



PRF Annual Report

PHYSICIANS REIMBURSEMENT FUND, INC.

A Risk Retention Group

President's Report

The Physicians Reimbursement Fund (PRF) was founded in 1976 in the form of an offshore captive insurance company domiciled in Grand Cayman. From its inception in 1976 and through all the changes PRF has made during the 27 years that followed, the Company has remained true to its founding mission, principles and objectives. The longevity of the founding members as PRF Insureds speaks to the quality of the Company and to its unique sense of community. The average number of years (to date) that our founding members have spent as PRF Insureds is 17. Today PRF still insures 16 of the 71 original founding members.

In 2002 PRF continued on with the business plan that it began in January 2001. That is, PRF retained the primary level of risk, while the Company purchased reinsurance for the excess level of risk. Due to the

escalating cost of reinsurance, the PRF Board of Directors elected to make a change in the business plan during year 2003. Effective January 1, 2003, Physicians Reimbursement Fund retained the full amount of risk (both primary and excess levels) for claims where the incident giving rise to the claim occurred on or after January 1, 2003.

By eliminating the cost of reinsurance the Company eliminates a known annual expense in excess of \$400,000. At the same time the Company retains an increased risk, but that risk represents a potential expense as opposed to the given expense of a reinsurance premium. Historically, the actual losses paid per year have been less than the cost of the reinsurance premium. Further, the reinsurance market is uncertain. At best the reinsurance premium was likely to increase. In the worst case scenario the rein-

surer could cease writing reinsurance for medical malpractice. The Board of Directors considered the Company's excellent history of penetrating the excess level only twice in 27 years and weighed the consequences of the annual known expense of reinsurance versus the "potential" risk of a loss or losses greater than \$500,000. The Board decided it was in the best interest of the Company and its Insureds for PRF to retain the full level of risk. As always, the change in business plan was done with the full knowledge and approval of the Vermont Department of Insurance.

The objective of this annual report is to provide PRF Insureds with a better understanding of the history and operations of the Company.

George F. Lee, MD, President
Physicians Reimbursement Fund, Inc.
A Risk Retention Group

Mission Statement

The purpose of Physicians Reimbursement Fund is to provide competitively priced, occurrence based medical malpractice insurance to our policyholders while proactively working with our Insureds to advocate excellent patient care and to reduce the occurrence of malpractice claims.

- Approved by the PRF-RRG Board of Directors, August 20, 2002

Highlights of 2002

CHANGE IN BUSINESS PLAN

During the years 2001 and 2002 PRF purchased reinsurance for the excess level of coverage. From year 2001 to 2002 there was an increase of approximately \$77,000 in PRF's reinsurance premium. A further increase in 2003 reinsurance premium would guarantee an expense greater than \$400,000. Bearing all this in mind the PRF Board of Directors (the Board) began to consider other options for the Company's excess layer of coverage.

PRF is a risk retention group domiciled in Vermont. Therefore PRF applied to the Insurance Commissioner of the Vermont Department of Insurance for approval of a change in its business plan. The Board's plan was for the Company to retain the full risk for both primary and excess levels of coverage and eliminate the time and cost associated with reinsurance. In order for PRF to implement a change in its business plan, the Vermont Department of Insurance required PRF to acquire an additional \$500,000 in capital. PRF was able to secure the additional capital through a loan from the excess insurance company, Physicians Excess Insurance Company (PEIC) to PRF's parent company, Sphargis, Inc. PRF received approval from the Vermont Department of Insurance and the Company implemented the new business plan as of January 1, 2003. This was an important step toward consolidating and simplifying PRF's operations and minimizing its overhead.

SPHARGIS, INC. PROMISSORY NOTES

Physicians Reimbursement Fund, Ltd., was founded in 1976 as an offshore captive insurance company domiciled in Grand Cayman. In the late 1990s the Board of Directors began exploring various options to bring the Company onshore as a risk retention group. After extensive research, the Board settled on Vermont. The Vermont Department of Insurance required PRF to have an additional \$1 million in capital. The Board went directly to the Company's Insureds and put a call out to prospective investors. Seventy-one of PRF's Insureds opted to invest in the Company. PRF's parent company, Sphargis, Ltd., issued promissory notes during the first and second quarters of 1998 as PRF Insureds invested a collective total of \$1.6 million. The notes paid simple annual 13% interest, with return of principal due by the fourth anniversary of the note (year 2002). Individual investments varied from \$10,000 to \$160,000. In 2002 investors were offered the opportunity to rollover their existing notes (up to \$20,000) and continue to collect 10% simple annual interest. Principal exceeding \$20,000 was returned to remaining investors in 2002; thus, no outstanding notes exceeded \$20,000. In 2003 the remaining outstanding rollover notes were paid down so that no outstanding notes exceed \$10,000.

