



**THE RISK  
MANAGEMENT  
LETTER**

This article is excerpted from The Risk Management Letter (ISSN 1070-0102), a publication of Warren, McVeigh & Griffin, Inc., independent risk management consultants.

The Risk Management Letter focuses on important news and information for professionals involved with risk and insurance issues.

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## **Retrospective Rating Plans: A Joint Management Process**

*Many insureds enjoy the benefits of retrospective rating plans that provide a contractual guarantee for the return of premiums for good loss experience. Nevertheless, disputes can arise when the insurance company is solely responsible for investigating, reserving and paying claims. The following is an analysis of the relationship between the insured and insurer when handling retrospective rating plans.*

*Volume 20, Issue 4 (1999)*

**BY JAMES BUKOWSKI AND BRAD DAVENPORT**

Retrospective rating plans (also called "retro plans") are a method of risk financing commonly used for workers' compensation (and third-party liability) loss exposures. Insurers typically offer retro plans to policyholders with good loss experience that are willing to assume the risk that premiums may increase should losses exceed those anticipated under the plan. Insureds choose retrospective rating plans because they provide a contractual guarantee (not just a dividend) for the return of premiums for good loss experience.

Under such plans the insurer adjusts, reserves and pays for claims mostly with the insured's own money, subject to the policy limits and the insured's loss assumptions in the retrospective rating formula. Such retro plans can pose a conflict of interest for an insurer and impose special duties toward the policyholder. Where disputes arise over the insurance company's handling of claims, courts have tended to place a burden of proof upon insurers to demonstrate why they believe particular claims were compensable and settlement amounts reasonable.

Disputes related to retro plans can be avoided if both the insurer and the insured work together in the managing of the claims. Retro plans work best when the insured diligently monitors the insurer's claims handling, conducts periodic audits of claim files, keeps good records of the retro calculations and meets with the insurer's claims staff to discuss findings and continuous improvement.

### **Retro Plan Mechanics**

Retrospective rating plans are probably familiar to most *Risk Management Letter* readers. Retro plans are a form of "cost-plus" or "loss-sensitive" risk financing. The insurer calculates and collects a standard premium based upon the insured's payrolls and experience modification. The insurer determines the final premium retrospectively, at periodic intervals, based on the cost of claims incurred *during the policy period*. Each year, or until the insured and insurer agree otherwise, the insurer undertakes a "retro adjustment" and calculates either a refund of part of the premium (return premium) or an additional amount due (additional premium). The insurer also collects a fee for its

services, which is built into the retro formula as a percentage of the losses, payroll or standard premium.

The insurer's claims-handling role is critical for the proper working of a retrospective rating plan. As with any insurance program, an insured should know the insurer's claims-handling and reserving practices before entering into a retrospective rating plan. Unfortunately, disputes sometimes arise over how claims are handled under such plans. Some observers believe retrospective rating plans create an inherent conflict of interest between the two parties, the insurer and the insured.

### **Potential Conflict Of Interest**

A conflict of interest may exist because the insurance company is responsible for investigating, reserving and paying claims, but is not financially at risk (except for the amount of claims exceeding the plan per-loss or maximum limits). In essence, the insurance company handles the claims, but the money to pay for the claims comes from the policyholder.

Over the past 30 years, there have been numerous legal disputes involving retrospective rating policies. The typical complaint is that the insured believes that the insurer has paid and reserved too much for workers' compensation claims, causing the insured to pay additional premium. When faced with such additional premiums, some insureds have

refused to pay. This refusal in turn has prompted some insurers to sue their policyholders, or insureds have sued first, seeking a declaratory judgment or a refund of past premium overpayments.

The central issue facing courts in such situations is the "burden of proof." Does the *insured* have the burden to prove that the insurer has overpaid/overreserved? Or does the *insurer* have the burden to prove that it acted reasonably and properly in administering, paying and reserving workers' compensation claims. In the course of deciding this "burden" issue, the courts have analyzed in depth the nature and implications of retrospective rating policies.

