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Retrospective Premium Clauses Create Wave of Litigation

THE STANDARD workers' compensation insurance policy contains a retrospective premium clause (RPC) that enables the carrier to recover from its insured additional premiums beyond the amount originally paid at the inception of the policy.

The amount of the retrospective premium, if any, is based on a calculation of the actual costs experienced by the carrier during the term of the policy. The factors considered by the carrier in determining the amount of the additional charge are set forth in the RPC and typically include the administrative expenses incurred in processing and investigating claims, together with the amount paid for losses.

As discussed below, because the use of RPCs create an inherent conflict of interest between the insurer and its insured, courts throughout the country have been confronted with a wave of retrospective premium litigation.

In retrospective premium cases, the insured employer questions its carrier's good faith in conducting claim investigations, setting reserves and settling claims on its behalf. The central allegation contained in its pleading is that the insurer breached the implied covenant of good faith and fair dealing found in every policy of insurance.

Of the 10 state courts[1] that have reportedly decided whether an employer's allegations of such a breach states a cause of action or defense, only New York[2] apparently has refused to recognize the employer's right to sue or defend a retrospective premium action based on the claimed breach of the implied covenant of good faith and fair dealing.

This article will provide a general synopsis of the law outside of New York and discuss the uncertain future

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of retrospective premium litigation within the state.

Generally, in defending bad faith claims in the past, insurers relied on the standard policy provision that grants them the right to investigate and settle claims without their insureds' consent. Indeed, even today, insurers view such provisions as protection from challenges to their authority to dispose of claims in any matter they deem appropriate. In recent years, however, this defense has been rejected by many courts, which have held that the mere fact that an insurance contract gives the insurer the right to make claims decisions does not obviate its obligation to carry out this entitlement in good faith.

Inherent Conflict

Indeed, the majority of state courts that have found for the employer have done so based on the conflict of interest created by the use of RPCs. The conflict emanates from two sources.

First, since the amount of the retrospective premium due the insurer depends upon the settlement amounts and administrative expenses incurred in the previous year, the plan provides insurers with ample reason to conduct investigations with indifference to their insureds' interest or to make unreasonable settlements.

Moreover, considering the economics involved, such polices provide the unscrupulous insurer with a financial incentive to settle claims for unreasonable amounts, and therefore lends itself to further abuse.[3] In short, the more the insurer pays, the more the insured owes in retrospective premiums.[4]

The second source, a corollary of the first, is that under a retrospective premium arrangement, the insurer settles claims, in effect, with the insured's money.[5] The settlement costs are recovered by the insurer in the form of increased premiums.

As a result of the inherent conflict generated by retrospective premium plans, most courts have had little trouble imposing a duty upon insurers to act reasonably in settling claims and setting reserves.[6]

In most instances, these courts have viewed such a duty as being a logical extension of the rationale for holding insurers liable for breaching their duty of good faith in failing to settle claims within policy limits.[7]

Consequently, in these states, an employer's well pleaded allegations of bad faith are recognized as a legal defense to its insurer's action to recover retrospective premiums.

While, as noted above, other state courts have found insurers to be bound by the duty of good faith in implementing retrospective premium policies, New York courts have had few opportunities to address the issue.

In fact, only one New York State appellate court reportedly has had occasion to decide whether an insured may defend an action by its insurer to recover retrospective premiums by alleging the insurer's bad faith in investigating and settling claims — and that was almost 12 years ago. In *Hartford Acc. & Indem. v. Coastal Dry Dock*, the First Department held it did not and granted summary judgment to the insurer.[8]

To understand the potential impact the Hartford decision may have on future retrospective premium cases brought in New York, it must be examined within the context of its particular facts and considered in conjunction with the Court of Appeals recent decision in *Pavia v. State Farm Mut. Auto. Ins. Co.*[9]

In *Hartford*, the insurer sued its insured to recover retrospective premiums due under its workers' compensation policy. The insured raised the standard affirmative defenses, including, inter alia, improper investigation of submitted claims.[10]

In dismissing the insured's affirmative defenses and granting summary judgment to the insurer, the court apparently relied on two facts. First, the policy conferred upon the insurer the perfunctory right to "negotiate claims as it deem[ed] appropriate" and, second, the insured never objected prior to commencement of the action to settlement of any of the claims that formed the basis of the insurer's claim for retrospective premiums.[11] Thus, based on the expressed language of the policy and the acquiescence of the insured in questioning the premiums, the court concluded that the insured's affirmative defenses were "legally insufficient."[12]

At first blush, the *Hartford* court's decision would seem to be a sweeping victory for New York underwriters of retrospective premium policies — a confirmation of their absolute right to investigate and settle claims without having to account to their insureds. But is it? For the reasons that follow, the answer may be no.