To date the total amount of the outstanding balance of Sphargis Promissory Notes is \$600,000. During the years 2002 and 2003, Sphargis returned slightly over \$1 million of the principal, thereby reducing the company's debt and interest expense. The remaining principal of \$600,000 will be returned to Investors no later than 2006. In 1998 PRF Insureds demonstrated their confidence in the Company by investing their own money. That investment in PRF's parent company, Sphargis, Inc., has served both PRF and its Insureds well. Figure 1 is a graphic

representation of the return on investment realized by holders of the Sphargis Promissory Notes, all investors being PRF Insureds.

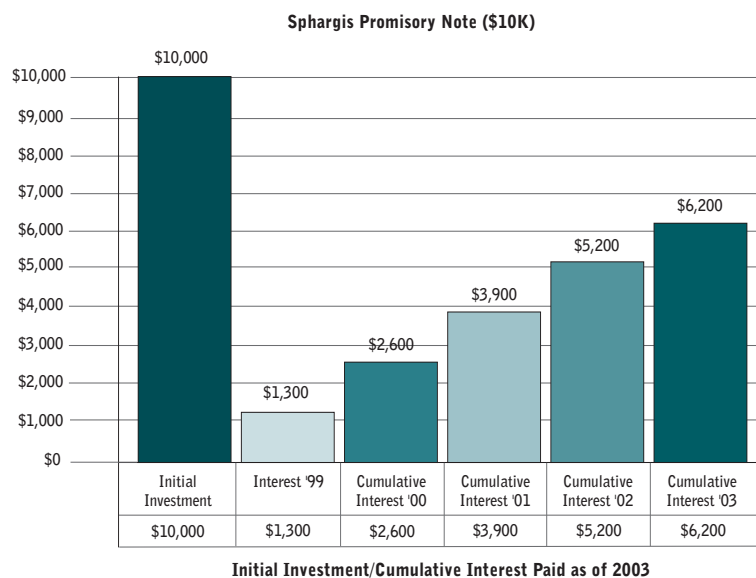


Figure 1: Sphargis Promissory Note: \$10,000 Investment (based on 5-year life of note)

OUTSIDE PROFESSIONALS NECESSARY TO THE MANAGEMENT OF THE COMPANY

The Physicians Reimbursement Fund, Inc. is domiciled in the state of Vermont. The Company continues to work in concert with the staff of U.S.A. Risk Group of Vermont (formerly known as Vermont Insurance Management) to ensure that it is in compliance with all regulatory issues and that its audited financial statements are filed in a timely manner with the Vermont Department of Insurance. In addition to filing quarterly financial statements with the Vermont Department of Insurance, PRF is required to have an annual actuarial analysis. Typically, the actuarial analysis is performed concurrently with the annual audit process. In 2002 PRF established a working relationship with the actuarial firm Milliman U.S.A. Milliman works extensively with risk retention groups and has an in-depth understanding of our business.

PRF works with the accounting firm of Saslow, Lufkin & Buggy for purposes of the annual audit of the financial statements, preparation of tax filings and any audit or tax issues that may arise during the course of the year. The Company employs a corporate attorney, Alan Sparer, of Howard, Rice, et al., who attends all meetings of the Board of Directors and the Patient Care and Management Committee and oversees defense of all active claims. If and when a suit is filed relating to a claim made against one of its Insureds, PRF works with several highly esteemed local law firms and will assign outside counsel from one of these firms to represent the interests of its Insured. The Company's investment portfolio is managed by Leenthal, a Division of Advest Inc., along with the concurrence of Damian Augustyn, MD, PRF's Treasurer and Chief Financial Officer, and the advice and consent of the Board of Directors.

THE NUMBER OF INSURED / TYPES OF PRODUCTS

PRF closed 2002 with a total of 190 Insureds. This number of Insureds was comprised of 97 specialists, 4 office-based specialists, 51 primary care physicians, 4 Ph.Ds, 19 allied healthcare professionals, and 15 oral surgeons. Currently the Company has 200 Insureds, and we anticipate a slight increase during the course of 2003. For further detail see Figure 2, which shows the percentages of PRF Insureds by Specialty as of April 2003.

