



TEXAS MEDICAL LIABILITY TRUST  
ANNUAL REPORT

2002



FACING the  
*future*

# FACING *the* future

## CONTENTS

Message from the Chairman	1
Message from the President	2-3
TMLT Board of Governors	4
At-a-glance TMLT 2002	5
Message from the CFO	6-7
Independent auditors' report	8
Consolidated financial statements	9-24



**THIS** year has been an enlightening one for me, both as chairman of TMLT Governing Board and as chairman of Texas Alliance for Patient Access (TAPA). These organizations have had important objectives to accomplish, and I have been honored to work with both of them on issues of great consequence to Texas doctors and their patients.

At TMLT the dominant effort in 2002, outside normal Trust operations, has been the work we have done to promote medical lawsuit abuse tort reform during the 2003 Texas Legislative Session. In January of 2002, TMLT, along with the Texas Hospital Association and the Texas Medical Association, launched TAPA. Modeled after CAPP, a similar consortium in California that saw the 1975 MICRA tort reform measures passed and has had a solid record of success in maintaining them since then, TAPA contends that similar measures will work well to solve the medical liability crisis in Texas.

TAPA's mission is to improve patients' access to health care by this kind of sustainable tort reform. To date, TAPA has well over 200 institutional members which include a broad spectrum of stakeholders in the health care delivery system – physician groups, professional associations, hospital systems, professional liability carriers, nursing home organizations, and health care insurers. Working together, all members of the TAPA consortium have contributed to a year of success which has well exceeded our expectations.

TAPA's work over the course of the year has included specific tasks. Once the organizational structure was established, TAPA's first task was to develop the legislative proposals needed to address medical lawsuit abuse and to curb the runaway indemnity payments that exploded in the late 1990s and which have resulted in skyrocketing premiums for all of us. After nearly a year of study and many hours of meetings and negotiations, the TAPA Legislative Committee compiled more than a dozen of these tort reform proposals. We appreciate the enormous effort that this endeavor entailed and thank the experienced defense and appellate attorneys, claims executives, hospital administrators, and other experts in Texas who served on the Legislative Committee. Both the Texas Medical Association and the Texas Hospital Association played key roles all along the way.

Our second task, and an on-going one, has been to raise the money required for a robust political effort. In that regard, TAPA members have been unfailingly supportive. Third, TAPA has retained experienced political advisors who helped us prepare for the Texas Legislative Session and who continue to advise and guide us as we discuss our proposals with legislators and other government officials.

Our fourth task, another successful one, has been to keep the consortium intact. Only through a united effort can we ultimately pass the effective and sustainable tort reforms that we seek.

The TMLT Board of Governors and executive staff have been extremely supportive of the TAPA tort reform effort. At TMLT we believe that the physicians of Texas are best served by a professional liability system in which potential claims are predictable and reasonable. Unlimited jury verdicts and settlements ultimately mean unlimited premiums for physicians. Unlimited premiums tear away at the fabric of the health care system. Thus, it is our hope that the Texas tort reforms of 2003 will stem the tide and result in a professional liability system that is fair to both physicians and injured patients.

I am proud of the leadership that TMLT has demonstrated in the Texas tort reform effort. Over the past four years, 14 professional liability carriers have left Texas because the medical liability climate was in such turmoil. However, TMLT, founded by and for Texas physicians, has stood firm and fought back, working hard to better that climate for all of us.

One of the anticipated benefits of tort reform is that it will create incentives for quality professional liability carriers to return to Texas and therefore foster a healthy, competitive insurance environment. We welcome that competition and know that TMLT will always strive to bring our insured physicians the best value in professional liability insurance and long-term security for our families.

**HOWARD R. MARCUS, MD**  
Chairman of the Board of Governors

*Through a united effort*



Through the minefield

### LEADERSHIP in TIME of CRISIS

The past year at TMLT proved to be the most challenging since I joined the Trust staff over 18 years ago. Operating a medical professional liability organization successfully in an incredibly turbulent environment required the cumulative expertise and fortitude of the TMLT staff, special consultants, and our physician board as we guided the Trust through a minefield of complicated issues. “Medical lawsuit abuse reform” was our daily watch phrase as we worked on legislative and operational issues, regained our financial footing, and positioned the Trust to battle on many fronts in 2003. I cannot recall a time when the governing board and the executive staff were more cognizant of the impact their decisions would have on access to health care and access to affordable malpractice coverage in Texas.

When the 2003 legislative session begins, the debate over the issues facing Texas physicians, medical malpractice insurance carriers, and trial attorneys will be fierce. The medical community must stand firmly united if we are to be successful. As rising rates continue to plague physicians, we are cautiously optimistic that we can achieve effective solutions to the problems we’ve experienced in Texas since 1995.

### TMLT OPERATIONS

Based on the most recent actuarial data, we increased premium rates only once in 2002. After increasing rates in both January and July the two previous years, we believed that premiums were adequate. Surplus deposits – those funds held in reserve to provide a financial cushion during volatile periods of claims frequency and severity – had fallen to levels we were not comfortable with. In an effort to bolster these financial reserves, the governing board approved a call for surplus from both renewing policyholders and new applicants.

This decision was understandably met with mixed reviews by policyholders already squeezed by declining reimbursements. Unlike premium, surplus may be refunded to policyholders in the future at the discretion of the TMLT governing board when the financial condition of the Trust warrants. I would like to remind you that, in the past during periods of claims stability, the Trust has maintained surplus levels that allowed us to return portions of the surplus to policyholders. As a not-for-profit organization, it is our intent to return surplus when we can. I would also like to emphasize that the surplus call was not a “premium assessment” but rather a call for a cash infusion into the surplus fund account. With this experience behind us, it is not our intent to make such a request again; however, in business as in medicine, there are no guarantees. The surplus call was successful and we ended the year with surplus of \$67.7 million, up from \$22.9 million in 2001.

