

# The John Liner Review

THE QUARTERLY REVIEW OF ADVANCED RISK MANAGEMENT STRATEGIES

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VOL. 23 NO. 4

WINTER 2010

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*Employers should be aware of the precise terms of any collateral agreement and should negotiate unfavorable terms.*

# How to Avoid Collateral Damage to Your Workers Compensation Program

ALEX D. HARDIMAN

When the cost of workers compensation programs rose in the 1980s and 1990s, employers began to explore alternatives to the traditional “guaranteed cost” or “retrospective premium” workers compensation policies. While self-insurance can be an attractive option for companies willing to invest the time, effort, and manpower needed to set up and maintain a self-insured workers compensation program, many employers do not qualify under applicable state regulations for self-insured workers compensation programs. One attractive alternative is the use of “large deductible” (LD) workers compensation policies, which offer the control and cost savings that might be associated with self-insurance while at

the same time offering the advantage of an insurance company as the ultimate guarantor of claims being paid, even in the absence of the employer being willing or able to pay such claims.

LD policies typically provide for a deductible ranging from \$100,000 to \$500,000. Claims that are within the deductible are the responsibility of the policyholder, and the insurance company is responsible for any claims exceeding the deductible. The insurance company, however, remains the ultimate guarantor for payment of all claims, whether they are under or exceed the deductible.

When an insurance company takes on this guarantor role, it usually will require the policyholder to

post collateral to secure the risk. That collateral typically takes the form of cash or a letter of credit and is governed by terms set forth in a collateral agreement that is separate and apart from the policy. How that collateral is calculated, when additional demands for collateral can be made by the insurance company, and the policyholder's rights and remedies in the event of a dispute over the amount of collateral are all governed by the terms of the collateral agreement.

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### **The Pitfalls in Collateral Agreements**

Disputes regarding collateral and the terms of agreements governing collateral have become increasingly common since the economic downturn. Insurance companies, concerned about the risk that employer insolvencies will leave them responsible for the payment of claims without sufficient collateral, have been increasing their collateral demands or holding onto existing collateral for longer periods than necessary. Policyholders, on the other hand, dealing with shrinking payrolls and increasing costs or difficulties in obtaining letters of credit, have been seeking to lessen collateral requirements or seeking the return of collateral already held. In this climate, policyholders should be aware of the pitfalls associated with many collateral agreements and how to avoid those pitfalls.

#### **Your Collateral Might Not Be Securing Just Your LD Policy**

When an employer has experienced a drop in its payroll or has terminated its existing insurance company's workers compensation policy or when an insurance company has been holding the full amount of collateral beyond any realistic time in which workers compensation claims will be made, employers often anticipate no resistance to their

request that some of the collateral be returned. However, some collateral agreements contain provisions permitting the insurance company to apply the collateral to any existing or past insurance policy purchased from that same insurance company. An example of language to this effect is as follows:

Subject to the terms of this Agreement, we may apply any collateral we hold in connection with this or any other primary casualty insurance Policies or agreements to your Payment Obligation. ...

"Your Payment Obligation" means the amounts that You must pay us for the insurance and services in accordance with the terms of the Policies, this Agreement, and any similar casualty insurance Policies and agreements ... Such amounts shall include, but are not limited to, any of the following, including any portions thereof not yet due and payable ... [this] includes any ... other obligations that we shall have calculated on the basis of reserves for Loss and ALAE.

The effect of this language is to permit the insurance company, per an agreement that ostensibly governs only the collateral held in connection with a workers compensation policy, to apply that collateral to any other policy issued by the same company on the basis of the insurance company's unilateral assertion of collateral needs for that other policy.

In the face of a demand for return of collateral on a workers compensation insurance policy by an employer, this kind of provision permits the insurance company to assert that it requires the collateral to secure other policies such as a commercial general liability (CGL) policy. In some instances, even when the CGL policy has expired and was a guaranteed-cost policy with no further premiums due, insurance companies have asserted a right to use workers compensation collateral to secure the CGL policy based on the possibility of a future insolvency and the insurance company's desire to settle claims within the CGL policy's retention layer so that their obligation to pay is not reached.