In addition to medical malpractice insurance for physicians and allied healthcare professionals, the Company offers medical malpractice insurance for laboratories. Currently the Company insures five medical laboratories. Finally, the Company offers Medical Board Coverage for a nominal annual premium. Insureds who purchase Medical Board Coverage are provided with counsel, who will review the case in question with the Insured and accompany the Insured to their Medical Board hearing.

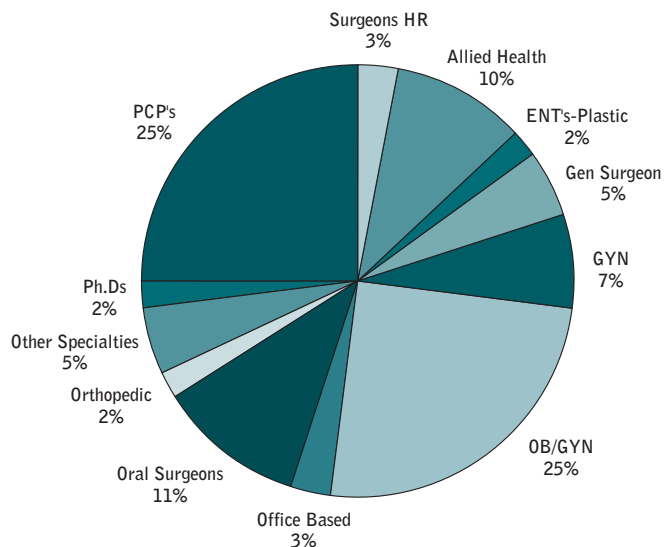


Figure 2: PRF Insureds by Specialty as of April 2003

INVESTMENTS

The Company's investment portfolio accounts are held with Lebenthal, a Division of Advest Inc., under the supervision of PRF's Treasurer and Chief Financial Officer, Damian Augustyn, MD and the advice and consent of the Board of Directors. PRF's overall investment portfolio increased by 7.3% during 2001. Further, PRF's overall investment portfolio increased by 7.4% during 2002.

THE STRUCTURE OF THE COMPANY

In spite of all the organizational changes within the Company, from offshore captive insurer, to onshore risk retention group, to purchasing reinsurance, the corporate structure of the Company has remained constant. PRF is under the direction and management of its Board of Directors, which consists of five physicians who are Insureds or former Insureds of the Company. The day-to-day operations of the Company are the responsibility of its Executive Director, June Riley, and its Director of Membership, Soad Kader. The Board of Directors and the PRF staff are assisted by various standing committees, i.e., the Patient Care and Management Committee, the Education and Risk Management Committee and the Peer Review Committee. To doubly ensure that the Board of Directors is kept apprised of any and all important developments in between Board meetings, the Executive Director meets with the President on a weekly basis.

PRF'S LEVEL OF LOSS EXPERIENCE

The total loss payout for the year 2002 was \$528,000. In 2001 the total loss payout was exceptionally low, i.e., \$187,000. In 2000 the loss payout was \$345,000. However in year 1999, the total loss payout was an exceptionally high \$976,000. Historically PRF's overall loss experience has been excellent, especially considering the fact that PRF's membership has a large percentage of high risk specialties.

The above figures only represent the costs associated with settlements, judgements or awards. It is not unusual for the total costs defending claims to exceed the dollars paid out in loss. In fact, as shown in Figure 3, 5 times in the past 10 years the aggregate costs of defending claims has exceeded the aggregate costs associated with settlements, judgments or awards.