Even with higher premiums and an increased surplus deposit requirement, our underwriting department was overwhelmed with a flood of applications from physicians seeking medical malpractice coverage. This influx was primarily the result of the swift exodus of malpractice carriers from Texas due to the unpredictable claims environment. Consequently, physicians had a narrow field of medical liability carriers available. TMLT continued to underwrite new business in all specialties and in all areas of the state, so with apologies to applicants, we extended our application processing time in order to properly underwrite potential new business. By mid-year, we had written \$7.7 million in new premium and the applications kept rolling in. We retained 87% of our existing policyholders at renewal.

Our operating expenses in 2002 were below the industry average at 9%. Although working with tightened budgets, I am gratified to report that services to our policyholders were not restricted or reduced in any way in 2002.

Achieving effective solutions

TMLT took in 2,309 claims in 2002. We won 69 out of 76 cases in the courtroom or 90% of claims taken to trial. We closed 86.89% of claims with no indemnity payment to the plaintiff. TMLT's claim philosophy has always been to defend doctors rather than just settle claims. We have maintained that philosophy throughout the medical liability crisis, when the frequency and severity of claims filed were escalating to record levels. We have a 24-year reputation as vigorous defenders in the courtroom. Highly experienced claim supervisors and defense attorneys come together to provide you with claim service unmatched in Texas. Our average cost to defend a medical malpractice claim in 2002 was \$22,425 compared to \$20,386 in 2001. The cost of claim defense is not going down, but we believe having "the best defense" is one of the reasons physicians seek coverage with TMLT.

TMLT's 2002 risk management education programs were a popular value with policyholders. Participation increased by 26% over 2001. Approximately 1,113 physicians received practice reviews in 2002. We added 2 convenient, online CME courses, bringing our total online course offerings to 6. Additionally, phone consultations with our risk management staff increased by 26%. Physicians called in with questions concerning HIPAA compliance, incident reporting, and general risk management issues.

#### **MEDICAL LAWSUIT ABUSE REFORM for TEXAS**

In his message to policyholders, Howard Marcus, 2002 chairman of the board of governors at TMLT, addresses at length our participation with the Texas Alliance for Patient Access. I won't restate what has already been said, but I will say that TMLT was in the fray and not on the sidelines. We dedicated many work hours of our staff to this process by preparing information for consultants and legislators, testifying at committee hearings,

and meeting with the media. It was not easy. It required patience, persistence, and a big picture mentality to see it through. The experience has been sobering, but it will serve TMLT well in the future as we begin a new medical liability chapter in Texas.

#### **TMLT'S FUTURE**

At the close of 2002, we face many challenges and uncertainties as we prepare for the 2003 legislative session. One thing you can be sure of is TMLT's dedication to physician advocacy, our support of organized medicine, and our commitment to continue to provide Texas physicians with excellent medical liability products and services. We also pledge to continue to work closely with the Department of Insurance, sharing data, and keeping them informed of emerging trends in the medical liability arena.

In 2004, we will celebrate TMLT's 25th year of writing medical liability coverage for Texas physicians. It is our hope that proposals made and passed in the 2003 legislative session will provide some financial relief for our 10,489 policyholders and for the medical liability insurance industry, restoring healthy competition and choice to Texas.



**W. THOMAS COTTEN**  
President and CEO

## 2002 GOVERNING BOARD

### Officers

Howard R. Marcus, MD, Chairman  
Internal Medicine, Austin, Texas

Dennis J. Factor, MD, Vice Chairman  
Obstetrics/Gynecology, Dallas, Texas

Dave W. Kittrell, MD, Secretary-Treasurer  
Obstetrics/Gynecology, San Antonio, Texas

### Physician Members

Alan C. Baum, MD  
Ophthalmology, Houston, Texas

Nancy Byrd, MD  
Pediatrics, Houston, Texas

Daniel A. Chester, MD  
Obstetrics/Gynecology, McAllen, Texas

Richard C. Geis, MD  
Thoracic/Cardiovascular Surgery, Houston, Texas

Robert I. Parks, MD  
Anesthesiology, Dallas, Texas

Martin F. Scheid, MD  
General Surgery, Houston, Texas

### TMLT 2002 EXECUTIVE STAFF

W. Thomas Cotten, President and CEO  
Bob R. Fields, Executive Vice President, Claim Operations  
Ray Demel, Vice President, CFO  
Don Chow, Vice President, Marketing  
Jim Hilscher, Vice President, Underwriting  
James Goreham, Vice President, Business Development  
Jane Mueller, Vice President, Risk Management  
Gail Nichols, Vice President, Human Resources  
Treg Russell, Vice President, MIS  
Jill McClain, Vice President, Claim Operations

## EXECUTIVE COMMITTEE

Howard R. Marcus, MD, Chairman  
Dennis J. Factor, MD, Vice Chairman  
Dave W. Kittrell, MD, Secretary-Treasurer

## UNDERWRITING REVIEW COMMITTEE

Nancy Byrd, MD, Chairman  
Howard R. Marcus, MD  
Richard C. Geis, MD  
Dave W. Kittrell, MD  
Martin F. Scheid, MD  
Daniel A. Chester, MD