Employers should be aware of this and similar language that may effectively permit an insurance

company to hold collateral indefinitely based on the insurance company's asserted needs pertaining to other policies also issued to the employer. Accordingly, employers should negotiate terms that tie the insurance company's right to collateral solely to the employer's workers compensation policy.

#### **Discretionary Insurance Company Collateral Review and No Opportunity for Policyholder Review**

Employers should closely examine the terms governing their rights to collateral review. Typically, collateral agreements provide for an annual review of collateral and give the insurance company (but not the employer) the power to review collateral at "any time we [the insurance company] deem reasonably necessary." As might be expected, an insurance company is likely to exercise its discretion to review collateral only when it believes an increase in collateral is required, but not when a return of collateral might be due.

Employers should also examine closely their rights in the event that an insurance company demands an increase in collateral or if a return of collateral is indicated. A common provision might state as follows:

If as a result of any review we find that we require additional collateral, you will provide us such collateral within 30 days of our request ... If a return of collateral to You is indicated, we will return annually the amount to You within 30 days of our written acknowledgement thereof.

The disparity between the rights of the employer and the insurance company is evident in this provision — on the one hand, the policyholder must satisfy the insurance company's demand for increased collateral within 30 days, whereas an employer will receive a return of collateral only annually and then only after the insurance company has acknowledged that the return of capital is indicated — an acknowledgement that has no required time frame.

Employers should ensure that any collateral agreement includes a right of the employer to request an interim review of collateral in addition to the annual review. By doing so, employers can increase the likelihood of a return of collateral in the event a material change in the employer's business diminishes the workers compensation risk. In addition, employers should ensure that their rights to a return of collateral

mirror the rights of the insurance company to receive additional collateral.

#### **Default Provisions Can Have Drastic Consequences**

Among the most important areas of a collateral agreement are the provisions regarding the employer's default under the agreement. A default can have drastic consequences for the employer, ranging from the cancellation of the workers compensation policy to the liquidation of all collateral.

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Collateral agreements generally will set out what constitutes default by the employer under the terms of the agreement. "Default" often is defined broadly to include any failure by the policyholder to abide by the terms of the agreement, including the failure to pay a demanded collateral increase at the time it is due. More recently, some collateral agreements have included a downgrade in an employer's financial rating or condition as a default event.

The consequences of a default — which can occur simply as a result of the employer disputing the insurance company's demand for increased collateral — can be dire. Consequences, no matter how minor the default, may include (1) no right to the return of any collateral, even excess collateral that is not in dispute; (2) the liquidation and taking ownership by the insurance company of all collateral, irrespective of the amount in dispute; and (3) the cancellation of the workers compensation policy.

Employers should carefully examine default provisions and negotiate a dispute procedure that permits the employer to dispute any demands for additional collateral without being in default of the agreement. In addition, employers should seek to limit the often-draconian consequences of a default by ensuring that the consequences are commensurate with the amount of collateral at issue in the dispute.

### Over-Reserving Claims: Loss Picks and LDFs

The over-reserving of claims can have a significant impact on the amount of collateral demanded by the insurance company and the ability of the insurance company to justify the collateral demanded.

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*When a dispute arises with an insurance company over collateral, an employer should have an independent expert review the collateral requirements.*

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At the outset, an insurance company will calculate the “loss pick” — essentially, the insurance company’s estimate of the employer’s future losses based on past losses — applicable to the employer. The loss pick is used as the basis for the initial calculation of collateral. Often, insurance companies will use industrywide data to calculate an employer’s particular loss pick, even if a policyholder’s claims history is significantly better than the average in the industry. Using an independent actuary’s analysis, employers should arm themselves with their own loss pick based on their individual loss history in order to counter the insurance companies’ loss pick — the higher the loss pick, the higher the collateral that is likely to be demanded.

