



Risk Financing[®] **PERSPECTIVES**

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RECENT CASELAW FROM RETROSPECTIVE RATING PLAN DISPUTES

Retrospective rating plans allow insureds to benefit from their success at controlling losses. Under such plans, an insured's initial premium is based on a retrospective premium calculation using an estimate of *projected* losses. The final premium is determined after the policy expires using the insured's *actual* losses. Although retrospective rating is not as prominent as it was in the past, many insureds still prefer retro plans due to their simplicity and the opportunity to reduce premium without taking on as much risk as other loss sensitive plans.

Insurers have a few reasons of their own to like retro plans. For one, they provide insureds with an incentive to control losses. More importantly, under a retro plan the insurer retains control of claims adjusting and the corresponding charges for such services. It is here that an inherent conflict of interest arises. Under a retro plan, an insured benefits the most when losses are minimized, which in turn results in the lowest amount of revenue for the insurer. An insurer actually benefits from higher losses, from which

it generates more revenue from claims adjusting and other charges. This inherent conflict can lead to disputes between insureds and insurers over retrospective premiums. In this issue of *Risk Financing Perspectives*, we offer a brief summary of some recent court decisions on such disputes.

Retrospective Rating

The basic calculation for a "retro" is fairly straightforward as indicated in Exhibit 1.

Exhibit 1

Retrospective Rating Formula

$$\text{Retrospective Premium} = [\text{Basic Premium} + \text{Converted Losses}] \times \text{Tax Multiplier}$$

The "*basic premium*" is determined by multiplying standard premium by a "*basic premium factor*," which is generally between 0.15 and 0.30. "*Converted losses*" are simply losses multiplied by a "*loss conversion factor*." *Loss conversion factors*

continued on page 2

... *Recent Caselaw cont. from p. 1*

compensate the insurer for unallocated loss adjusting expenses and typically range from about 1.10 to 1.40. The "tax multiplier" applies to allow the insurer to recoup premium taxes. Some retro plans include other charges as well, such as for loss limitations. Also, retro plans are subject to a minimum and a maximum premium. Retrospective rating and each of these components are described in more detail in sections III.D and III.E of *Risk Financing*.

The result of the retrospective rating formula is that an insured whose actual loss experience is better than what was expected receives a premium credit, subject to the minimum premium. Where losses are worse than expected, the

insured is charged additional premium, subject to the maximum. Retrospective rating plan premium adjustments begin approximately 6 months after expiration of the coverage term. They are performed annually until the insurer is satisfied that there will be no further loss development and all claims are closed for that coverage period. Generally, a retro plan remains open for 4 to 7 years after the coverage term.

Retrospective Rating Disputes

Retrospective rating plans create unique dynamics between insureds and insurers, often resulting in traditional characteristics of the relationship being reversed. Under a retro, an insurer adjusts premium calculations based upon an insured's loss experience, whether on a "paid loss" or an "incurred loss" or reserve basis. Thus, profits rise for the insurance company when the losses or loss reserves increase. Consequently, disputes arising out of retrospective rating plans are often borne out of unconventional circumstances where the insured may suffer detriment when the insurer pays out large amounts for claims under the policy.

Moreover, specific losses or policies also trigger disputes. For example, disputes emanating from losses such as environmental or asbestos claims will typically implicate more than one policy year. As a result, allocation or concentration of the loss is often at the heart of the dispute. Insurers may seek to allocate the entire loss to a single policy year in order to maximize the retrospective premium. Conversely, insureds should pay close attention to allocation of losses and question such allocation decisions. By monitoring and questioning allocations, disputes may be avoided; however, at the very least an insured will understand the insurer's actions and be able to challenge the decisions with more focus and efficiency.

continued on page 3



Risk Financing PERSPECTIVES

Steven T. Bird, CPCU
Editor

Jack P. Gibson, CPCU, CRIS, ARM
Technical Adviser

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... *Recent Caselaw cont. from p. 2*

Amicable resolution is not always reached and actions often must be pursued in court or by means of alternative dispute resolution methods such as arbitration or mediation. As a general proposition, the law in most jurisdictions is favorable to insureds challenging the legitimacy of retrospective premiums and claims handling. Courts recognize the conflict of interest that exists between an insurer seeking to maximize revenues through increased retrospective premiums and the insured to which the insurer owes an obligation of good faith and fair dealing. In fact, many courts have actually found a fiduciary relationship to exist between insureds and their insurers. In such jurisdictions, the insurer is required to act with paramount good faith toward its insureds. As a result, insureds can approach disputes arising out of retrospective premium policies with confidence in knowing that the law will place fair, but exacting, scrutiny on insurers.

