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Buyer beware! Side agreements are not part of the insurance policy and may not be approved by state insurance authorities.

Do You Want a Side Agreement to Go With That Insurance Policy?

JOHN G. NEVIUS

In obtaining basic workers compensation and general or auto liability coverage, policyholders may be required to sign separate additional contracts referred to as “deductible security agreements,” “payment agreements for insurance and risk management services,” or “cross-collateralization agreements.” Often, these “agreements” (side agreements) are presented as part of creative premium programs that transfer risk (and eventual claims costs) back onto policyholders. Call them what you will, but side agreements can lead to large additional costs for policyholders and tie up their credit. Side agreements also generally are subject only to limited, if any, state insurance regulation.

For multiple-claim liabilities such as workers compensation or auto-fleet fender benders, insurance companies may offer, in conjunction with side agreements, third-party administrative services with limited risk transfer that may involve significant collateral requirements. For insurance companies, the claim-service element of the business arrangement may be more important economically than the provision of coverage. In other words, the type of coverage at issue can be considered by insurance companies to be excess over the initial (primary) effort to manage claims.

Programs such as “retrospective” or “earned” premium programs may be marketed as money savers, but

they generally contain tough provisions in the event of a dispute or nonrenewal. Side agreements are not part of the insurance policy and may not be approved by state insurance authorities or subject to standard legal protections for policyholder consumers.

Insurance consumers would be well advised to make sure all necessary documents are presented and signed *before* entering into a coverage program. This includes side agreements.

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What Can Go Wrong?

The following three generalized examples based upon actual cases illustrate what can go wrong when side agreements are brought into the coverage mix.

Retrospective Premium Programs

A policyholder received a bill for one 10-year-old workers compensation claim because the claim had never been resolved. The insurance company went to court to collect even though it had ceased doing business with the policyholder 10 years before and it had not obtained state protections that normally would have been available to the policyholder. The insurance company had applied for so-called second injury fund relief from the state in its capacity as claims administrator but did not actually obtain the relief for some reason. The insurance company sent the bill because there was a so-called retrospective-premium-program side agreement.

Collateralization Agreements and Arbitration Provisions

A large holding company purchased a comprehensive workers compensation program from a major insurance company. After issuing the policy and providing coverage for a few months, the insurance company submitted to the policyholder a premium-

collateral side agreement on a take-it-or-leave-it basis. When the policyholder later balked and obtained alternative coverage going back to the date of inception, the insurance company refused to release any collateral or return premiums, arguing that the dispute had to be resolved pursuant to the terms of the side agreement.

Deductible Security Agreements

A policyholder with a taxi and limousine service purchased liability coverage for its fleet of cars. Any individual claim was subject to a \$50,000 deductible. After receiving the policy, the policyholder was asked to sign a deductible-security side agreement, with repeated reassurances that it was merely part of the program. When the policyholder questioned the arrangement, available collateral was retained by the insurance company, which also then sought additional premiums.

The Problem

Under a traditional insurance policy, the policyholder pays a fixed premium. The more insurance companies pay in claims, the less they make in profits — so they have a strong incentive to control claim costs. In contrast, the premiums paid by a policyholder under a retrospective or earned-premium type of arrangement are directly linked to the dollar amount of claims paid by the insurance company. For this reason, an insurance company has less incentive to manage and handle claims to control costs. The more it pays for claims, the more revenue it brings in via additional “retrospective” premiums and the more reserve collateral it can require. Moreover, if the claims fall within the deductible, the insurance company can charge more for administration or settlement costs without incurring any additional loss.

The problem is compounded by the complexity of the numbers, the presence of deductibles, and a lack of interest and experience on the part of policyholders in dealing with insurance generally. Unfortunately, the advantage to insurance companies of side agreements is simply a product of basic economics — the more the insurance company pays in claims today, the more it can later charge and hold as security for future potential claims. The problem may become especially acute when a policyholder does not renew its coverage and thereby creates even less incentive

for an insurance company to minimize costs or provide service generally with respect to covered claims that have not yet been reported when the nonrenewal takes effect.