Similarly, employers should insist that their insurance company disclose the loss development factor (LDF) used to calculate adjustments to the collateral during the life of the workers compensation insurance program and during subsequent policy renewals. LDFs are used to project the additional cost expected on claims associated with each loss period — such as late developing aspects of certain losses (e.g., from unrecognized medical complication or ultimate verdicts that are different than the amount reserved for a claim) and losses that occur during the loss period but have not yet been reported (IBNRs). Insurance companies tend to use LDF numbers that are much more conservative than an independent actuary might use because a higher LDF number will allow them to demand more collateral in the future. Employers

should negotiate the LDF number and ensure that it is disclosed in the collateral agreement.

### Overpaying Claims Within the Deductible

As part of an LD policy program, insurance companies frequently offer claims administration service and take responsibility for the administration and payment of all claims, including claims that fall within the deductible. Under traditional fixed cost workers compensation insurance with small deductibles, insurance companies have an incentive to minimize payments to claimants in order to maximize the return on their premium. LD policies are different — the higher the payment on a claim that falls within the employer’s deductible, the worse the employer’s loss history will be.

Employers should be aware that insurance companies administering workers compensation claims may have an incentive to settle claims within the deductible for more than they are worth, thereby creating a negative “artificial” loss history that translates into a basis for the insurance company to demand increased future collateral and higher premiums. To minimize this risk, employers should develop a close relationship with the insurance companies’ claims service and involve themselves to whatever extent possible in the decisions made on claims.

### Resolving Disputes: Act Early and Use Experts

The best way to resolve a dispute is to have laid the groundwork for resolution before any dispute develops.

When purchasing an LD policy, the first document that should be requested is the insurance company’s proposed collateral agreement. All too often, collateral agreements are treated as a minor side issue and presented to the employer only at the last moment before a policy is being issued or after the policy has already been issued. Insufficient time to analyze terms of a proposed collateral agreement diminishes any leverage an employer may have to negotiate more favorable collateral agreement terms. Employers should build enough time into the purchase process to have collateral agreements reviewed by knowledgeable counsel before the policy is issued.

When a dispute arises with an insurance company

over collateral, an employer should have an independent expert review the collateral requirements so that the employer can effectively counter the insurance company's position. In the event that a dispute cannot be resolved informally, collateral agreements usually provide for arbitration of disputes. Typically, these arbitration clauses do not require strict application of the law, may require that retired insurance company executives be appointed as the arbitrators, and may not provide a basis for the employer to recoup its attorneys' fees if it prevails. Because of these terms and the fact that arbitrators are more inclined to issue an award that is a "compromise" of an otherwise fully valid claim, employers should avoid the inclusion of an arbitration clause in any collateral agreements or negotiate a clause that does not require the use of retired insurance executives, if possible.

Even in the face of an arbitration clause, however, a number of grounds exist to challenge the clause's validity. For example, depending on the state, a collateral agreement may be void on the ground that it is an insurance agreement that was not approved and filed with the particular state's insurance department. This may permit the employer to litigate the dispute without being subject to the arbitration clause or other unfavorable terms in the agreement. In addition, a few states do not permit mandatory arbitration of insurance disputes, so employers should check the

relevant state statutes. Likewise, where the dispute involves allegations that the insurance company was overpaying or otherwise misusing the claims process, good arguments exist that such a dispute relates to the workers compensation policy itself (which typically does not contain an arbitration clause) and, therefore, should not be subject to arbitration. Employers should always consider challenging collateral agreement arbitration clauses, both because the challenge itself may create the leverage necessary to resolve the dispute early and because, ultimately, a court may be a more favorable forum for an employer in a dispute over collateral.

## Conclusion

Collateral agreements are an increasing area of dispute between insurance companies and policyholders, particularly since the economic downturn. Employers should ensure that they are aware of the precise terms of the collateral agreements and use the purchase and renewal process to negotiate changes when faced with unfavorable terms.

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