Recent Court Decisions

Recent decisions arising under retrospectively rated programs have illuminated the role of both governmental agencies and nongovernmental entities in disputes between insureds and their insurers. In *Liberty Mut. Ins. Co. v. Muskin Leisure Prods., Inc.*, 2007 WL 2407302 (M.D. Pa. 2007), the court rejected the Liberty Mutual's contention that the insured, Muskin, was barred from challenging a retrospective premium because Muskin failed to pursue an objection to the policy with the Pennsylvania Compensation Rating Bureau (PCRB). The PCRB is not an agency of the Commonwealth of Pennsylvania, but rather, is a "nongovernmental organization charged with 'the task of determining a system of risk classifications to be used in the computation of workmen's compensation insurance premium rates paid by employers.'" *Id.* At *3 (quoting *Commonwealth Ins. Dep't v. Colonial Gardens Nursing Home*, 347 A.2d 770, 771 (Pa.

Commw. Ct. 1975)). The court squarely rejected Liberty Mutual's failure to exhaust remedies contention, noting that the insured was not arguing that Liberty Mutual used improper rates in calculating the retrospective adjustment, but rather, was arguing that Liberty Mutual could not make indefinite retrospective adjustments under the policy terms and that the adjustments lacked substantiation. *Id.* The court then explained that Muskin's challenge was not a challenge to the PCRB system, but rather a contract dispute and, because the PCRB lacked any authority to adjudicate a contracts dispute, Muskin was not required to present the dispute to the PCRB prior to initiating suit. *Id.* at *4. As *Muskin* illustrates, insureds need to be aware of any administrative remedies it must first pursue in a retrospective premium dispute. However, not all entities that are involved in the retrospective premium process have authority over a dispute and, thus, insureds must be aware of what is and is not an administrative prerequisite to filing a suit involving a retrospective premium dispute.

In the recent New York decision in *Castle Oil Corp. v. Reliance Ins. Co.*, 2009 WL 2242669 (N.Y. Sup.), the court, in affirming an arbitration award in favor of Reliance Insurance, allowed the insurer seeking retrospective premiums to do so despite the fact that the retrospective rating premium was in violation of New York insurance regulations. In the *Castle Oil* case, Reliance had sold four retrospectively rated workers compensation policies to Castle between 1997 and 2000 and sought to recover premiums under those policies. *Id.* at *1. The dispute was initially submitted to arbitration, with the Panel awarding an award of \$779,572, which represented premiums owed over the 4-year period, plus interest, for a total award of \$917,449.89. *Id.* Castle had argued at arbitration, and again before the New York state court in seeking to vacate the award, that Reliance's retrospective rating

continued on page 4

... *Recent Caselaw cont. from p. 3*

premium failed to comply with New York's retrospective Rating Plan Large Risk Rating Option ("Rating Option"). The Rating Option, which was established by way of a New York state insurance regulation, permitted retrospective premiums only where the total estimated annual premium exceeded \$500,000. Because the annual workers compensation premium for Castle did not exceed the \$500,000 threshold, Castle argued that the policies it purchased from Reliance were unlawfully contrary to public policy and, therefore, unenforceable. *Id.*

The court rejected Reliance's argument that it could aggregate all of its lines of coverage sold to Castle in order to exceed the \$500,000 threshold, and found that Reliance violated the Rating Option. *Id.* at *8. However, the court deemed Reliance's violation as a mere "technical" violation and refused to vacate the arbitration award. The court noted that the Rating Option was designed to prevent "excessive, inadequate or unfairly discriminatory rates, to promote the availability and reliability of insurance, and to regulate cooperation between insurers" but, subsequently stated the Rating Option did not "affect the public directly" despite a goal of making insurance more affordable for large sophisticated businesses. *Id.* at *8-9. According to the court, Castle failed to demonstrate that "any of these fundamental public policy considerations were so seriously offended as to permit Castle to avoid paying the full amount of the reduced premiums that the flawed insurance plan inappropriately awarded to it by Reliance." *Id.*