## RISK MANAGEMENT COMMITTEE

Dennis A. Factor, MD, Chairman  
Robert I. Parks, MD

## CLAIMS REVIEW COMMITTEE

Daniel A. Chester, MD, Chairman  
Alan C. Baum, MD, Ophthalmology  
Nancy Byrd, MD, Pediatrics  
Dennis J. Factor, MD, Obstetrics/Gynecology  
Richard C. Geis, MD, Thoracic/Cardiovascular Surgery  
Dave W. Kittrell, MD, Obstetrics/Gynecology  
Howard R. Marcus, MD, Internal Medicine  
Robert I. Parks, MD, Anesthesiology  
Martin F. Scheid, MD, General Surgery  
Byron Brown, MD, Plastic Surgery  
Presley H. Chalmers, MD, Anesthesiology  
Clyde Danks, MD, Radiology  
Peter Dawson, MD, Ophthalmology  
Fred DeFrancesco, MD, Orthopedics  
Arthur Evans, MD, Neurosurgery  
David G. Joseph, MD, Family Practice  
M. Dwain McDonald, MD, Family Practice  
Stuart McDonald, MD, Internal Medicine  
Richard Morton, MD, ENT  
Jimmy Strong, MD, Pediatrics  
Randolph Zuber, MD, Urology

**CLAIM OPERATIONS**

Number of claims received:	2,309
Number of claims closed:	2,407
Claim frequency (including mass litigation):	22.82%
Percent of claims paid without indemnity:	86.89%
Average paid claim:	\$188,217
Number of cases taken to trial:	76
<b>Number of trial victories:</b>	<b>69</b>

**RISK MANAGEMENT**

Number of physicians receiving practice reviews:	1,113
Problem most frequently encountered during practice reviews:	medical records
Number of physicians attending TMA/TMLT CME programs:	1,384
Number of physicians completing TMLT online CME courses:	659
<b>Total number of physicians attending TMLT CME programs:</b>	<b>5,958</b>
Number of telephone consultations:	3,786

**UNDERWRITING**

<b>Total policyholder count:</b>	<b>10,489</b>
Percentage of policies cancelled due to underwriting action:	1.2%
Retention rate:	87%
Percentage of new policies issued within 10 working days:	99.3%
Percentage of existing policies processed within 30 days of renewal:	97.8%

**SALES**

<b>Number of new policies:</b>	<b>1,775</b>
Total new written premium:	\$17,151,610
Total quotes made:	4,047
Number of personal visits by sales staff:	187
Number of medical conferences attended:	21
Total number of direct mail mail campaigns:	87

TRIAL VICTORIES

CME ATTENDEES

POLICYHOLDERS

NEW POLICIES

69  
5,958  
10,489  
1,775

*Remain financially strong*

**THE** following financial statements detail TMLT's financial position for 2002.

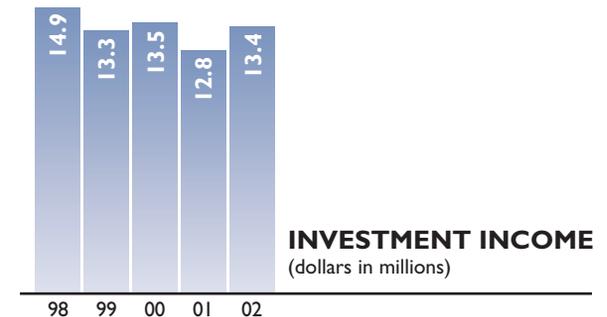
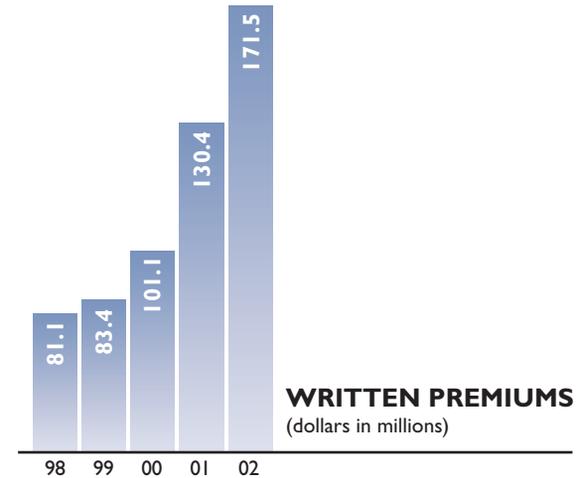
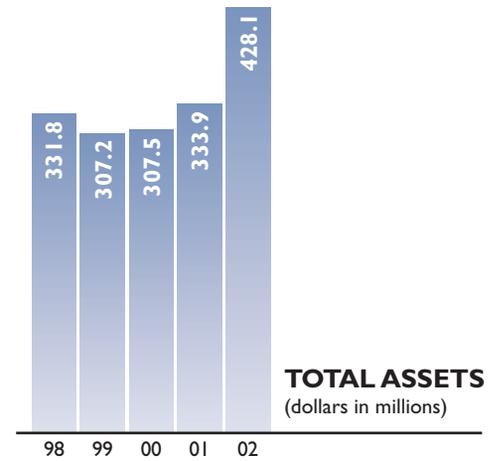
TMLT's consolidated financial statements have been prepared in accordance with accounting principles generally accepted in the United States. Preparation of these statements requires that estimates and judgments be made that affect the recorded amounts of assets, liabilities, revenues and expenses. Actual results may differ from these estimates under different assumptions or conditions.

