

Audit Report

**Medical Mutual Liability Insurance Society
of Maryland**

February 2008



OFFICE OF LEGISLATIVE AUDITS
DEPARTMENT OF LEGISLATIVE SERVICES
MARYLAND GENERAL ASSEMBLY

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Karl S. Aro
Executive Director

DEPARTMENT OF LEGISLATIVE SERVICES
OFFICE OF LEGISLATIVE AUDITS
MARYLAND GENERAL ASSEMBLY

Bruce A. Myers, CPA
Legislative Auditor

February 25, 2008

Senator Verna L. Jones, Co-Chair, Joint Audit Committee
Delegate Steven J. DeBoy, Sr., Co-Chair, Joint Audit Committee
Members of Joint Audit Committee
Annapolis, Maryland

Ladies and Gentlemen:

As required by the Insurance Article, Section 24-213 of the Annotated Code of Maryland, we have audited the accounts and transactions of the Medical Mutual Liability Insurance Society of Maryland (the Society) for the period beginning January 1, 2005 and ending December 31, 2006.

Our audit disclosed that the Society could improve certain controls over professional services including legal services obtained from various law firms. For example, formal written agreements were not established with many of the firms, so neither the services to be provided nor the basis for payments to the firms were clearly established.

We also noted that the Society had no formal procurement policy, and had internal control deficiencies relating to payroll processing and information systems security.

Respectfully submitted,

Bruce A. Myers, CPA
Legislative Auditor

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Background Information

Society Responsibilities

The Medical Mutual Liability Insurance Society of Maryland (the Society) was established under Section 24-203 of the Insurance Article of the Annotated Code of Maryland. The Society operates under a certificate of authority issued by the Commissioner of the Maryland Insurance Administration (MIA), and provides medical professional liability and general liability insurance to health care providers exclusively in Maryland. The Society was established as a non-stock corporation and, accordingly, is not a department, unit, agency or instrumentality of the State. The Society's funds are not part of the General Fund of the State.

Since the Society is a domestic insurer, MIA must examine the Society at least once every five years for compliance with applicable insurance laws and regulations. In addition, since the Society received rate subsidy payments from the Maryland Health Care Provider Rate Stabilization Fund (the Fund), MIA is required to conduct an annual audit (as required for any insurer receiving subsidy payments) to verify the information submitted by the Society when it applied for such payments from the Fund. Furthermore, the Society obtains an annual audit of its financial statements by a certified public accounting firm. For the year ended December 31, 2006, the Society reported in its audited financial statements net premiums earned of approximately \$157.3 million and total losses and expenses (excluding any investment losses) of approximately \$103.5 million (\$82.1 million in losses plus \$21.4 million in underwriting expenses). The Society has about 90 employees.

Dividend Declared by the Society

On September 12, 2007, the Society's Board of Directors (the Board) declared a dividend to its members in the amount of \$68.6 million. Notice of the resolution adopted by the Board approving and implementing the dividend payment was provided to the State's Insurance Commissioner on the same date. Pursuant to the Society's participation in the Maryland Health Care Provider Rate Stabilization Fund (the Fund), as well as certain related statutory requirements, the Society proposed in its resolution distributing a portion of the dividend to the State (approximately \$44.2 million), with the remainder being distributed to its policyholders in the form of a credit against their renewal premiums effective January 1, 2008.

Chapter 1, Laws of Maryland 2005 established the Fund, in part, to retain certain health care providers in the State by subsidizing their malpractice insurance

premiums for a specified number of years, specifically through fiscal year 2009. As of December 12, 2007, the Society had received subsidies on behalf of its policyholders from the Fund for this purpose totaling approximately \$72.4 million, and was due an additional \$11.7 million for calendar year 2007 for a total of \$84.1 million. However, the law also provides certain conditions under which an insurer participating in the Fund must pay a portion of any dividend or similar distribution to the State. On September 13, 2007, the State Insurance Commissioner issued an order to the Society to cease and desist from advertising, publicizing, implementing, or otherwise taking any action under or with respect to the dividend resolution adopted by the Society's Board of Directors. According to that order, a question existed as to the exact portion of the dividend to which the State was entitled. The Commissioner held public hearings on this matter, and on November 20, 2007, issued a final order requiring the Society to pay the entire dividend to the State for the benefit of the Fund. Payment was due within 30 days from the date of the order to allow parties from MIA and the Society to meet and determine if other alternatives to the Commissioner's order existed.