Conclusion

Despite finding that New York's insurance regulations sought to protect insureds from unfair retrospective premiums, the court in *Castle Oil* upheld an award that it described as "inappropriate" and arising from a "flawed insurance

plan." Consequently, insureds in a retrospective premium dispute in New York and elsewhere must carefully consider the specific regulations, its intent, and the specific public policy concerns addressed by the regulation when relying upon state regulations and policy considerations in their disputes. As is always the case in the unique world of retrospectively rated policies, insureds should consult their brokers and counsel at the outset of any dispute process so that the allegations are properly tailored and presented to insurers.

Darin McMullen is a Principal in the Philadelphia Office of Offit Kurman. He concentrates his practice in the areas of insurance recovery and business litigation. Mr. McMullen can be contacted at dmcullen@offitkurman.com.

IRMI'S RISK FINANCING MARKET CORNER

A recent report by PriceWaterhouseCoopers highlights the pending changes facing the property and casualty insurance industry. It lists potential changes in tax laws including more stringent requirements for transparency, efforts to increase federal oversight of the industry, and a new wave of industry consolidation as the main drivers. Yet the property and casualty insurance market during the fourth quarter of 2009 can appropriately be described as "stable." The continued pressure on premium revenue due to persistent soft market conditions and the slow economy were balanced by improvements in financial markets and the lack of any noteworthy reserve development or catastrophic loss events. Conditions may not seem that attractive to underwriters and others who feel a firming of the

continued on page 5

... *Market Corner cont. from p. 1*

market is long overdue, but most other industries would be quite pleased to be characterized as "stable." From their perspective, stability over the past year or so would have been an extremely attractive outcome.

Additional good news for insurance buyers is that there seems to be little threat of a significant change on the horizon. Expectations for the first half of 2010 are what can best be described as "stable." Insurers continue to pursue market share for the major lines of coverage, and simply are not able to impose rate increases. The competition in the market is dictating pricing and driving insurers to offer some of the most favorable coverage terms policyholders have seen in years.

In certain market segments, insurers are so weary of being undercut that they are starting to pull back and focus their efforts in other areas. However, it is difficult to identify areas that have not been saturated with new capacity. Even excess and surplus lines (E&S) insurers continue to see increased interest in market segments that traditional insurers have avoided in the past, but now are targeting as areas in which to expand. E&S insurers believe the lack of experience in these segments will result in underwriting losses and eventually force traditional insurers out. In the meantime, they can only wait and try to decide how far to deviate from their own guidelines in order to retain business.

A recent survey by the Reinsurance Association of America indicated that net premiums to reinsurers declined slightly in 2009. However, reinsurer loss ratios declined significantly as well. This fact, in combination with the improvements in the capital markets, has eased concerns regarding reinsurers' ability to access capital on reasonable terms in the event of a catastrophic loss. The rating outlook for the reinsurance industry has been labeled "stable" as well.

Late in 2009, the U.S. House of Representatives passed a bill called "The Wall Street Reform and Consumer Protection Act of 2009," forming a federal insurance office within the Department of the Treasury for the stated purpose of collecting information. The bill also establishes a Consumer Financial Protection Agency from which property and casualty insurers are exempt. The bill's backers in Congress say it will provide federal regulators with the authority to identify and respond to systemic risks, including breaking up firms that pose a threat to the financial services industry. Insurance associations which support the measure say that it addresses the need for greater insurance knowledge in Washington D.C., eases requirements for excess and surplus lines coverage, and alleviates some of the difficulties state regulators have in effectively representing the U.S. insurance market on the international front. However, groups opposed to the bill contend that it subjects insurers to possible assessments for the risks presented by the failure of noninsurance institutions, and that it could be a first step toward an optional federal charter.

