurer under capitalized. The implementation of policies that benefit stockholders and management in the short term but that may be detrimental to the stability of the insurer, the interests of policyholders and, ultimately, to the health of the market as a whole, can be curtailed by independent directors. Such directors, whose decisions are not motivated by personal gain but who instead will act in the long-term interest of the insurer and its policyholders, will serve as a counterbalance to those directors who have a direct financial stake in their decisions. Exempting foreign insurers would contravene the Department's intent in proposing the rules, as it would exempt from their requirements a large segment of insurers providing medical malpractice liability insurance in this State.

Further, while it was stated that the governance complications resulting from these rules could be "quite extreme," no support was provided for this assertion.

Moreover, the assertion that a domestic insurer that avails itself of the exemption set forth in N.J.S.A. 17:27A-4d(5) would be in violation of these rules actually ignores the operation of these rules. Medical malpractice liability insurers would be required to comply with these rules with respect to the provision of medical malpractice liability insurance in this State, independent of N.J.S.A. 17:27A-4d(3) through (5). While this statute permits the requirements for independent boards of directors and committees thereof to be satisfied at the holding company level, the holding company or insurer's ultimate parent could be several layers removed from the insurer providing medical malpractice liability insurance in this State. The further removed the entity with the independent boards and committees is from the insurer, the less impact the decisions of such boards and committees may have on the operations of the medical malpractice insurer. However, the Department believes that it is reasonable and consistent with the intent of N.J.S.A. 17:27A-4d to permit an exemption if the insurer is a direct subsidiary of an entity that

satisfies the requirements set forth in N.J.A.C. 11:27-12.3 and 12.4(a). This exemption requires the independency of the board of the direct corporate parent of the insurer, and that such a board will be responsible for recommending independent certified public accountants and reviewing the insurer's financial condition, including independent and internal audits as referenced in N.J.A.C. 11:27-12.5(a). By doing so the amendment realizes the intent of the rules, while providing additional flexibility for insurers to comply with the requirement. Thus this amendment addresses some of the commenters' concerns, while ensuring that the rules will have the intended effect with respect to the provision of medical malpractice liability insurance in this State. N.J.A.C. 11:27-12.4(a) has been amended upon adoption to reflect this modification.

COMMENT: Several commenters expressed concern with adopting more stringent requirements for medical malpractice insurers than are required by statute in the domiciliary states of foreign insurers. One commenter stated that the general philosophy of accreditation by the National Association of Insurance Commissioners (NAIC) is uniform financial regulation of insurers with the primary oversight provided by the insurer's domestic regulator. Adopting more stringent regulation on foreign insurers than is required in their state of domicile would be inconsistent with this philosophy. In addition, several commenters believed that these requirements will act as a disincentive to solvent foreign insurers entering the New Jersey insurance market. The commenters noted that a large segment of the medical malpractice market is written by alien non-admitted insurers and by non-traditional insurers, such as risk retention groups and captive insurers that are not subject to traditional NAIC solvency regulation. The rules as written would reduce the incentive for foreign insurers that are subject to traditional NAIC solvency regulation to enter the New Jersey insurance market. One commenter

additionally stated that this could provide support for the assertion that a patch work of 50 inconsistent regulatory standards exists in the state regulatory environment avowed by proponents of the Federal regulation of insurance.

Another commenter stated that the Department lacks the statutory authority to treat foreign and domestic medical malpractice insurance writers the same in establishing a so-called independent board of directors.

Another commenter specifically stated that a foreign insurer will be subject to two different regulators who may have conflicting requirements as to the internal corporate governance of the insurer. The commenter stated that an insurer can only have one corporate governance structure no matter how many states in which it may operate. The commenter believed that it is arbitrary and capricious to subject a foreign insurer to conflicting regulation over its internal corporate governance. The commenter stated that the only way for an insurer to resolve such a conflict would be to withdraw from New Jersey, which would reduce availability of insurance in New Jersey, contrary to the express purpose of the proposed rules. In addition, the commenter stated that New Jersey courts will not enforce the New Jersey requirement if it conflicts with the requirements of the foreign company's home state, and cited in support of this assertion: Brotherton v. Celotex Corp., 202 N.J. Super. 148 (Law Div. 1985); Barr v. Harrah's Entertainment, 2008 U.S. Dist. LEXIS 26018 (D. N.J. March 31, 2008); and Edgar v. Mite Corp., 457 U.S. 624 (1982). Accordingly, this commenter suggested that N.J.A.C. 11:27-12.1(b) be amended to delete the references to foreign insurers by deleting the reference to N.J.S.A. 17:32-1 et seq., and that the definition of "insurer" in N.J.A.C. 11:27-12.2 be amended to delete references to foreign insurers and delete the language "or admitted pursuant to N.J.S.A. 17:32-1 et seq."