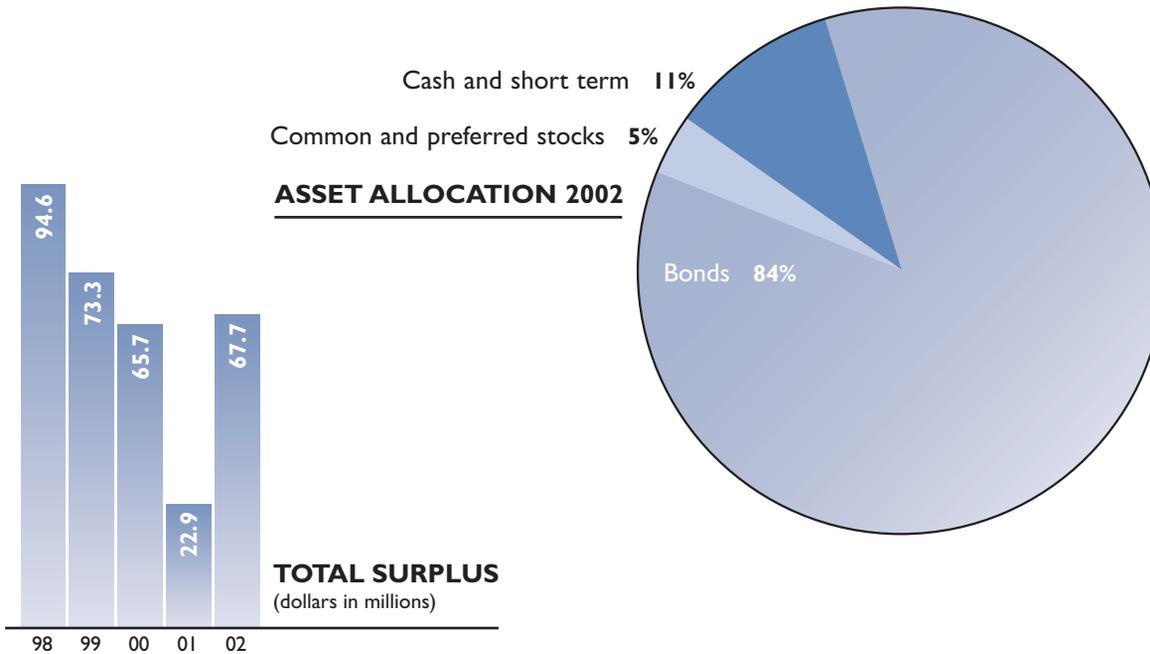
TMLT's re-underwriting and premium pricing efforts resulted in consolidated written premiums of \$171.5 million in 2002 compared to \$130.4 million in 2001 and \$101.1 million in 2000. Earned premiums in 2002 improved to \$130.7 million compared to \$98.9 million in 2001.

Claims expense was \$117 million in 2002 compared to \$137 million in 2001. Claims expense in 2001 included a reserve strengthening charge of \$40 million while no such charge occurred in 2002.

Net investment income in 2002 was \$13.4 million compared to \$12.8 million in 2001. Although interest rates declined in 2002, the effect of this decline was offset by additional interest generated from a larger base of invested assets of \$75 million. This increase in investable assets is the result of additional cash flow available to TMLT from increased premium and surplus contributions from our policyholders.

TMLT incurred \$300,000 in capital losses in 2002 compared to losses of \$2.2 million in 2001. The 2001 losses were attributed primarily to realized losses on equity investments while no equity losses were realized in 2002.





Operating expenses were \$17.4 million in 2002 compared to \$16.4 in 2001. Earnings before tax in 2002 were \$11.3 million compared to a loss of \$42.3 million in 2001. As a result of the loss incurred in 2001, TMLT was able to recover federal income taxes of \$6.5 million in 2002.

Total assets at year-end 2002 were \$428.1 million compared to \$333.9 million at year-end 2001 or an increase of \$94.2 million. Liabilities increased \$49 million due to an increase of \$31 million in reserves for unpaid claims and unearned premiums and an increase of \$13 million in reinsurance premiums payable. Surplus increased \$44.8 million to \$67.7

million primarily due to current net earnings of \$17.9 million and surplus contributions of \$26.5 million from policyholders.

While we are currently operating in challenging market conditions, TMLT remains financially strong. We are determined to protect our balance sheet and provide long-term stability for our policyholders.

**RAY DEMEL**  
Vice President, CFO



Board of Directors  
Texas Medical Liability Trust and Subsidiary  
Austin, Texas

We have audited the accompanying consolidated balance sheets of Texas Medical Liability Trust and Subsidiary as of December 31, 2002 and 2001, and the related consolidated statements of operations, changes in policyholders' surplus and cash flows for the years then ended. These financial statements are the responsibility of the Trust's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall combined financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the financial statements referred to above present fairly, in all material respects, the consolidated financial position of Texas Medical Liability Trust and Subsidiary at December 31, 2002 and 2001, and the consolidated results of their operations and their cash flows for the years then ended, in conformity with accounting principles generally accepted in the United States of America.

*Calhoun & Co., LLP*

April 11, 2003

## CONSOLIDATED FINANCIAL STATEMENTS

Balance sheets	9-10
Statements of operations	11
Statements of changes in policyholders' surplus	12
Statements of cash flows	13
Summary of significant accounting policies	14-17
Notes to consolidated financial statements	18-24

## CONSOLIDATED BALANCE SHEETS

December 31,	2002	2001
		(in thousands)
<b>ASSETS</b>		
Securities, available-for-sale, at fair value:		
Fixed-maturity securities	\$ 226,390	\$ 181,580
Common stocks	11,648	19,414
Preferred stocks	2,500	—
Securities, held to maturity – fixed maturity annuities	16,500	—
Cash and cash equivalents	30,814	11,961
Premiums receivable	55,836	43,436
Accrued interest receivable	3,049	2,305
Surplus contributions receivable	7,500	—
Reinsurance recoverables:		
On paid losses	3,627	4,890
On unpaid losses and loss adjustment expenses	41,781	40,742
Prepaid reinsurance premiums	11,638	8,726
Deferred tax asset	10,853	10,619
Cash surrender value of key man life insurance	2,588	2,588
Other	3,357	7,644
	<b>\$ 428,081</b>	<b>\$ 333,905</b>

