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A Dangerous Oxymoron:

So-Called Alternative Risk Transfers Do *Not* Transfer Risk

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Wake up! So-called alternative risk transfers ("ART's") are altering the face of the insurance marketplace by confronting policyholders with a distorted reality: pay a little now and pay a lot later for the risk that was never transferred. A more appropriate name for these "alternative" arrangements is simply "anti-insurance." Unfortunately, policyholders do not understand that ART's are not insurance because such products do not transfer risk. Well-intentioned policyholders lose sight of the fact that ART's are merely financing arrangements designed to lure policyholders into disregarding the fundamental purpose of insurance—to transfer risk. However, all is not lost for policyholders who purchased these products. Despite increasing efforts to the contrary, policyholders with ART's are still accorded many of the same legal rights and protections that policyholders under traditional insurance policies possess.

Failing to Transfer Risk is Penny Wise But Pound Foolish

In addition to the well-known types of non-insurance, such as captives, self-insurance and retrospectively-rated insurance policies, ART's also include insurance programs with large self-insured retentions, and self-exhausting or reducing limits policies. These products are the modern day equivalent of snake oil, promising policyholders short-term financial benefits while providing insurance companies tremendous long-term financial benefits. ART's often place the policyholder's financial resources at risk in amounts equal to or beyond those of the insurance company, making the insurance company more of a claims adjuster or risk manager rather than the party financially responsible to satisfy any claims. Unlike traditional insurance, the policyholder may retain some or all of the financial risk.

Policyholders must realize that short-term cash flow and tax benefits are only that—such business benefits do not mystically convert into insurance by virtue of their up-front money saving graces. Policyholders relying on ART's, if hit with claims on the scale of the pending asbestos, lead paint, breast implant or latex glove litigations, would face certain bankruptcy—because they did *not* transfer their risk to an insurance company.

A brief review of what makes different ART's tick reveals that ART's are geared to having the policyholder, not the insurance company, pay most claims.

Retrospectively-Rated Insurance Policies

Retrospectively-rated insurance policies typically cost the policyholder an up-front premium. In addition to paying the premium, the policyholder is required at certain fixed time periods to reimburse the insurance company for loss payments paid out on the policyholder's behalf, including claims handling expenses and other fees. These "fees" can be as high as forty percent of the total payment on a claim.

Policies with retrospectively-rated premium endorsements usually work by establishing a cap on the policyholder's exposure, either on a per claim and/or an aggregate of claims basis. Until the policyholder reaches that cap or "loss limit," the policyholder is actually self-insuring itself against losses and paying claims with its own money. Thus, until exceeding the established loss

limit, policyholders in essence pay for all claims, as well as the expenses incurred to resolve those claims, even though the claims fall within the scope of the policy's coverage, until exceeding the established loss limit. The insurance company bears little or no financial risk as to the outcome of any particular claim until the loss limit is exceeded. In fact, the only real insurance that is sold to the policyholder under a retrospectively-rated premium endorsement is the insurance company's obligation to indemnify the policyholder for all payments due for claims *above* the "loss limit."

Courts have recognized the inherent conflict of interest in an arrangement where the more money spent on defending and resolving claims, the greater the expense to the policyholder, but the greater the income to the insurance company, since the insurance company is able to charge the policyholder its additional fees. Policyholders should also watch for insurance companies which settle close to the loss limit, since it is to the insurance company's advantage to settle high and within the loss limit rather than defend the claim and receive a judgment beyond the loss limit. Contrary to how insurance companies act with their own money, retrospectively-rated policies give insurance companies an incentive to spend, rather than conserve, money in resolving claims. These considerations have made courts receptive to policyholders' demands to impose heightened obligations on insurance companies selling retrospectively-rated policies.

Fronting Policies and Self-insured Retentions

Under so-called "fronting" insurance policies and insurance policies containing large self-insured retentions ("SIRs"), policyholders agree to pay a portion of the claims within the scope of the policy's insurance coverage. Yet the policyholder often must also cede control over the defense and settlement of claims to the insurance company. Like retrospectively-rated policies, these financing arrangements raise significant concerns for the policyholder who frequently has significant financial responsibility for the claims.

Courts have generally recognized that policyholders with fronting policies or SIRs must have more control over the handling and defense of their claims, since it is their money at stake. Courts have been loathe to impose obligations on the policyholder to settle or handle claims in a manner which would force the policyholder to expend its funds, even where that decision may ultimately prove to have been incorrect.

Policyholders responsible for certain claims under an SIR or "fronting" arrangement should demand to have significant input in the selection of defense counsel, the handling of the defense and any related matters. Judicial recognition that it is the policyholder's funds at risk in an SIR or fronting arrangement makes it likely that courts will enforce policyholders' rights to actively participate in the claims management process.

Self-exhausting/Reducing Limits Policies

Typically, only indemnity obligations are applied to reduce the liability limits of an insurance policy. Under self-exhausting or reducing limits policies, the policy liability limits are decreased by indemnity payments *and* defense costs, including attorney's fees and other expenses. Policyholders with self-exhausting policies are particularly interested in minimizing defense costs to the extent possible, since defense costs directly impact the amount of indemnity protection available under a given policy. The insurance company, on the other hand, has already capped its obligations, thereby relieving it of any concerns of excessive defense costs. Many self-exhausting policies give the insurance company the right to control the defense.

This type of insurance arrangement requires that the policyholder actively participate in managing the claims defense process. Indeed, many courts have imposed an increased burden on insurance companies to keep policyholders fully informed of the defense costs and expenses, as well as insisting that the insurance company obtain for the policyholder the normal, reasonable charges that it would have usually obtained for itself. Further, some courts have recognized the conflict of interest these arrangements impose on the defense counsel handling the claims.

Conclusion

As policyholders attempt to find innovative mechanisms to reduce their liability insurance costs, they must remain cognizant of the ramifications "alternative" arrangements may have once the claims for which the "alternative" arrangement arise. In many circumstances, unless the policyholder engages in proactive risk management,

it may find that it has given up far more than it has gained. Because ART's often place the policyholder's interests in a directly competing fashion to those of the insurance company, policyholders should monitor the activities under these programs regularly, and not hesitate to voice objections when a problem surfaces. Otherwise, the only "alternative" the policyholder may face is dramatically increased liability financing costs or far less liability protection—neither of which are an acceptable "alternative." ■

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