RESPONSE: Upon review, the Department has determined that no change is required. As noted in the Response to the previous Comment, the rules are intended to address the operations of medical malpractice liability insurers in this State in an attempt to ameliorate the volatility and cyclical nature of rates for this kind of insurance which, unlike other types of insurance, can have direct and significant public health implications. While the Department acknowledges that, as recognized by the NAIC Accreditation Program, states usually rely on domiciliary regulators as the primary regulator of insurers, states are not precluded from regulating specific aspects of an insurance market in their state through the application of laws and rules to all insurers, both domestic and foreign.

The Department further believes that the assertion that the requirements will act as a disincentive to foreign insurers entering the New Jersey insurance market, or will increase the use of non-traditional entities, such as risk retention groups and captive insurers, is speculative and premature. As noted below, the Department will monitor the impact of the rules and propose amendments as deemed appropriate and necessary.

The Department also disagrees that it lacks the statutory authority to implement these rules. N.J.S.A. 17:32-2b provides that no insurer shall be admitted to transact business in this State until it "satisfies the Commissioner that its condition or methods of operation are not such as would render its operation hazardous to the public or its policyholders in this State." N.J.S.A. 17:32-2d also provides in part that "the commissioner may refuse to issue or renew any … certificate of authority if, in his judgment, such refusal will best protect the interests of the people of this State or if the company fails to comply substantially with any requirement or limitation of this subtitle applicable to it or any rule or regulation promulgated by the

commissioner thereunder which in the judgment of the commissioner is reasonably necessary to protect the interests of the people of this State…." As noted in the proposal Summary and herein, the Department believes that the establishment of the independent boards required of members of an insurance holding company system will help to ensure that medical malpractice liability insurers operate in a financially sound manner and to avoid or at least temper the significant impacts upon residents of this State that result from problems with the availability and affordability of medical malpractice liability insurance that can be exacerbated by excessive volatility in rates. In addition, the rules implement the intent of the Legislature as expressed in the Medical Care Access and Responsibility and Patients First Act, P.L. 2004, c. 17, to help ensure that residents continue to have adequate access to high-quality health care in this State. As noted previously, the Department believes that these rules are reasonable and appropriate to address issues related to the availability and affordability of medical malpractice liability insurance in this State that have arisen in the past and threatened adequate access to health care in this State.

The Department also disagrees that these rules are arbitrary and capricious in that they would subject a foreign insurer to conflicting regulation over its internal corporate governance. The Department recognizes that an insurer will have a single corporate governance structure. However, the Department does not agree that these rules will require that an insurer enact a corporate structure that will conflict with the laws of its state of domicile. While the insurer's state of domicile may not require corporate governance standards with respect to the provision of medical malpractice liability insurance identical to the requirements set forth in these rules, the Department doubts, and the commenter did not assert, that the insurer's state of domicile would prohibit corporate governance requirements as set forth in these rules. Accordingly, no conflict

exists. The Department also notes that the cases cited by one of the commenters do not relate to the regulation of insurance. Given the significant public health issues involved, the Department believes that insurers that wish to provide medical malpractice liability insurance in this State should be required to adhere to the requirements set forth in the rules and can do so without taking actions that are proscribed by the laws of their domiciliary state.

COMMENT: Several commenters expressed concern that the rules apply to insurers authorized or admitted to transact medical malpractice insurance, and are not limited to those insurers actually writing medical malpractice insurance. The commenters noted that the Department does not grant a separate authorization to write "medical malpractice" liability insurance, but that this authority is included within the authority to write "other liability" insurance as defined in N.J.S.A. 17:17-1. The commenters believed that essentially all licensed property/casualty insurers are authorized to write "other liability" insurance in New Jersey. Accordingly, the rules would apply to insurers that do not write medical malpractice liability insurance in New Jersey, which would have an adverse effect on the entire New Jersey property/casualty insurance market. Some commenters noted that a consequence could be a decision of some insurers to remove this line of business from their certificates of authority, resulting in less capacity for medical malpractice liability insurance in New Jersey.

One commenter also expressly stated that it is arbitrary and capricious to extend a medical malpractice regulation to almost all property/casualty insurers. The commenter thus suggested that N.J.A.C. 11:27-12.1(b) should be amended to limit it only to insurers "who write medical malpractice liability insurance." The commenter suggested a similar change to the definition of "insurer" at N.J.A.C. 11:27-12.2.

RESPONSE: As was stated in the proposal Summary, the goal of the new rules is to address issues related only to those companies writing medical malpractice liability insurance. Consequently, the Department agrees that the rules should be revised upon adoption to clarify that they apply to insurers that "write medical malpractice liability insurance." Accordingly, N.J.A.C. 11:27-12.1(b) and 12.2 (definition of "insurer") are being changed upon adoption to better reflect the Department's intent.