## CONSOLIDATED BALANCE SHEETS

December 31,	2002	2001
		(in thousands)
<b>LIABILITIES and POLICYHOLDERS' SURPLUS</b>		
<b>Liabilities</b>		
Reserves:		
Unpaid losses and loss adjustment expenses	\$ 230,360	\$ 217,675
Unearned premiums	81,123	62,837
	311,483	280,512
Revolving line-of-credit	13,518	10,500
Premiums received in advance	5,294	3,953
Accounts payable and accrued expenses	6,166	5,034
Reinsurance premiums payable	23,910	11,000
<b>Total liabilities</b>	<b>360,371</b>	<b>310,999</b>
<b>Commitments and contingencies (Notes 3, 4, 6 and 9)</b>		
<b>Policyholders' surplus</b>		
Contributed surplus	46,618	11,221
Surplus contributions receivable	(9,516)	(488)
	37,102	10,733
Accumulated other comprehensive loss	(530)	(985)
Unassigned surplus	31,138	13,158
<b>Total policyholders' surplus</b>	<b>67,710</b>	<b>22,906</b>
	<b>\$ 428,081</b>	<b>\$ 333,905</b>

See accompanying summary of significant accounting policies and notes to consolidated financial statements.

## CONSOLIDATED STATEMENTS of OPERATIONS

Years Ended December 31,	2002	2001
		(in thousands)
Premiums earned, net of reinsurance	\$ 130,749	\$ 98,876
Investment income, net of investment expenses of \$211 in 2002 and \$299 in 2001	13,370	12,762
Net realized losses on securities available	(360)	(2,292)
Other revenue	2,292	1,980
<b>Total revenues</b>	<b>146,051</b>	<b>111,326</b>
Losses and expenses:		
Losses and loss adjustment expenses	117,343	137,235
Other underwriting expenses	17,378	16,406
<b>Total operating expenses</b>	<b>134,721</b>	<b>153,641</b>
Income (loss) before income taxes	11,330	(42,315)
Income tax benefit	(6,650)	—
<b>Net income (loss)</b>	<b>\$ 17,980</b>	<b>\$ (42,315)</b>

See accompanying summary of significant accounting policies and notes to consolidated financial statements.

## CONSOLIDATED STATEMENTS of CHANGES in POLICYHOLDERS' SURPLUS

	Contributed Surplus	Unassigned Surplus	Accumulated Other- Comprehensive Income (Loss)	Total Policyholders' Surplus	Comprehensive Income
(in thousands)					
Balance, January 1, 2001	\$ 10,539	\$ 55,473	\$ (353)	\$ 65,659	
Other comprehensive income (loss)	–	–	(632)	(632)	\$ (632)
Net loss	–	(42,315)	–	(42,315)	(42,315)
Contributed surplus, net	194	–	–	194	–
Balance, December 31, 2001	10,733	13,158	(985)	22,906	\$ (42,947)
Other comprehensive income	–	–	455	455	\$ 455
Net income	–	17,980	–	17,980	17,980
Contributed surplus, net	26,369	–	–	26,369	–
Balance, December 31, 2002	\$ 37,102	\$ 31,138	\$ (530)	\$ 67,710	\$ 18,435

See accompanying summary of significant accounting policies and notes to consolidated financial statements.

## CONSOLIDATED STATEMENTS of CASH FLOWS

Years Ended December 31,	2002	2001
		(in thousands)
<b>Operating activities:</b>		
Net income (loss)	\$ 17,980	\$ (42,315)
Adjustments to reconcile net income (loss) to net cash provided by (used in) operating activities:		
Depreciation	338	487
Net accretion on securities	(288)	(198)
Deferred income taxes	(234)	(325)
Net realized losses	360	2,292
Changes in operating assets and liabilities:		
Premiums receivable	(12,400)	(10,935)
Reinsurance recoverables	224	(16,566)
Reserves	30,971	47,165
Reinsurance premium balances	9,998	(3,921)
Other	5,829	11,509
<b>Net cash provided by (used in) operating activities</b>	<b>52,778</b>	<b>(12,807)</b>
<b>Investing activities:</b>		
Purchases of securities	(120,076)	(50,139)
Proceeds from disposals and maturities of securities	64,415	52,019
Purchases of furniture and equipment	(151)	(278)
<b>Net cash (used in) provided by investing activities</b>	<b>(55,812)</b>	<b>1,602</b>
<b>Financing activities:</b>		
Net borrowing under line-of-credit	3,018	10,500
Net surplus contributions	18,869	194
<b>Net cash provided by financing activities</b>	<b>21,887</b>	<b>10,694</b>
<b>Net change in cash and cash equivalents</b>	<b>18,853</b>	<b>(511)</b>
Cash and cash equivalents at beginning of year	11,961	12,472
<b>Cash and cash equivalents at end of year</b>	<b>\$ 30,814</b>	<b>\$ 11,961</b>

See accompanying summary of significant accounting policies and notes to consolidated financial statements.

## ORGANIZATION

Texas Medical Liability Trust (TMLT) was formed in June 1978 to provide professional liability and office premises liability insurance coverage to eligible physicians who are members of the Texas Medical Association and who practice primarily in Texas. TMLT was organized under Article 21.49-4 of the Texas Insurance Code under the name “Texas Medical Association Health Care Liability Claim Trust” and began operations in 1979.

TMLT provides professional liability coverage to the ancillary staff of TMLT’s policyholders through its wholly-owned subsidiary, Texas Medical Insurance Company (TMIC), which was formed in 1995 as a state-regulated property/casualty insurance company.

## BASIS of PRESENTATION

The consolidated financial statements include the accounts of TMLT and TMIC (collectively, the “Trust”) after elimination of all significant intercompany accounts.

## USE of ESTIMATES

The preparation of financial statements requires management to make estimates and assumptions that affect amounts reported in the financial statements and accompanying notes. Such estimates and assumptions could change in the future as more information becomes known which could impact the amounts reported and disclosed herein.