Insurance companies generally present a different view. The sales pitch is this: Policyholders can save money, can outsource claims handling to specialists, and will get the benefit of being able to demonstrate they have the requisite insurance coverage. In many circumstances, claims operations may be unaware of whether some sort of retrospective arrangement exists and, if so, how it actually works. Claims-service vendors may provide services to insurance companies on a flat-charge basis depending on claim type (e.g., medical, indemnity, etc.). Given that the claims side may have limited economic incentives or disincentives to control costs, underwriting and sales considerations often represent a far stronger driving force behind side agreements. This is partly why most serious disputes arise after coverage has not been renewed for whatever reason.

Retrospective Premiums

The ostensible purpose of a retrospective or earned-premium program is to make the premium paid more closely reflect the amount of loss a policyholder accrues. In theory, policyholders with a low loss experience should be rewarded with lower final costs, while policyholders with a high loss experience are penalized by paying more. This gives the policyholder added incentive to control risk. However, there is a potential for an insurance company to charge policyholders more premiums, including more for claims handling, as losses mount. In fact, losses often benefit the insurance company by generating recoverable administrative expenses and increasing theoretical reserve amounts. Indeed, many insurance side agreements contain provisions that allow an insurance company to unilaterally calculate premiums or security owed without any oversight.

For these reasons, policyholders may be at odds with their insurance company regarding the ultimate valuation of the final premium or security due under their insurance policy. This can lead to drawn-out litigation, during which the policyholder's money is tied up, possibly affecting the policyholder's credit and ability to take advantage of business opportunities.

Buyer Beware

A prudent policyholder must stay alert for insur-

ance side agreements purporting to provide savings. Policyholder consumers should beware of any trade practice where additional contractual requirements are presented or demanded by an insurance company or broker after coverage has been purchased and has become effective. Premium programs should be explained in detail and should provide all descriptions regarding the insurance policy and coverage provided (or not included) prior to inception. Often, professional legal advice is essential.

At the very least, policyholder consumers need to stay well informed on how the insurance company sets reserves, manages claims, and allocates losses among policy periods before entering into these types of coverage programs or being compelled to sign a side agreement in conjunction with, or after, policy issuance.

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Possible Solutions

If a policyholder has already entered into a side agreement such as the programs described or feels ill-served by an insurance company, solutions do exist.

Taking Legal Action

Too often, policyholders refuse to pay unanticipated costs or premiums they believe are unfair and, as a consequence, are sued by their insurance companies or compelled to arbitrate. Most insurance companies have lawyers on discounted retainer that deal with these types of disputes routinely. In contrast, many policyholders will use standard outside general counsel who may have contract experience but little, if any, practical coverage experience. Insurance policies, however, are not standard contracts. Accordingly, side agreements that are part of insurance programs should not be treated as standard contracts, either. Counsel with specific insurance experience should be engaged

to deal with these matters. Such counsel should be familiar with specific case law, statutes, and regulations that exist to protect insurance consumers.

In an action by an insurance company to recover premiums allegedly due under a retrospective premium arrangement, the insurance company must introduce sufficient evidence of the amounts paid on the policyholder's behalf and any other computation to support the amount sought. Additionally, all state high courts that have considered the question of insurance company misconduct have ruled that a policyholder need not pay retrospective premiums where the additional premium demanded has been inflated by poor claim handling, improper setting of reserves, or other insurance company misconduct. Moreover, numerous courts in many states place upon the policyholder the burden of merely producing sufficient evidence to suggest that the insurance company violated an implied obligation of acting reasonably and in good faith in handling claims. These courts place the ultimate burden upon the insurance company of persuading a jury (or other finder of fact) that it acted reasonably and in good faith.

A red flag should go up when matters encompassed in a proposed side agreement would normally be addressed somewhere in the insurance policy.