COMMENT: One commenter noted that the proposal Summary indicates that the requirements in the proposed rules reflect "those requirements set forth in the recently enacted amendments to the Annual Financial Reporting Model Rule adopted by the [NAIC]." The commenter stated, however, that New Jersey has not yet completed its work in adopting the most recent NAIC version of the model rule. In addition, the commenter stated that the NAIC model does not break out or distinguish any particular line of authority, such as medical malpractice liability insurance, but rather focuses on a domestic insurer.

RESPONSE: Upon review, the Department has determined that no change is required. The Department believes that the requirements are reasonable and appropriate given their objective of ameliorating the public health ramifications that result from disruptions in the availability of health care for the citizens of this State caused by excessive volatility in medical malpractice liability insurance rates, as set forth more fully in responses to previous comments above. For the same reasons, while the Department has not yet adopted the most recent NAIC model, which applies to all lines of a domestic insurer, the Department believes that the requirements set forth

in these new rules applicable to companies writing medical malpractice insurance are reasonable and appropriate.

COMMENT: One commenter expressed concern that an independent board requirement could result in unnecessary expense that could result in increased premiums. Accordingly, the commenter requested that the Department better define the duties, responsibilities and functions of the oversight board.

RESPONSE: The Department disagrees. The Department believes that the duties of the board are sufficiently specific as set forth in the rules. These requirements reflect the language set forth in N.J.S.A. 17:27A-4d, which is based on NAIC model language, or the Model Annual Audited Financial Reporting Rule, which thereby reflects the national standard. Further, the Department does not believe that the requirement of an independent board and committee should add additional expense. According to "best practices," every board should have an independent audit committee. To the extent that the audit committee is made up of non-independent members, this rule, which requires that such a committee be composed of independent members, does not require that the overall size of the board be increased. Moreover, as noted above, the requirements of the independent committee are listed in the rules, which are based on the holding company statute and Model rule. The Department believes that the specific duties and actions of the board and committee should be left to the company, consistent with the duties set forth in the rule, to provide an appropriate level of flexibility in an insurer's operations.

COMMENT: One commenter stated that while the requirements set forth in the proposed new rules are similar to the NAIC annual financial reporting model rule, the model audit rule contains an exemption from the requirements for the audit committee. Foreign or alien insurers that are a Sarbanes-Oxley (SOX) compliant entity, or direct or indirect wholly-owned subsidiary of a SOX compliant entity, are exempt from many requirements, including the audit committee requirement under Section 14 of the model audit rule. The commenter stated that while the new rules have been proposed to "ensure that appropriate business decisions are made" and that an insurer will "operate in a financially sound manner," a SOX compliant entity, or a direct or indirect wholly-owned subsidiary of a SOX compliant entity, is already under rules and regulations to ensure the appropriateness of the entity's actions. The commenter suggested that there be an exception to the rules for any company that meets certain standards, for example, a certain rating criteria or surplus size, or if it meets the corporate governance requirements of its domestic regulator.

RESPONSE: Upon review, the Department has determined that no change is necessary. As was noted more fully above, the Department believes that these requirements are reasonable and appropriate to help address excessive volatility in rates, exacerbating affordability and availability problems in medical malpractice liability insurance, which can have significant public health implications. The exemptions cited by the commenter relate solely to financial condition. While it is true that financial condition is one of the issues to be addressed, the primary issue relates more to business practice. If insurers are SOX compliant, the insurer should be in a position to comply with these rules more readily. Similarly, merely maintaining a certain rating or surplus size would not achieve the goal of the rule. These ratings or surplus

amounts could vary throughout the year. In addition, the corporate governance requirements of the insurer's domestic regulator may not include the requirements in these rules, and thus the exception suggested by the commenter would not assure the achievement of the goals for which the rules were proposed.

COMMENT: Several commenters questioned whether the proposal would achieve its stated goal of ensuring that appropriate business decisions are made and that an insurer will operate in a financially sound manner. The commenters specifically stated that the implication in the proposal that insurers without independent boards and committees make inappropriate business decisions and do not operate in a safe manner is arguable. One commenter requested that the Department clarify its views concerning the impact this proposal will have on the market place. Another commenter stated that the proposal suggests that the ability to obtain medical malpractice liability insurance in New Jersey has been hampered by insurers who became insolvent due to poor board management. However, the commenter stated that the text of the rules themselves do not address an insurer's medical malpractice liability insurance business. The independent board committee would be responsible for recommending the selection of independent accountants and reviewing the insurer's financial condition, audit, scope, results and internal audits, and generally oversee the work of the insurer's accountants. It is unclear how such actions by an independent committee would make medical malpractice liability insurance more readily available.