## PREMIUMS

Policies written are generally for a one-year term and premiums are recorded as earned on a pro rata basis over the life of the policy. Policies are written on both an occurrence and claims-made basis. Unearned premiums represent the portion of premiums written which are applicable to the unexpired terms of the policies in force.

Billings for calendar year premiums are rendered in advance of the premium year. Also, surplus deposits are received from physicians applying for coverage in advance of approval of their application. Premiums and deposits collected in advance of the period covered are classified as premiums received in advance.

## UNPAID LOSSES and LOSS ADJUSTMENT EXPENSES

Unpaid losses and loss adjustment expenses represent the estimated liability for claims reported through year end (case-basis) plus the estimated losses and loss adjustment expenses relating to incidents incurred but not yet reported. These amounts have been estimated by management and the Trust's consulting actuaries based on available industry data and the Trust's actual experience and represent estimates of the ultimate cost of all losses incurred, but unpaid, through year end. However, the ultimate cost of settling claims may vary significantly from the estimated liability. The estimates are continually reviewed and adjusted as necessary; such adjustments are included in current operations and are accounted for as changes in estimates.

Unpaid losses and loss adjustment expenses have been discounted using a 4% factor as of December 31, 2002 and 2001. This discount reduces gross unpaid losses and loss adjustment expenses to their present value. The discount amount was approximately \$15,800 and \$14,000 at December 31, 2002 and 2001, respectively.

The Trust considers anticipated investment income in determining whether a premium deficiency exists on the unexpired terms of the policies in force. No such deficiency exists as of December 31, 2002.

## REINSURANCE

Amounts recoverable from reinsurers for unpaid losses and loss adjustment expenses and the amounts payable to reinsurers for reinsurance premiums are estimated in a manner consistent with the related liabilities associated with the reinsured policies. Consistent with the estimate of the unpaid loss and loss adjustment expenses, the reinsurance balances are discounted at a rate of 4%. The effect of this discounting decreased a portion of ceded premiums by approximately \$(27) and \$24 at December 31, 2002 and 2001, respectively. Adjustments to the provisional reinsurance premiums are provided for in the ceded premiums.

Amounts paid to reinsurers under prospective, short-duration reinsurance contracts are recorded as prepaid reinsurance premiums which are recognized as the related premiums are earned.

## INVESTMENTS

SFAS No. 115 requires that certain debt and equity securities be classified into one of three categories: held-to-maturity, available-for-sale, or trading securities. Investments in debt securities that the enterprise has the positive intent and ability to hold to maturity are classified as held-to-maturity and reported at amortized cost in the statement of financial position. Securities that are bought and held principally for the purpose of selling them in the near term (thus held for only a short period of time) are classified as trading securities and reported at fair value. Trading generally reflects active and frequent buying and selling, and trading securities are generally used to generate profit on short-term differences in price. Investments not classified as either held-to-maturity or trading securities are classified as available-for-sale securities and reported at fair value.

Investments, except investments in certain annuities, are categorized as available-for-sale. Accordingly, the investment portfolio is carried at fair value. Unrealized holding gains and losses on securities are reported in accumulated other comprehensive income (loss) and are classified as a separate component of policyholders' surplus.

Investments in annuities are classified as held to maturity and are carried at amortized cost. The Trust has the intent and ability to hold these investments to maturity.

The cost of fixed-maturity securities is adjusted for amortization of premiums and accretion of discounts to maturity, or in the case of loan-backed securities, over the estimated life of the security. Such amortization and interest earned are included in investment income. Realized gains and losses are included in net realized gains on investments. The cost of securities sold is based on the specific identification method.

**INCOME TAXES**

The Trust uses the liability method of accounting for income taxes. Under this method, deferred tax assets and liabilities are determined based on differences between financial reporting and tax bases of assets and liabilities and are measured using the enacted tax rates and laws that will be in effect when the differences are expected to reverse.

**ACQUISITIONS COSTS**

Acquisition costs are expensed as they are incurred; the financial statement effect of this method does not differ significantly from the effect of using the deferral method.

**CASH EQUIVALENTS**

Money market funds and commercial paper with initial maturities of less than three months are considered to be cash equivalents.

**DISCLOSURES ABOUT  
FAIR VALUE of  
FINANCIAL  
INSTRUMENTS**

The fair value of financial instruments, as defined by accounting principles generally accepted by the United States of America, approximates the recorded book value of such instruments.

**ACCOUNTING  
CHANGES**

During 2001, TMLT and TMIC changed their method for recording investment transactions from the settlement date to the trade date. The cumulative effect of changes in accounting principles should be reported as an adjustment to unassigned surplus in the period of the change in accounting principle. The cumulative effect is the difference between the amount of capital and surplus at the beginning of the year and the amount of capital and surplus that would have been reported at that date, if the new accounting principle had been applied retroactively for all prior periods. This cumulative effect as of January 1, 2001, has no material effect on the financial statements.

## I. COMPREHENSIVE INCOME

In accordance with SFAS 130, Reporting Comprehensive Income, the Trust presents comprehensive income (loss) within the consolidated statements of changes in policyholders' surplus.

Components of other comprehensive income (loss) consist of the following:

Years Ended December 31,	2002	2001
		(in thousands)
Change in unrealized losses on available-for-sale securities	\$ 689	\$ (957)
Income tax (expense) benefit	(234)	325
Other comprehensive income (loss)	\$ 455	\$ (632)

Accumulated other comprehensive income shown on the consolidated statements of changes in policyholders' surplus is solely comprised of unrealized gains (losses) from available-for-sale securities, net of tax of \$234 and \$325 for the years ended December 31, 2002 and 2001, respectively.

