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A Prospective Primer on Retrospective Premium Policies

By Darin J. McMullen


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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.

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 policyholder's 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.

> ***"There are a number of strategies that insurance companies use to increase the retrospective premiums they charge."***

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.

"A Prospective Primer on Retrospective Premium Policies" continued p2

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 policyholder's 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 company's 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 company's 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.

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A New Year's Look Back at 2008 and Forward to 2009

By William G. Passannante

We at Anderson Kill would like to share with you some important developments in insurance recovery from the past 12 months. Courts in 2008 cast a cold eye on many attempts to avoid coverage advanced by insurance companies. Here are some of the year's developments in insurance recovery at Anderson Kill:

Directors and Officers Liability Insurance

Advancement of Full Defense Costs (Criminal). The Delaware Superior Court rejected an attempt by D&O insurance companies to allocate defense costs, instead required full advancement of defense costs, and found that excess polices can be triggered when the policyholder has spent the limit of underlying insurance. *HLTH Corporation and Emdeon Practice Services, Inc. v. Federal Insurance Co., et al.;*

Advancement of Full Defense Costs (Civil). The New York State Supreme Court, the Appellate Division and the Court of Appeals, upheld the broad obligation of a D&O insurance company to pay defense costs when incurred. The court entered judgment on the full amount of the policy limits plus pre- and post- judgment interest. *The Trustees of Princeton University vs. Nation Union and AIG,* No. 650 202/06;

Insurance for Environmental Liabilities. A California Appellate Court ruled that when a policyholder cannot distinguish between the covered and non-covered portions of a loss, then insurance providers must cover a loss unless they meet the burden of demarcating the non-covered part of the loss. If upheld by the California Supreme Court, the decision in favor of the State of California will provide policyholders with an important bulwark against anti-concurrent causation clauses; Anderson Kill earlier won a jury verdict in favor of the State which has recovered gross settlements of over $121 million for the Stringfellow cleanup. *State of California v. Underwriters et al.,* Riverside County Superior Court No. 239784;

Insurance for Income Tax Liability. Anderson Kill secured a multi-million dollar recovery in a confidential arbitration under a tax liability insurance policy which insured against the risk of IRS liability relating to a tax reduction strategy developed by a major accounting firm. The insurance company paid out its policy limit in full, but sought reimbursement in arbitration, alleging breach of warranty, non-cooperation, and policy exclusions.The arbitration panel rejected those claims in their entirety;

Insurance for Asbestos in Bankruptcy. The assignment of liability insurance policies to a Trust formed under Bankruptcy Code section 524(g) was allowed in *In re: Federal-Mogul Global Inc., T & N Limited, et al.*, No. 01-10578 (D. Del. Bankr.). Judge Judith K. Fitzgerald held that "once an event occurs that gives rise to the insurer's liability under the policy, the policy itself can be assigned."

Disability Insurance. The U.S. Second Circuit ruled against First Unum in a disability coverage dispute. Citing "First Unum's well-documented history of abusive [claims handling] tactics," the Second Circuit reversed a District Court decision in favor of First Unum finding "powerful evidence that First Unum's denial of McCauley's appeal [for disability benefits] was arbitrary and capricious." *John E. McCauley v. First Unum Life Ins. Co.*, (2d Cir December 24, 2008);

Insurance Coverage for Alleged Bodily Injury from Cell Phones. Policyholders obtained insurance coverage for several class action lawsuits based upon alleged exposure to cell phone radio frequency radiation ("RFR"). The underlying cases were brought on behalf of consumers allegedly exposed to RFR, on the premise that such exposures cause biological injury, even though none of the putative claim members has a diagnosed injury. The Texas Supreme Court rejected the insurance company argument that the duty to defend should be denied based upon underlying pleadings in which the plaintiffs purportedly concede that there are no issues of individualized injury. *Federal Insurance Company V. Samsung Electronics America, et al.*, No. 06-1040 (Texas);

Consequential Damages for Insurance Policyholders. The New York Court of Appeals held that policyholders can seek consequential damages when their businesses collapse as a result of the insurance company's failure to fulfill its contractual obligations. Anderson Kill filed a "friend of the court" brief in the case. *Bi-Economy Market, Inc. v. Harleysville Insurance Company, et al.;* and

Anderson Kill Awards. Anderson Kill was recognized during 2008 by a number of organizations. *Benchmark: Litigation* (2009) identified the firm as a leading national litigation firm; *Chambers USA* (2008) noted the firm as #1 in Insurance Dispute Resolution in New York; *Best Lawyers in America* (2009) recognized AKO lawyers; Legal 500 recognized the firm's practice in policyholder insurance litigation.

The results mentioned above are reflections of efforts by Anderson Kill attorneys and staff on behalf of our clients. As we are celebrating our 40th anniversary we are glad to have been of service to you during these years and look forward to continuing our relationship in 2009 and the future.

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