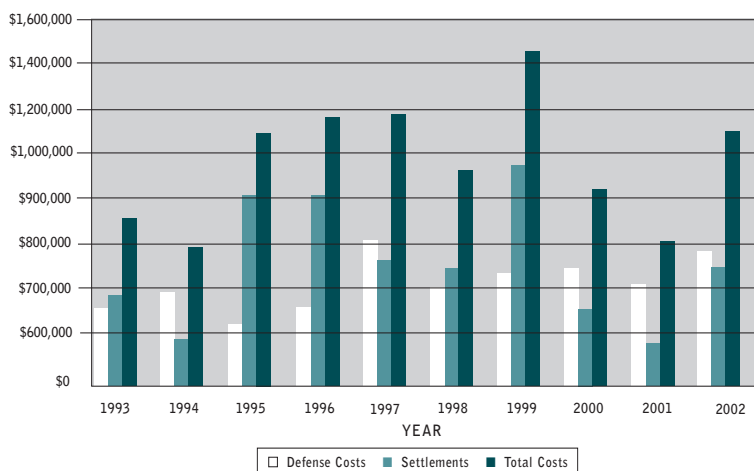


Figure 3: PRF Cost of Claims Experience 1993 - 2002

ANNUAL GENERAL MEETING

PRF held its Annual General Meeting (AGM) in April 2003. All PRF Insureds were invited to attend. The AGM is an opportunity for Insureds to meet the PRF Board of Directors, the staff and the Chair of the Patient Care and Management Committee, Reuben A. Clay, Jr., MD. The AGM focuses on the state of the business and the claims experience of the Company during the previous year. Historical information is also provided on the structure of the Company, the changes it has gone through and claims experience in terms of losses and costs of defense. The Board welcomes the chance to meet with Insureds and answer any questions they may have regarding the Company. We encourage each of you to make every effort to attend the next AGM in April 2004. Notices of the exact date, time and location will be sent to all Insureds in March of 2004.

PROJECTIONS FOR 2003 AND 2004

The Board of Directors of the Physicians Reimbursement Fund will continue to carefully monitor the business operations of the Company. The Company is currently in a position to increase its membership. During this period of potential growth it is important to maintain PRF's sense of community and peer visibility. With a proven track record spanning 27 successful years, PRF has shown that it offers the best product (occurrence based coverage) at a premium rate that is reasonable and manageable to PRF Insureds. The Board of Directors is pleased to provide this necessary and valuable service to PRF Insureds, enabling physicians to concentrate on the health care needs of their patients.

History and Founding Principles/ Objectives of the Company

PRF, Ltd., a medical malpractice insurance company, was organized in 1975 to provide professional liability insurance coverage to physicians practicing principally at California Pacific Medical Center (CPMC) (formerly Children's Hospital and Presbyterian Hospital). PRF, Ltd., was formed in response to the crisis in availability of medical malpractice insurance in California. At that time, as a result of a sharp increase in both expense and number of medical malpractice injury awards, malpractice carriers in California either stopped writing policies or drastically increased their premiums. The high cost of professional liability insurance became so prohibitive that some physicians either stopped practicing or left California to practice in states with affordable premiums.

The founding objectives of PRF, Ltd., were to:

- a) Eliminate the overhead expenses inherent in commercial insurance coverage;
- b) Implement a philosophy in risk and claims management which involved early identification and resolution of patient problems before they turn into lawsuits;
- c) Retain for the owner-physicians the benefit of these efficiencies in the form of stable, below market insurance premiums, and;
- d) Offer occurrence based coverage (not claims made) thereby allowing its Insureds an increased sense of security and freedom in terms of their individual choice of practice.

Even though the Company has grown from an offshore captive insurance company (PRF, Ltd.) to a fully-regulated onshore risk retention group (PRF-RRG), its objectives remain the same. In simple terms, PRF's objectives are to proactively take better care of patients, thereby reducing the number of lawsuits and maintaining competitively priced premiums.

Today, as in the past, PRF strives to reduce the incidence and cost of medical malpractice lawsuits through the following methods:

- **Code Green** is PRF's program for resolving patient issues without regard to whether anyone is to blame or is responsible in the legal sense. In most cases the Insured will work directly with the patient to resolve the matter to the patient's satisfaction. PRF will in turn reimburse the Insured.
- **Binding Arbitration.** It is PRF's policy that its Insureds make every good faith effort to have each patient sign an arbitration agreement. While the discovery process for disputes resolved by trial or arbitration is similar, the amount of time the Insured defendant spends away from his or her practice is significantly shortened, and arbitration provides a less public forum than trial by jury.
- **Management Reports.** PRF requests that Insureds inform the PRF office whenever an undesirable outcome occurs. A simple one-page management report is provided to the Insured, wherein the pertinent facts are outlined by the Insured.
- **Patient Care and Management Committee** oversees the handling of all claims, code green incidents, and management reports.
- **Patient Education and Risk Management Committee** oversees the production of PRF's newsletter, which focuses on topical risk-management issues relevant to our Insureds.

The implementation of the Medical Injury Compensation Reform Act of 1976 (MICRA), which placed a \$250,000 cap on non-economic damages, has been instrumental in containing the cost of medical malpractice insurance in California. MICRA is crucial to the availability of professional liability insurance, assuring that physicians have the means to practice medicine and treat their patients. PRF supports the continuation of MICRA through its annual contribution to Californians Allied for Patient Protection (CAPP). In addition, George F. Lee, MD, President of the PRF and one of its founding members, serves on the Board of Directors of CAPP and continues to serve on a national task force, which is supporting federal legislation similar to MICRA.



2002 Annual Report

Physicians Reimbursement Fund, Inc.

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Soad Kader
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