## 2. SECURITIES

The amortized cost and fair value of the Trust's investments in fixed-maturity securities and annuities are summarized as follows:

	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Estimated Fair Value
				(in thousands)
At December 31, 2002:				
U.S. Government and its agencies	\$ 12,237	\$ 1,364	\$ –	\$ 13,601
Annuities	16,500	–	–	16,500
Corporations	90,736	5,542	214	96,064
Loan-backed securities and collateralized mortgage obligations and other	112,427	9,013	4,715	116,725
	\$ 231,900	\$ 15,919	\$ 4,929	\$ 242,890
At December 31, 2001:				
U.S. Government and its agencies	\$ 11,281	\$ 478	\$ 23	\$ 11,736
Corporations	80,588	2,691	2,162	81,117
Loan-backed securities and collateralized mortgage obligations and other	86,858	2,219	350	88,727
	\$ 178,727	\$ 5,388	\$ 2,535	\$ 181,580

At December 31, the Trust's investment in common stocks and preferred stocks had a cost basis of \$23,440 and \$23,759 in 2002 and 2001, respectively. Gross unrealized gains and gross unrealized losses were \$101 and \$9,393, respectively in 2002 and, \$756 and \$5,101, respectively in 2001.

**2. SECURITIES** (continued)

The fair values generally represent quoted market value prices for securities traded in the public marketplace or analytically determined values using bid or closing prices for securities not traded in the public marketplace.

The amortized cost and estimated fair value of the fixed-maturity securities and annuities at December 31, 2002 are summarized, by stated maturities, as follows:

	Amortized Cost	Estimated Fair Value
		(in thousands)
Years to maturity:		
One or less	\$ 11,114	\$ 11,315
After one through five	52,214	55,089
After five through ten	72,609	72,355
More than ten	10,644	10,639
Loan-backed securities and collateralized mortgage obligations	85,319	93,492
	\$ 231,900	\$ 242,890

Actual maturities may differ from the contractual maturities in the foregoing table because certain borrowers have the right to call or prepay obligations with or without call or prepayment penalties.

Proceeds from the sales of available-for-sale securities were \$64,055 in 2002 and \$43,442 in 2001. Gross realized gains and gross realized losses on these sales were \$515 and \$875, respectively, during 2002, and \$529 and \$2,869, respectively, during 2001.

### 3. UNPAID LOSSES AND LOSS ADJUSTMENT EXPENSES

The following table provides a reconciliation of the beginning and ending reserve balances for unpaid losses and loss adjustment expenses (LAE), net of reinsurance recoverables, for 2002 and 2001:

Years Ended December 31,	2002	2001
		(in thousands)
Reserve for unpaid losses and LAE, net of related reinsurance recoverables at beginning of year	\$ 217,675	\$ 144,308
Add provision for claims, net of reinsurance, occurring in:		
Current year	114,235	104,803
Prior years	3,108	32,432
Incurring losses during the current year, net of reinsurance	117,343	137,235
Deduct payments for claims, net of reinsurance, occurring in:		
Current year	317	511
Prior years	146,122	104,099
	146,439	104,610
Reserve for losses and LAE, net of related reinsurance recoverables, at end of year	188,579	176,933
Reinsurance recoverables on unpaid losses and LAE, at end of year	41,781	40,742
Reserve for unpaid losses and LAE, gross of reinsurance recoverables on unpaid losses, at end of year	\$ 230,360	\$ 217,675

The foregoing reconciliations shows that the Trust's reserve for unpaid losses and LAE, net of related reinsurance recoverable, at December 31, 2002 and 2001 was increased by \$3,108 and \$32,432 for claims that had occurred on or prior to 2001 and 2000, respectively. During 2002, the Trust increased reserves due to higher than anticipated loss severity and frequency, which resulted in higher reserves for both current year and prior year reported claims. This change in management's estimate of claims resulted from plaintiff's attorney's response to recent changes in the procedure for filing lawsuits and the time period allowed for discovery in Texas.

Medical malpractice claims have a very long development period. Historically, cases have taken years to be reported and, as a rule, take years to adjust, settle, or litigate. With respect to the Trust's estimates of reserves for unpaid losses and LAE, there is additional uncertainty related to the strength of case reserves and the effect of changes in the reinsurance of ALAE. Accordingly, should management's assumptions as to case reserve redundancies or reinsurance recoverables differ from the actual closure of claims, reserves are likely to develop adversely. Loss and loss adjustment reserve estimates are reviewed regularly and adjusted, as appropriate.

#### 4. REINSURANCE

The Trust cedes certain risks to various reinsurers. These reinsurance arrangements allow management to control exposure to potential losses arising from large risks and provide additional capacity for growth. A significant portion of the reinsurance is effected under quota-share reinsurance contracts and, in some cases, stop-loss coverage.

Ceded premiums are charged to operations as a deduction from premiums written. The effect of reinsurance on premiums written and earned are as follows:

	2002 Premiums		2001 Premiums	
	Written	Earned	Written	Earned
	(in thousands)			
Direct	\$ 171,509	\$ 153,224	\$ 130,380	\$ 115,753
Ceded	25,387	22,475	19,668	16,877
Net premiums	\$ 146,122	\$ 130,749	\$ 110,712	\$ 98,876

The amounts deducted from losses and loss adjustment expenses in the income statements that related to reinsurance were \$15,298 for 2002 and \$27,623 for 2001.

Reinsurance ceded contracts do not relieve the Trust from its obligations to policyholders. The Trust remains liable to its policyholders for the portion reinsured to the extent that any reinsurer does not meet the obligations assumed under the reinsurance agreements. To minimize its exposure to significant losses from reinsurer insolvencies, the Trust evaluates the financial condition of its reinsurers and monitors concentrations of credit risk arising from similar geographic regions, activities or economic characteristics of the reinsurers.