### **Insurer's Duties To The Policyholder**

Insurance policies normally grant the insurer the right to investigate and settle claims within the policy limits without the permission or consent of the insured. Courts adjudicating insureds' claims against insurance companies routinely protect this right

## **Managing Retro Plans**

Insureds should consider the following points when managing their retrospective rating plans:

1. Understand that a retro program is a form of cost-plus or loss-sensitive risk financing. The insurance company, for the most part, is acting as a third-party claims handler with duties imposed by law toward injured workers.
2. Clarify with the broker and the underwriter the mathematics of exactly how the premium will be calculated and over what period of time.
3. Create and maintain a file with the original plan mathematics and a written agreement documenting all points.
4. Designate someone in your company to monitor every claim on a monthly or quarterly basis. This should include reviewing copies of the insurer's written claims reviews and reserving calculations.
5. Conduct an annual claims review at least two months before the retro adjustment date, using internal, broker and insurer personnel. The review should consider (a) the claim status last year, (b) claim developments during the past year, and (c) the prognosis and plan to close the claim. These meetings should be documented, and copies of the meeting minutes should be sent to the insurer, the insurer's claims department and your company's retro file.
6. If more than one retro year is running (as is often the case), the claim review should be conducted for each individual retro year.
7. Require the insurer to notify your company of every hearing or claims review requested by the state or injured party, and to provide you with a written summary of the process.
8. Continue this review process until the actual retrospective agreement is finalized in writing. Even after a plan maximum premium has been reached, claims need attention because the incurred reserves may not have been paid out and all losses affect the experience modifier.

of the insurer, recognizing that the insurer's money is at stake.

Most courts have recognized that retrospective rating insurance policies 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 of these decisions are (1) the inherent conflict of interest under retrospective rating policies, and (2) the duty of good faith placed on insurers who settle and pay claims, in effect, with their policyholder's money.

The courts have held a potential conflict of interest exists between an insurer and a policyholder if claim settlements impose residual consequences on the policyholder in the form of additional premiums. Because the amount of retrospective premiums charged and insurance company income is based on settlement amounts, claim reserves and administrative expenses, insurers sometimes are alleged to conduct indifferent investigations and make unreasonably generous settlements to claimants. Even under the best circumstances, an insurer administering a retrospective rating policy does not have the usual incentive to minimize settlements, reserves and expenses to save *itself* money.

The second key aspect, the duty of good faith, relates to the fact that an insurer's decision to settle a claim has a direct economic effect on the policyholder. This is similar to the effect 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.

### **Burden Of Proof**

Most courts have found that policyholders have the right to sue an insurer not acting in good faith in administering a retrospective rating policy. The courts are less clear about who has the burden of proof: the *policyholder* (to prove that the insurer acted improperly) or the *insurer* (to prove that it acted properly). Insurers usually want the policyholder to bear the burden because it is the one challenging the reasonableness of the insurer's actions. Insurers argue they would face exorbitant administrative and legal expenses if forced to prove the reasonableness of every challenged workers compensation claim.

Nevertheless, courts have tended to place the burden of proof with insurers. This means that insurers can be asked to demonstrate why they believe particular claims were compensable and settlement amounts reasonable. Insurers have been required in many cases to produce documents in the form of accident, medical and investigative reports, and most importantly, recommendations from the responsible adjuster and lawyer. Placing such documents in evidence usually answers the question why insurers have settled claims or set case reserves.

An insurer, therefore, must be prepared to demonstrate its good faith and reasonableness once a policyholder questions the insurer's actions. The primary reason for this is that the insurer is the party responsible for investigating and adjusting claims and has the relevant information in its possession. The policyholder likely will not have this information in its possession because it has delegated the right and duty of investigation and settlement to the insurer. In essence, if the policyholder is to be charged retrospective premiums based on the 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.

## **Conclusion**

A retrospective rating plan works best when all parties realize the core issue is proper claims management. Retros are a joint management process in which each party has duties and rights that should be understood in advance. Insurers have the right to follow their claims best practices, reserve and settle claims and require timely additional premium when called for by the plan formula. Insureds have the right to understand and monitor their insurer's claims handling and reserving practices and retro calculations. When both parties carry out their duties competently, there are relatively few disputes regarding retro premiums and adjustments. ☞

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