On December 12, 2007, the Board rescinded its original dividend declaration of \$68.6 million and declared a new dividend in the amount of approximately \$97.9 million. The Board proposed to divide the dividend between the Fund (\$84.1 million) and the Society's policyholders (\$13.8 million). Additionally, the Society proposed that policyholders' 2008 rates be reduced by eight percent from the rates the Society charged in 2007. On the same date, the Commissioner and the Society entered into a consent order agreeing to the terms in the Board's proposal. The Society also agreed that in 2008 it would not participate in the Fund nor would it receive any further disbursements. On December 19, 2007, the Society transferred \$72.4 million (\$84.1 million less \$11.7 million due to the Society but not yet received) to MIA to be credited to the Fund.

Findings and Recommendations

Contracts

Finding 1

Certain controls over professional services were inadequate. For example, the Society did not have formal written agreements with many of the law firms it used for claims defense and general legal services.

Analysis

The Medical Mutual Liability Insurance Society of Maryland (the Society) could improve certain controls over professional services including legal services obtained from various law firms. Specifically, the Society lacked formal written agreements with many of the law firms it used for claims defense and general legal services. Additionally, for a law firm with whom the Society did have a written agreement, bonus payments were made to a partner in the firm that were not provided for in the agreement. Written agreements should be prepared and should serve to clearly identify critical provisions, such as services to be provided, the basis for billings and payments, the use of retainers if applicable, and the responsibility for other expenses incurred.

For example, we noted that there was no formal agreement with the firm that provided general legal services to the Society, even though the firm was paid approximately \$170,000 during calendar year 2006. Similarly, the Society had no agreement with the majority of the law firms that provided claims defense services, including seven firms that received payments totaling approximately \$5.7 million during 2006. Although the Society received hourly rate schedules from these firms, good business practices dictate that the Society have formal written agreements with the law firms that it uses. In this regard, we noted that the Society had written agreements in place with certain other law firms used for claims defense services.

Furthermore, we noted that a consulting contract effectively guaranteed a certain level of payments without the related billings requiring documentation of hours worked or tasks completed. The agreement stipulated that the Society would use the consultant's services for no less than 500 hours at a rate of \$300 per hour for each year of the two-year contract. In this regard, the consultant emailed a payment request twice a month indicating 20 hours worked and no other supporting detail was submitted.

Recommendation 1

We recommend that the Society enter into formal written agreements, which include the terms for any payments, with all law firms from which it obtains

significant services. We also recommend that, for future consulting agreements, the Society ensure that the basis for amounts to be paid correlates with the services provided or deliverables received. We also recommend that sufficient documentation be required to support the propriety of billings.

Finding 2

Certain law firms hired for claims defense services were not being used to the fullest extent permitted by their contracts, but the fixed monthly fees paid to those firms remained constant.

Analysis

Certain law firms hired for claims defense services were not being used to the fullest extent permitted by their contracts, but the fixed monthly fees paid to those firms remained constant. As previously mentioned in Finding 1, the Society did not have formal agreements with most of the law firms it used. However, contracts were established with four firms used for claims defense services. Under the terms of those contracts, the Society paid a fixed monthly fee for which the applicable firm agreed to handle, in any given month, a specified average number of open claims. However, during calendar year 2006, the average number of open claims at each of the four firms was 12 to 50 percent below the average caseloads specified in their contracts, and at the same time additional claims were assigned at additional costs to firms other than these four firms.

In total, the four firms handled a monthly average of approximately 230 open claims during calendar year 2006, and were paid approximately \$6.3 million. At the same time, the Society also assigned claims to several other law firms that were not under similar fixed monthly fee type contracts (see Finding 1). These firms billed the Society their customary hourly rates. According to the Society's records, these firms handled a combined monthly average of approximately 190 open claims during 2006, and were paid approximately \$5.7 million.

We recognize that factors other than quantity need to be considered when assigning claims to law firms. However, considering that claims are not being assigned to the aforementioned four firms to the fullest extent permitted by their fixed fee contracts, while additional claims are being assigned at significant costs to other firms, we believe it is incumbent upon the Society to evaluate its contracts with the four firms and the assignment of claims for cost effectiveness.

Recommendation 2

We recommend that the Society evaluate its contracts with the firms, along with the overall assignment of claims, to determine if changes are needed,

such as adjusting the average caseloads and related monthly fees. We also recommend that the Society use the four law firms under contract to provide claims defense services to the fullest extent permitted under the terms of their contracts.

Procurement Policy

Finding 3

The Society lacked a formal procurement policy.