Invoking Regulatory Oversight

Some courts have also recognized that side agreements cannot be used to circumvent state statutory insurance guidelines and regulations that are designed, in large part, to protect consumer interests. For example, the Texas courts, in *Brookshire Grocery Co. v. Bomer*,¹ held that a mutually entered into side agreement that purported to amend the retrospective premium due under a workers compensation policy and was neither authorized nor approved by the State Board of Insurance was “invalid, illegal and void under both statutory and regulatory provisions, as well as applicable case law.”

Another case where courts have refused to enforce

side agreement provisions is *Appleton Papers, Inc. v. Home Indemnity Co.*² In *Appleton*, an insurance company attempted to enforce a mandatory arbitration provision contained in a “deductible security” side agreement. The court held that the mandatory arbitration provision was void because it was not approved by the state insurance commissioner pursuant to Wisc. Stat. § 631.85. The court reasoned that because the side agreement allegedly containing a policyholder's premium obligation was essential to the contract of insurance, it also was subject to Wisconsin insurance law and regulations. As such, because Wisconsin law required mandatory arbitration provisions to be approved by the state insurance commissioner and the insurance company did not submit the side agreement for approval, the court held the arbitration provision void under Wisconsin law.

All states have insurance law requiring that certain policy-related documents or forms be submitted to state regulators for review and approval.³ Existing case law and experience suggest that these regulations are not being complied with uniformly. Moreover, some states provide protections requiring insurance companies to provide information on how premium rating systems have been applied.⁴ For example, in pertinent part, New York Insurance Law § 2319 provides that “... every insurer or rate service organization shall provide within this state reasonable means whereby any person aggrieved by the application of its rating system may be heard, in person or by an authorized representative, on written request to review the manner in which such rating system has been applied in connection with the insurance afforded or offered”

The Heart of the Dilemma

These regulatory issues go to the heart of the side agreement dilemma. Side agreements can be beneficial and reduce claim costs. However, where matters that should be included in the insurance policy itself are placed outside of the insurance policy, problems can arise.

A red flag should go up when matters encompassed in a proposed side agreement would normally be addressed somewhere in the insurance policy. For example, if a large deductible endorsement is already in place, what would be the need for a separate security-collateral agreement? If an endorsement mechanism

commonly known as a LRARO (Large Risk Alternative Rating Option) involving retrospective premium calculations is already attached to the policy, what would be the need for a separate paid-loss retrospective side agreement? Policyholders and insurance companies need to be sure that any side agreement is really necessary if one is to be used at all.

Conclusion

The sample cases discussed in this column highlight an important issue for policyholders and insurance companies. Under many insurance programs today, liability insurance companies accept lesser risk and transfer the risk back onto the policyholder while controlling the claim process. Often, the insurance mechanisms used are subject to limited regulatory and legal protections. In addition, side agreements involving complicated risk transfer mechanisms that are understood and administered by the insurance companies themselves fall through regulatory cracks all too often or fail to raise alarms on the policyholder side before it is too late.

Security, collateral, retrospective, or other side agreements may be useful, but must be treated with

caution and analyzed closely. Professional advice from a broker or coverage lawyer is important. If you are asked to sign something after being sold coverage, review it carefully. Make sure it does not take away your rights. Policyholders need to be especially careful when asked to sign a contract separate from the policy after the coverage has inception.

Endnotes

1. *Brookshire Grocery Co. v. Bomer*, 959 S.W.2d 673, 678 (Tex. App.-Austin 1997, pet. denied).
2. *Appleton Papers, Inc. v. Home Indemnity Co.*, 612 N.W.2d 760 (Wis. Ct. App. 2000).
3. See, e.g., Wis. Stat. § 631.20; NY Ins. Law § 2307; Tex. Ins. Code art. 5.57.
4. See *Investors Ins. Co. of America v. Karbel Wholesale Autos Inc.*, 148 Misc.2d 933 (1st Dep't 1990).

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