

A Prospective Primer On Retrospective Premium Policies

Retrospective premium insurance policies, or retrospectively-rated policies, may, at first blush, appeal to the cost-conscious risk manager or executive. The selling point is simple, yet patently attractive: the total premiums paid are determined by the amount of loss incurred by the policyholder and actual claim payments made by the insurance company. Thus, the risk manager with effective and proven loss control procedures and a low loss history could reasonably anticipate paying lower premiums than when purchasing a traditional, fixed-premium policy. Despite the curb appeal of these policies, however, policyholders must have their eyes open in advance of purchase and claims submission to appreciate the myriad issues and claims handling tactics that could result in dramatically *increased* premiums.



DARIN J.
MCMULLEN

Up is Down, Left is Right

Under a traditional fixed-premium policy, the less the insurance company pays in claims, the more it gains in profits.

In the context of a retrospective premium policy, adjustments are made to the premium calculation based on loss history, either on a paid loss basis, that is, actual losses paid, or an incurred

loss or reserve basis determined at the time a reserve is set for a claim. Consequently, a counterintuitive financial incentive exists for the insurance company: the higher the amounts paid or reserved, the higher the premium that is paid by the policyholder as a result of the retrospective adjustment. Because the insurance company likely maintains exclusive control over loss payments and total control over reserves, it has control over the amount and timing of additional premiums under a retrospectively-rated policy.

Further, the additional premiums charged are not simple dollar for dollar offsets for what the insurance company pays to claimants. There are a number of strategies that insurance companies use to increase the retrospective premiums they charge.

■ Inflated Reserves Equal Inflated Revenues

Following the policyholders submission of a claim, the insurance company sets a reserve that, in theory, should fairly and accurately approximate the full cost of resolving the claim. Because retrospective premiums can increase with higher reserves, the insurance company has every motivation to set the reserve

artificially high. This is especially true under incurred loss programs where premiums are wholly tied to reserves. Thus, based upon a reserve determination exclusively within the insurance company's control and direction, policyholders may end up paying increased premiums.

The over-reserving of claims also gives the insurance company a second bite at reaping revenues in the context of a subsequent policy year's base premium. Because reserves factor into a policyholder's experience rating, an inflated reserve will lead to an increased premium at the time of policy renewal, even before any retrospective calculation is applied. If a policyholder has concerns about the size of a reserve, it should consult its broker, risk management professionals, the insurance company or counsel.

■ Take My Money, Please: The Insurance Company Settles High

To the fixed-premium policyholder, the concept of an insurance company settling a claim for an amount in excess to its actual value is foreign to the point of nonsensical. However, when premiums increase based upon the amount of settlement paid, the concept makes much more sense: a higher settlement amount equals higher premium revenue for the insurance company. Some, though not all, retrospective premium policies have loss limit or maximum premium provisions that cap the premium that a

policyholder may have to pay for a policy year. If a policy does not contain such a limitation or if the settlement of claims does not reach the loss limit, then the insurance company may reap more premiums by settling a claim for more than its actual value.

■ **Settlement: Timing is Everything** When settlement is being considered, the type of policy will likely dictate the approach to settlement taken by the insurance company. Under an incurred loss retrospective policy, an insurance company receives immediate premium revenue at the time it sets the reserves. Thus, the longer the claim is unpaid, the more interest on the policyholders money is earned by the insurance company.

Under a paid loss retrospective policy, an insurance company will not receive its adjusted premium payment until the claim is resolved and the loss is actually paid out. Once again, the insurance company has an incentive to settle quickly, and at an inflated amount, to obtain increased premiums from the policyholder. The lesson here is clear: before settlement discussions begin, a policyholder should be aware of whether it has purchased an incurred loss or paid loss retrospective premium policy to properly monitor the insurance companys conduct and approach to settlement.

■ **Look For Loss Concentration Or Allocation** Certain types of losses, most notably environmental and asbestos claims, tend to occur in more than one policy year. Insurance companies may attempt to allocate the entire loss for these types of continuing injury claims into a single policy year to which a retrospective premium applies. The insurance companys incentive is

not only to increase the retrospective premium, but also to avoid paying under a guaranteed cost policy if the entire loss can be concentrated into the retrospective policy year. Policyholders should question such allocation of losses both directly with the insurance company, as well as with brokers and counsel.

A Fight Worth Fighting

The unique financial incentives created by retrospective premium policies create a challenge for the policyholder as the potential traps are numerous and active and diligent monitoring is required of the policyholder. When amicable efforts to resolve questions or disputes are unsuccessful, the policyholder is not without recourse through litigation as the law in most jurisdictions is favorable to the retrospective premium policyholder challenging the legitimacy of retrospective premiums and claims handling.

Courts have recognized the conflict of interest between the insurance company seeking to increase revenues through increased retrospective premiums and the policyholder to which the insurance company owes a duty of good faith throughout the claims handling process. In fact, many courts have held that the relationship between the insurance company and the policyholder is fiduciary in nature. This fiduciary relationship requires the insurance company to act with paramount good faith toward its policyholders.

Moreover, a policyholder generally has to produce only sufficient evidence to suggest that the insurance company violated its duty of good faith during the claims handling process. Conversely, courts require the

insurance company to persuade the finder of fact that it acted reasonably and in good faith. As such, the onus of proving the justification for an increased retrospective premium is squarely on the insurance company, which must demonstrate that it acted in the utmost good faith. Consequently, if a retrospective premium dispute must be addressed in litigation, policyholders have an important weapon and advantage on their side and should not hesitate to assert their rights.

Darin J. McMullen is an attorney in the Philadelphia office of Anderson Kill & Olick, P.C. Mr. McMullen concentrates his practice in the areas of insurance recovery and business litigation. Anderson Kill represents policyholders only in insurance coverage disputes, with no ties to insurance companies and no conflicts of interest. Mr. McMullen can be reached at dmcullen@anderson-kill.com or 267-216-2708.

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