Analysis

The Society did not have a formal written policy or procedure for the procurement of goods and services, such as when and how competitive bids are to be solicited and evaluated. Currently, purchasing discretion is generally left to department heads and payments are processed based on invoice approval by a designated employee on the Society's signature authority list. The list includes the types of purchases the individual is authorized to approve as well as the approval limit.

The Society's practice did not provide assurance that consistent and adequate procedures were employed throughout the Society to ensure effective broad-based procurement competition and that best values were obtained. During calendar year 2006, the Society made non-claims related disbursements of approximately \$8.9 million.

Recommendation 3

We recommend that the Society develop a formal comprehensive procurement policy that establishes standards and minimum requirements for purchasing goods and services. For example, the policy should address the solicitation of bids and establish approval requirements prior to the commitment to purchase.

Payroll

Finding 4

Internal control over the Society's payroll was not sufficient.

Analysis

Internal control over the Society's payroll was not sufficient since the processing of payroll was handled entirely by one individual. Specifically, one employee added and deleted employees from the payroll, recorded the biweekly hours

worked and leave taken, recorded adjustments such as overtime hours, transmitted the payroll to the service center for processing, and received the related payroll checks. In addition, there were no supervisory reviews or approvals of the biweekly payroll process. As a result of these conditions, errors or irregularities could occur without detection. During calendar year 2006, the Society's payroll expenditures totaled approximately \$6.1 million.

Recommendation 4

We recommend that supervisory personnel approve the biweekly time reports and, at least on a test basis, review supporting documentation for adjustments recorded on the reports, and that these reviews be documented. We also recommend that the individual who approves the reports release them to the service center for processing. Finally, we recommend that any employees involved in the payroll preparation and approval processes not have access to the related payroll checks. We advised the Society on accomplishing the necessary separation of duties using existing personnel.

Information Systems Security and Control

Finding 5

Security reporting and backups of critical network servers were inadequate.

Analysis

Security reporting and backups of critical network servers were inadequate. Specifically, we noted the following conditions:

- Security reports for the minicomputer hosting several critical applications were not generated. Specifically, security reports of user profile changes, system value changes, and direct modifications of certain critical files were not generated. As a result, significant security violations could go undetected by management, thus permitting unauthorized or inappropriate changes to certain critical files.
- Although backups of critical network servers were performed daily, the backup tapes were not taken offsite from January 27, 2007 to August 23, 2007. Accordingly, if the facility which houses both the original data and the backup tapes were destroyed by a disaster, the Society could lose a significant amount of data or system information that it could not readily recreate.

The Information Systems Department supports the Society's information technology infrastructure which includes the computing system that hosts critical applications, such as accounts receivable and claims payments and provides networking, telecommunications, and Internet access.

Recommendation 5

We recommend that the Society generate the aforementioned security reports, review these reports, investigate items as necessary, and document these reviews and investigations. We also recommend that backup of critical network servers be stored at a secure offsite location.

Audit Scope, Objectives, and Methodology

As required by the Insurance Article, Section 24-213 of the Annotated Code of Maryland, we have conducted an audit of the accounts and transactions of the Medical Mutual Liability Insurance Society of Maryland (the Society) for the period beginning January 1, 2005 and ending December 31, 2006. The audit was conducted in accordance with generally accepted government auditing standards.

The objectives of this audit were to examine the Society's financial transactions, records and internal control, and to evaluate its compliance with any applicable State laws, rules, and regulations.

In planning and conducting our audit, we focused on the major financial-related areas of operations based on assessments of materiality and risk. Our audit procedures included inquiries of appropriate personnel, inspections of documents and records, and observations of the Society's operations. We also tested transactions and performed other auditing procedures that we considered necessary to achieve our objectives. Data provided in this report for background or informational purposes were deemed reasonable, but were not independently verified.

The Society's management is responsible for establishing and maintaining effective internal control. Internal control is a process designed to provide reasonable assurance that objectives pertaining to the reliability of financial records, effectiveness and efficiency of operations including safeguarding of assets, and compliance with applicable laws, rules, and regulations are achieved.

Because of inherent limitations in internal control, errors or fraud may nevertheless occur and not be detected. Also, projections of any evaluation of internal control to future periods are subject to the risk that conditions may change or compliance with policies and procedures may deteriorate.

Our reports are designed to assist the Maryland General Assembly in exercising its legislative oversight function and to provide constructive recommendations for improving State operations. As a result, our reports generally do not address activities we reviewed that are functioning properly.

This report includes findings that we consider to be significant deficiencies in the design or operation of internal control that could adversely affect the Society's ability to maintain reliable financial records, operate effectively and efficiently and/or comply with applicable laws, rules, and regulations. Our audit did not disclose any significant instances of non-compliance with applicable laws, rules, or regulations. Other less significant findings were communicated to the Society that did not warrant inclusion in this report.

