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## Think ahead to avoid retro policy pitfalls

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**WORKERS COMPENSATION**  
INSURANCE policies frequently contain a retrospective premium clause that compels a policyholder to pay additional premiums based upon losses incurred during the policy period. Under many retrospective clauses, the insurer first pays the actual amount of workers compensation claims asserted against the policyholder and establishes reserves for estimates of future payments. The insurer is later reimbursed for these payments and reserves by the policyholder.

The insurer's compensation for its claims-handling services is typically a percentage of claims paid out and reserves established. The insurer is able to control the timing of additional premiums charged to the policyholder because it controls loss payments and reserves.

The overall effect is that the more the insurer pays out in claims and establishes reserves, the greater its own compensation.

This process continues periodically until all claims have been closed, at which time final premium is established and the policyholder is either owed a refund or owes additional premiums.

Risk managers have long recognized that retrospective premium features in workers comp policies create an inherent conflict of interest between insurer and policyholder. Until recently, many risk managers were reluctant to question their insurers' good faith in processing claims and grudgingly accepted premium charges. This trend has eroded in recent years as companies have increasingly litigated challenges to retrospective premium clauses in workers comp policies.

Some practical tips for risk managers who are confronted with retrospective premium clauses follow:

### Duties owed to the policyholder

Most insurance contracts contain standard policy provisions that grant the insurer the right to investigate and settle claims within policy limits without the permission or consent of the policyholder. Risk managers are well aware of this provision, as insurance companies typically rely on this clause when confronted with challenges to the processing or settlement of claims. Moreover, courts adjudicating claims against insurance companies have routinely protected the right of insurers to process and administer claims within policy limits in a manner the insurers deem appropriate. After all, it's the insurer's money that pays the claims.

Most courts in recent years have recognized that insurance contracts with retrospective premium clauses are an exception to the general rule of insurer discretion and autonomy.

These courts have found that insurers have a duty to act reasonably in settling claims and setting reserves when administering policies with retrospective premium clauses.

Two key aspects to these decisions are the courts' recognition of the inherent conflict of interest in retrospective clauses and the fact that insurance companies are, in effect, settling claims with their policyholder's money.

In the early years, The Minnesota Supreme Court first held in 1968 in *Transport Inc. vs. Dahlen* that a potential conflict of interest exists between insurer and policyholder if the settlement of a claim imposes residual consequences on the policyholder in the form of additional premiums.

Because the amount of retrospective premiums charged is based on settlement amounts, reserves established and

administrative expenses, unscrupulous insurers have ample reasons to conduct indifferent investigations and to make unreasonably generous settlements to claimants. Even under the best circumstances, an insurer administering a policy with a retrospective feature does not have the usual incentive to minimize settlements, reserves and expenses to save itself money.

The second source of the duty of good faith, as it relates to retrospective policies, is that an insurer's decision to settle a claim has an economic ramification on the policyholder. These ramifications are similar to the effects felt by a policyholder when its insurer wrongfully fails to settle a claim within policy limits and thus subjects the policyholder to an excess judgment.

Courts have ruled that insurers should likewise be held accountable when administering policies with retrospective clauses because insurers are, in effect, spending the policyholder's money every time a claim is settled. In short, the more the insurer pays out in claims and sets in reserves, the more the policyholder owes in retrospective premium adjustments.

### Burden of proof

Although most courts have found that policyholders have a right to sue because their insurers have not acted in good faith in administering policies with retrospective clauses, it is less clear who bears the burden of proof that an insurer has acted in bad faith. Insurers routinely say the policyholder must bear that burden since the policyholder is the one challenging the reasonableness of an insurer's actions in the form of settlement amounts and reserves established. Insurers fear they will face exorbitant administrative and legal expenses if forced to prove the reasonableness of every challenged workers comp claim.

In 1983, a state appeals court in Kansas held in *Transit Casualty Co. vs. Topeka Transportation Co.* that insurers' fears of high expenses in proving the reasonableness of workers comp claims were "exaggerated."

The court correctly reasoned that the issue in dispute in litigation involving retrospective clauses is whether the insurer had a good faith belief in liability, and whether settlement amount of the various claims was reasonable.

The Kansas court reasoned that to settle claims, insurers must have documentation that bears on the issues of liability and the amount of settlement. This documentation is in the form of accident, medical and investigative reports, and most importantly, recommendations from the responsible adjuster and lawyer. Placing these documents in evidence should easily answer the question of why an insurer settled a claim or set a reserve in a particular amount.

As the court noted, there is "no reason why such ultimate accountability to the insured for what is done with the insured's money should require any change in the operations of an insurance company dealing in good faith with its insured."

Clearly, the better view is that the insurer must establish its good faith and reasonableness once the policyholder calls its actions into question. This is especially the case since the insurer is the one charged with investigating and adjusting claims and has the relevant information in its possession to determine whether a settlement is reasonable and made in good faith. The policyholder will likely not have this information in its possession, since it has delegated the right and duty of investigation and settlement to the insurer.

Indeed, by the terms of the policy in dispute, the policyholder has put the information critical to the issue of reasonableness and good faith in the

exclusive possession of the insurer. In essence, if the policyholder is to be charged retrospective premiums based on losses paid and reserves established, the policyholder should at least be entitled to have the insurer produce the information pertinent to reasonableness and to assume the burden of proof, according to the Minnesota Supreme Court's ruling in *Transport Indemnity vs. Dahlen*.

### Practical tips for risk managers

Risk managers should be aware that the law is on the policyholder's side. With this knowledge, risk managers should not accept the standard argument of insurers that they, alone, have the right to investigate and settle claims without input from the policyholder. Risk managers should request that their insurer consult with them when deciding liability issues, settling claims and establishing reserves. To do this, risk managers must maintain and actively monitor files and demand that the insurer keep them informed about the progress of active files.

Moreover, insurance policies with retrospective agreements are complex and sometimes difficult to understand. Risk managers must make certain that they understand how these agreements work and, most importantly, how premium calculations are established. Risk managers should also be mindful of insurance companies establishing reserves or settling claims at figures larger than the average for a similar type of claim in their geographic area. This situation may occur if a policyholder is confronted with a large number of employee claims involving soft tissue injuries to the neck and back. Typically, insurers will establish reserves for the settlement of routine injuries by using an "average number" for the geographic area.

If risk managers have concerns that reserves established for the settlement of

routine claims are inflated and excessive, they should consult with brokers, risk management consultants or their attorney. These experts can provide independent analysis on the propriety and appropriateness of case-reserving and claim-handling practices used by a given insurer. These consultants can also assist in negotiations for a reduction of reserves that the risk manager believes are too high and help explain the sometimes complex formulas insurers use when justifying premium adjustments and calculations.

If insurers are reluctant or simply cannot justify their actions in administering claims, risk managers should consider taking active steps, including litigation, to enforce their rights under the policy.

Risk managers monitoring policies with retrospective clauses must remember that insurance companies owe them the duty to act in good faith in administering claims. The rationale for this position is quite simple, for the insurer lacks the usual incentive to minimize payments, reserves and expenditures since it is spending the policyholder's money.

Risk managers are thus in the unique position of being able to take an active role in monitoring files and demanding that they be involved when their insurers take any steps that will have residual consequences upon the policyholder. **BI**



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