## 5. FEDERAL INCOME TAXES

Significant components of the provision for income tax expense (benefit) were as follows:

Years Ended December 31,	2002	2001
		(in thousands)
Current expense (benefit)	\$ (6,650)	\$ —
Deferred expense (benefit)	—	—
	\$ (6,650)	\$ —

The Trust received income tax refunds of \$6,650 in 2002. No income tax refunds were received or taxes paid in 2001.

Significant components of the Trust's deferred tax assets and liabilities were as follows:

December 31,	2002	2001
		(in thousands)
Deferred tax assets:		
Loss reserve discounting	\$ 11,995	\$ 4,779
Unearned premium discounting	5,516	4,273
Net operating losses	7,151	16,662
Other	874	783
Total deferred tax assets	25,536	26,497
Valuation allowance for deferred tax assets	(14,410)	(15,378)
Total deferred tax assets, net of allowance	11,126	11,119
Deferred tax liabilities:		
Other	(273)	(500)
Total deferred tax liabilities	(273)	(500)
Net deferred tax asset	\$ 10,853	\$ 10,619

Under the provisions of FASB Statement No. 109, the Trust is required to record a valuation allowance on a deferred tax asset, if it is more likely than not that the benefit will not be realized. Accordingly, the Trust established a valuation allowance of \$14,410 and \$15,378 as of December 31, 2002 and 2001, respectively. Management believes that it is more likely than not that the net deferred tax asset recorded at December 31, 2002 will be realized from expected future taxable income.

The differences between the income tax benefit reported and the income tax benefit that would result from applying domestic federal statutory rates to pretax income in 2002 and 2001 resulted primarily from the effects of tax-exempt interest and changes in the valuation allowance.

The Trust has available at December 31, 2002, \$21,030 of unused operating loss carryforwards that may be applied against future taxable income and that expire in various years from 2019 to 2021.

## 6. REVOLVING LINE-OF-CREDIT

In January, 2001, the Trust entered into an agreement with a commercial lender which provides the Trust with a revolving credit facility of \$15,000 (\$13,518 outstanding at December 31, 2002). The funds available under the credit agreement may be used for general corporate purposes. The revolving credit facility expired in January, 2003. Under the revolving credit facility, the Trust granted liens with respect to certain fixed maturity investments owned by the Trust.

Interest on borrowings under the credit agreement are determined, at the Trust's option, based on the prime rate minus 2.35% or the LIBOR rate plus a margin of 0.7%. There is a commitment fee of .08% on the unused balance. At December 31, 2002, the prime rate was 4.35%.

Subsequent to year end, the line-of-credit was renewed for an additional year at substantially the same terms.

## 7. POLICYHOLDERS' SURPLUS

Eligible physicians desiring to purchase insurance through the Trust are required to purchase a Surplus Deposit Certificate. The Surplus Deposit Certificates are offered solely to provide surplus for the Trust and do not bear interest.

Surplus contributions receivable of \$7,500 as of December 31, 2002 were collected on various dates subsequent to year end but prior to the issuance of the consolidated financial statements.

## 8. COMMITMENTS AND CONTINGENCIES

The Trust leases office facilities and certain equipment through agreements which expire through 2004. As of December 31, 2002, the future minimum lease payments under these agreements for the years ending December 31 are as follows:

Year	Amount
2003	\$ 747
2004	652
2005	—
2006	—
2007 and thereafter	—
	\$ 1,399

Total rent expense was \$1,345 for 2002 and \$1,222 for 2001.

The Trust is named as a defendant in various legal actions principally from claims made under insurance policies. Those actions are considered by the Trust in estimating the loss and loss adjustment expense reserves. The Trust's management believes that the resolution of those actions will not have a material adverse effect on the Trust's financial position or results of operations.

## 9. EMPLOYEE BENEFIT PLAN

The Trust sponsors a noncontributory, defined contribution employee benefit plan, which covers all employees who have completed one year of service. The Trust makes contributions to the Plan equal to 10% of participants' salaries. Such contributions are reduced by forfeitures of participants who leave the Plan before they become fully vested. Plan expense was \$1,331 for 2002 and \$1,161 for 2001.

## 10. FAIR VALUE OF FINANCIAL INSTRUMENTS

The following methods and assumptions were used to estimate the fair value of each class of financial instruments for which it is practicable to estimate that value:

*Cash and Cash Equivalents.* For those cash equivalents, the carrying amount is a reasonable estimate of fair value.

*Investment in Securities.* For investments in securities, fair values are based on quoted market prices or dealer quotes, if available. If a quoted market price is not available, fair value is estimated using quoted market prices for similar securities.

The estimated fair values of the Trust's financial instruments which are not disclosed on the face of the balance sheet or elsewhere in the notes are as follows:

	2002		2001	
	Carrying Amount	Fair Value	Carrying Amount	Fair Value
Cash and cash equivalents	\$ 30,814	\$ 30,814	\$ 11,961	\$ 11,961
Fixed maturity securities	242,890	242,890	181,580	181,580
Common stocks	11,648	11,648	19,414	19,414
Preferred stocks	2,500	2,500	–	–
	\$ 287,852	\$ 287,852	\$ 212,955	\$ 212,955

***TMLT is the only health care liability claim trust  
created and endorsed by Texas Medical Association.***

TMLT is also endorsed by:

Bexar County Medical Society  
Dallas County Medical Society  
Harris County Medical Society  
Lubbock-Crosby-Garza County Medical Society  
Tarrant County Medical Society  
Texas Academy of Family Physicians  
Texas Osteopathic Medical Association  
Travis County Medical Society

TMLT is a Gold Corporate Affiliate of the Texas Medical  
Group Management Association.

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