The response from the Society to our findings and recommendations is included as an appendix to this report. As prescribed in the State Government Article, Section 2-1224 of the Annotated Code of Maryland, we will advise the Society regarding the results of our review of its response.

MEDICAL MUTUAL

Liability Insurance Society of Maryland

David L. Murray
President and Chief Executive Officer

February 21, 2008

Bruce A. Myers, CPA
Legislative Auditor
301 West Preston Street, Room 1202
Baltimore, Maryland 21201

RE: Legislative Audit Report

Dear Mr. Myers,

The following is in response to the February 2008 Legislative Audit Report for the period beginning January 1, 2005 and ending December 31, 2006. This report is the result of the first audit conducted by the Office of Legislative Auditors for the Society. We have taken all of the recommendations seriously, and we have or will implement those that we feel directly improve our overall operational effectiveness.

Recommendation 1 – *The Society should enter into formal written agreements, which include the terms for any payments, with all law firms from which it obtains significant services. We also recommend that, for future consulting agreements, the Society ensure that the basis for amounts to be paid correlates with the services provided or deliverables received. We also recommend that the sufficient documentation be required to support the propriety of billings.*

Society Response – The Society will enter into formal written agreements, which will include general terms with all law firms from which it obtains significant services. The Society disagrees with the assessment that we have any consulting agreements for which the amount paid does not correlate with the services provided or deliverables received. The Society always receives sufficient documentation to support the propriety of billings. This is a matter of documentation presentation. The Society feels that while it may not receive the information in a format that the legislative auditors are accustomed to in the public sector, we absolutely do receive sufficient support and documentation (in the form of frequent direct communications, specific identifiable tasks and other miscellaneous projects completed as assigned) to support the propriety of the billings.

Recommendation 2 – *The Society should evaluate its contracts with the firms, along with the overall assignment of claims, to determine if changes are needed, such as*

adjusting the average caseloads and related monthly fees. We also recommend that the Society use the four law firms under contract to provide claims defense services to the fullest extent permitted under the terms of their contracts.

Society Response – The Society does evaluate its contracts with the firms identified in this finding, along with the overall assignment of claims, to determine if changes are needed. The proposed recommendation to utilize the four firms to the fullest extent permitted under the terms of their contracts is inconsistent with the purpose of these contracts. It is vital that Medical Mutual have available premier quality attorneys to represent our insureds. The maximum case volume outlined in the contracts has always represented a threshold for the firms, not a guaranteed number of cases. If we were, as the recommendation says, to assign cases solely based on maximizing our utilization of these four firms based upon the contracts in place, we would lose access to non-contract firms available to defend Medical Mutual cases that bring unique strengths in certain cases and certain venues. Moreover, in light of certain conflict of interest prohibitions affecting attorneys and the cases they may handle, it is in the best interest of our insured physicians to maintain the current relationships that are now in place. Medical Mutual would not want to lose its ability to utilize its non-contracting firms and we strongly assert that implementing the recommendation would have a detrimental, adverse effect on our ability to provide quality legal representation to our insureds.

Recommendation 3 – *The Society should develop a formal comprehensive procurement policy that establishes standards and minimum requirements for purchasing goods and services.*

Society Response – While all significant purchases are evaluated thoroughly by senior management and competitive quotes are received and reviewed, we agree that no formal written policy exists. We will implement a formal written procurement policy for the purchasing of goods and services.

Recommendation 4 – *The Society should improve the internal controls surrounding the payroll process, specifically related to segregation of duties and supervisory review of biweekly payroll records.*


Society Response – The Society has numerous internal controls surrounding the payroll process, and many other compensating controls in place to detect errors or irregularities. The Society is in the process of upgrading its payroll processing software, which will allow for increased supervisory review and improve the segregation of duties.

Recommendation 5 – *The Society should generate several security reports, and review these reports, investigate items as necessary, and document these reviews. In addition, the Society should backup critical network servers and store them at secure offsite locations.*

Bruce A. Myers, CPA
February 21, 2008
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Society Response – The Society agrees and will begin generating the security reports discussed in the findings. In addition, the Society will investigate any irregularities and document the reviews. The Society does maintain backups for its critical network servers, and does store them at secure offsite locations.

Sincerely,

A handwritten signature in black ink, appearing to read "David L. Murray". The signature is fluid and cursive, with the first name "David" being more prominent.

David L. Murray
President & CEO

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