AKO POLICYHOLDER ADVISOR
The Policyholder Law Firm

Volume 3 Number 9 www.andersonkill.com September 1994

Retrospective Premiums:
The Law Favors The Policyholder

Eugene R. Anderson
Glenn F. Fields

"These [court] decisions could force some bad carriers to clean up their act and deliver a better quality product."—An unidentified insurance company executive, quoted in Business Insurance, December 2, 1991, at 19-20.

Insurance policies, particularly workers compensation insurance policies, frequently require the policyholder to pay additional premiums based upon the insurance companies' outlay to claimants. Many of the policies base these additional or retrospective premiums on reserves, the amount the insurance company estimates in advance that will ultimately be paid to the claimant. The insurance company thus has the use of the policyholder's money for the years the claim is pending. Such insurance policies are called "loss sensitive" and have "retrospective premium adjustments." These adjustments can be made on a "paid loss" basis or on an "incurred loss" (reserve) basis. The focus of this article is on the incurred loss retrospective premium.

Big Premiums, Big Profits

The premium adjustments, or requests for added premiums come as a severe jolt to many policyholders. The bigger the reserves and losses, the bigger the premium and the bigger the insurance company's profits. Since the insurance company often has exclusive control over loss payments and complete control over reserves, it can control the amount and timing of additional premiums.

If your company bought insurance policies with a retrospective premium feature, the law protects your interests. Do not hesitate to question your insurance company about settlement of claims, its reserves, or any other problems with your "retro" adjustments and bills for added premiums. Remember that some, but not all, insurance policies with retro premiums have "stop loss" or loss limitation provisions. Provisions limit the policyholders' additional premiums if a particular loss goes above the "stop loss."

The courts recognize the fact that the insurance company is paying every claim below the retro loss limitation, if there is a loss limitation, with your money. Indeed, a Kansas court in Transit Casualty Co. v. Topeka Transportation Co. (Kansas Ct. of App., 1983) stated that, in a retrospective premium context, "when the insurer settled a claim it did so with the insured's money." However, in recent years the courts have said much more than this in favor of the policyholders who are asked to pay retrospective premiums.

Courts Say Insurance Companies Have Duties Toward the Policyholder

The key aspect of recent court decisions regarding retrospective premiums is that the insurance company has certain duties toward the policyholder who is paying the additional premium. These duties stem mainly from the fact that the retrospective premium feature involves a possible conflict of interest between the insurance company and the policyholder. The Delaware Supreme Court, in Corrado Brothers, Inc. v. Twin City Fire Insurance Co. (1989) noted that there is a potential for conflict between the insurance company and policyholder if the settlement of a claim imposes consequences, such as an additional premium payment, upon the policyholder. If your policy has a retro premium, you are, in reality, paying for most settlements made by the insurance company. You are better off to have claims paid at a low figure.

All retro premium formulas have add-ons to "compensate" the insurance company. These "add-ons" can be as much as 40% of the insurance company's reserve or payment on a claim. You pay these "add-ons" in addition to the amount of the actual paid losses and reserves. The insurance company is motivated to settle higher so it can charge you more "add-ons." The conflict is obvious.

If the additional premium charged to the policyholder was dollar for dollar the amount the insurance company paid to the claimant, the problems would be minimized. This is not the case; insurance companies benefit from higher losses in three ways. First, there are the "add-ons." If the insurance company pays a claimant one dollar, the insurance company charges a retro premium of as much as $1.40. Second, incurred loss retrospective premiums are based upon the amount the insurance company "reserves" for future payment. Thus, the insurance company charging $1.40 for a $1.00 reserve has the present use of $1.40 to cover a claim it may not pay for several years. Third, the same reserves used go into the policyholder's experience rating. This fact usually leads to an increase in premium at renewal time for the policy. Thus, over-reserving gives the insurance company a "double dip"—more of your money to use in the present and a higher "standard" premium for the future.

This conflict of interest is why the insurance company has the following duties toward its policyholder:

Duty to exercise good faith. A key aspect of the duty of good faith—as it relates to retro policies—is that the economic decisions of the insurance company have economic ramifications for the policyholder.

Duty to investigate claims. The insurance company must act in good faith because the policyholder simply lacks the facts and resources needed to investigate and evaluate claims.

The "reasonableness test" and burden of proof. The burden of proof is on the insurance company, not the policyholder, to show that settlements are reasonable.

A Checklist for Examining Retrospective Premiums

Now that you know the law is on your side, you may next wonder what you should be aware of regarding retrospective premiums. What problems could arise?

- **Watch Out for The Bloated Settlement**—Beware the insurance company that settles claims just at, or close to, the loss limitation within the retro. If your policy has a $200,000 loss limitation, the insurance company gets more premium dollars and more "add-ons" by reserving or settling a claim at $200,000 rather than at $100,000.
- **The Old Shell Game**—"Find the Name of the Claimant"—Look at the "names" of all the newly opened claims. Investigate claims involving the names of claimants you do not recognize. Do not accept claims with the name "Unknown." Request supporting documentation from the insurance company.
- **Puffed Reserves**—Beware of reserves set at a figure larger than average for a similar type of claim. If you are concerned about the size of the reserves for newly opened claims, speak first with brokers, risk management consultants, and others in your industry—then with the insurance company.
- **The "Increased" Limits Problem**—Check your firm's records on older and current liability policies. Make sure that your policy limits were not suddenly, inadvertently "increased."
- **Improper Aggregate Impairment**—Watch out for the assignment of a claim (especially a paid loss) to an improper line of insurance. Was a workers compensation claim assigned as a general liability claim or vice versa? Improper assignment of claims can adversely affect your ability to access your excess insurance coverage.
- **Questionable Retro Assignment**—Watch out for the assignment of a claim to a policy year in which the retro is still open. Insurance companies are inclined to assign claims— particularly multi-year losses— to years which have an open retro.
- **Settling Disputes With Your Insurance Company**—If you are settling a dispute with an insurance company, it is always better to settle net of retro. Policyholders have been surprised to find that after reaching an agreement with an insurance company pursuant to which the policyholder is to receive a certain amount, the insurance company then sends a bill for up to 140% of that amount (the settlement amount plus the retro-adjustment). If you cannot settle net of retro, then agree in advance on the amount and method of retro charge back.
- **One Occurrence or Many?**—Beware of retro chargebacks of a "one occurrence" loss as multiple occurrences. Certain groups of claims, such as

asbestos claims, are usually viewed by the courts as a single occurrence. This results in a single retro charge and your immediately reaching the loss limitation. If, on the other hand, such claims are treated as multiple occurrences, then the loss limitation for each of the many claims would probably not be exceeded.

• **Inaccurate Loss Runs and Mathematical Errors**—Watch out for sets of loss runs from the same insurance company prepared within a few months of one another, covering the same policies but giving highly conflicting data. Perhaps the conflicting reports came from different insurance company data centers. Check into it. You have a right to get an accurate report.

It's Your Money

If you have an insurance policy with a retrospective premium feature, the law is on your side. The insurance company has certain duties toward you, the policyholder. Stop, look, and crunch those numbers. It's your money. ■

EUGENE R. ANDERSON IS A PARTNER IN THE NEW YORK OFFICE OF ANDERSON KILL & OLICK, P.C. HE REGULARLY REPRESENTS POLICYHOLDERS IN INSURANCE COVERAGE MATTERS. HE CAN BE REACHED AT (212) 278-1751 OR AT **eanderson@andersonkill.com**