RESPONSE: As set forth in the Response to the previous Comment, the rules are not intended solely to ensure the financial stability of insurers and to avoid insurer insolvencies. Rather, they

are intended to promote the stability of the medical malpractice liability insurance market over the longer term, and help to address issues regarding the availability of medical malpractice liability insurance in this State as noted more fully above. The commenter states it is unclear how these actions would make medical malpractice liability insurance more readily available. The Department believes that ameliorating volatility in rates will avoid periods where market fluctuations are so extreme as to contribute to the deterioration of an insurer's financial condition or its withdrawal from the New Jersey market. The Department's approach in this regard is reasonable and appropriate based on corporate governance issues that the Department has encountered through its examination and analysis of insurers in the past. The Department intends to evaluate the impact of the rule after it has been in place for some time.

COMMENT: One commenter stated that the solvency issues that have arisen for insurers writing malpractice insurance have almost always involved insurers writing malpractice for physicians and surgeons. Insurers that write other health care professions, but not physicians and surgeons, have avoided these solvency problems. The commenter stated that the express purpose of the rules is to set up better internal financial controls for medical malpractice insurers to avoid the solvency issues that have arisen with some of these writers. The commenter believed that it would be arbitrary and capricious to extend the rules to malpractice insurers that do not write policies that have caused the problem. Accordingly, the commenter believed that other malpractice insurers should be exempted from the rules and suggested that N.J.A.C. 11:27-12.1(b) be amended to provide that the rules apply to insurers "who write medical malpractice liability insurance covering physician and surgeons." The commenter also suggested that the definition of "insurer" in N.J.A.C. 11:27-12.2 be amended to refer to an insurer "who writes

medical malpractice liability insurance covering persons licensed under Article 1 of Chapter 9 of Title 45 of the New Jersey Statutes."

RESPONSE: Upon review, the Department has determined that no change is required for the reasons set forth substantially above. Moreover, while the Department agrees that the primary concerns relate to medical malpractice liability insurance covering physicians and surgeons, the Department believes that at this time the provision of medical malpractice liability insurance in general should be addressed. Companies that primarily or exclusively insure "smaller" malpractice risks, such as dentists, chiropractors, or podiatrists, tend to have a lower potential for experiencing financial difficulty because claims for those risks tend to be smaller and more predictable on average. However, at the other extreme, insurers of hospitals and/or large HMO's frequently have huge swings in premiums as markets harden and soften. Moreover, these swings generally do not occur in the "manual rate" component of the premium that is filed with the Department. The premium swings arise in the individual risk modifiers, found in the use of experience rating plans, schedule rating plans, size of risk discounts, etc., which are not, as a rule, reported to the Department. The result is that the Department has little or no advance warning of potential solvency issues in this area. The Department will monitor the impact of the rules and consider possible future amendments to exempt companies whose business is limited to providing medical malpractice liability insurance only to certain classes of insureds should the Department conclude that the cyclical volatility in the rates charged by such companies is not problematical.

Federal Standards Statement

A Federal standards analysis is not required because the adopted new rules are not subject to any Federal requirements or standards.

Full text of the adoption follows (additions to proposal indicated in boldface with asterisks ***thus***; deletions from proposal indicated in brackets with asterisks *[thus]*):

11:27-12.1 Purpose and scope

(a) The purpose of this subchapter is to set forth minimum requirements for the independence of the board of directors and the committees of the board of directors of an insurer *[transacting]* ***that is writing*** medical malpractice liability insurance in this State.

(b) This subchapter shall apply to all insurers *[authorized or admitted to transact] ***that are writing*** medical malpractice liability insurance in this State pursuant to N.J.S.A. 17:17-1 et seq. and 17:32-1 et seq., as applicable.

11:27-12.2 Definitions

The following words and terms, as used in this subchapter, shall have the following meaning, unless the context clearly indicates otherwise.

. . .

"Insurer" means an entity authorized pursuant to N.J.S.A. 17:17-1 et seq. or admitted pursuant to N.J.S.A. 17:32-1 et seq. *[to transact]* ***that is writing*** medical malpractice liability insurance in this State.

. . .

11:27-12.4 Independent board member committees

(a) The board of directors of an insurer shall establish one or more independent board member committees. Such committees shall be comprised of at least two members and shall be comprised solely of directors who are not officers or employees of the insurer or of any entity controlling, controlled by, or under common control with, the insurer and who are not beneficial owners of a controlling interest in the voting securities of the insurer or any such entity. Such

committees shall meet not less than quarterly. Such committees shall be responsible for recommending the selection of independent certified public accountants and reviewing the insurer's financial condition, the scope and results of any independent audit or review, and any internal audit.

1. The requirements imposed by (a) above and by N.J.A.C. 11:27-12.3 shall not apply to an insurer that is a direct subsidiary of an entity that satisfies the requirements set forth therein.

(b) - (c) (No change from proposal.)

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