First, the *Hartford* decision indicates that the dismissal of the insured's affirmative defenses could have been based on procedural grounds as much as the merits. In opposition to the insurer's motion for summary judgment, the insured submitted only an affidavit from its attorney, who did not have personal knowledge of the facts.

As the court noted, "such an affidavit is patently insufficient [to defeat a motion for summary judgment]."[13]

Because the insured offered insufficient proof to oppose the insurer's motion, the court would have been within its province to grant summary judgment based on this procedural deficiency alone.[14] Accordingly, the legal analysis that followed may be limited to dicta by subsequent courts attempting to construe the *Hartford* court's holding.

Second, even if the *Hartford* court's decision was based on the merits, its precise holding is ambiguous and therefore may result in a splintering among the other judicial departments.

For example, while acknowledging that the policy gave the insurer the right to investigate and settle claims, the court also stressed, in the same breath, that the insured never objected to the settlement of any of the claims included in the retrospective premium.[15] Thus, the court may have been more receptive to the insured's claim had such an objection been made.

Considering the contradiction in terms, it is difficult to discern whether insurers are immune from claims of bad faith or are subject to such defenses, provided the insured raised them in a timely matter and presumably well before commencement of the action.

Third, the Court of Appeals recent decision in *Pavia v. State Farm Mut. Auto. Ins. Co.*[16] casts serious doubt on any holding that would preclude an insured from maintaining a bad faith defense or claim based on the insurer's alleged failure to consider its interest in investigating or settling claims.

Although there have been few reported cases in New York involving retrospective premium litigation, the nationwide trend suggests that soon may change.

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Pavia involved the traditional third-party bad-faith claim where the plaintiff sought to hold the defendant carrier liable for an excess judgment because it failed or refused to settle a claim within policy limits. Although the plaintiff's claim was dismissed, the Court of Appeals reaffirmed the principle that an insurer may be held liable for the "breach of its duty of good faith in defending and settling claims over which it exercises exclusive control on behalf of its insured." [17]

In upholding the insurer's duty of good faith, the Court found it resulted from the conflict created when an insurer is given the absolute right to settle and investigate claims under an insurance policy. In particular, the Court noted that the parties' respective interests are different, to wit: "... the insurer's interest in minimizing its payments ... [as compared to] ... the insured's interest in avoiding liability beyond the policy limits." [18] By imposing a duty of good faith, the insurer's unfettered right to settle claims is made conditional.

The duty of good faith has been imposed in similar instances where the settlement of claims by the carrier makes the insured liable for the deductible.[19]

For example, recently, in *Commerce & Indus. Ins. Co. v. North Shore Towers Mgt. Inc.*, Judge Marcy Friedman of the New York City Civil Court noted that "... cases involving settlements within a deductible also present a potential conflict between the insured's interest in paying as small a part of the deductible as possible, and the insurer's interest in limiting its own exposure to liability by ensuring a settlement within the deducible, or in avoiding litigation expense to seek dismissal of a claim which may readily be settled within the deductible." [20]

Accordingly, in these situations, Judge Friedman concluded that the insurer's right to settle claims must be made conditional on it doing so in good faith.

As for what constitutes a breach of the insurer's duty of good faith, the Court of Appeals stated in *Pavia* that the insurer may be held liable where it shows a gross disregard for the insured's interest, i.e., a deliberate or reckless failure to place on equal footing the interests of its insured with its own interests when considering a settlement offer.[21]

The insured can prove the insurer's gross disregard for its interest by showing that the insurer rejected or failed to settle a claim within policy limits when opportunity to do so was presented at a time "... where the liability is clear and the potential recovery far exceeds the insurance coverage." [22]

Importantly, the *Pavia* Court also stated that the insured can introduce evidence of the "... insurer's failure to properly investigate the claim ..." to demonstrate that the insured did not possess the information necessary to make an informed decision of whether to settle.[23]

Consequently, in cases where the insurer settles a claim within the insured's deductible without conducting an earnest investigation, the insurer may be exposed to a bad faith claim,[24] particularly since it would be difficult for the insurer to maintain that it put its insured's interest on par with its own in settling the claim.

In fact, in denying the insurer's application for summary judgment in *Commerce & Indus. Ins. Co.*, Judge Friedman found the conflict present in these cases to require the imposition of a duty upon the insurer to investigate claims properly. Failure to do so, the court said, would "effectively immunize [the insurer] from any inquiry into its good faith in settling the claims, and would make the good faith obligation one in name only." [25]

By contrast, the *Hartford* court never considered the conflict RPCs present or whether a duty of good faith was needed to safeguard insureds against abuse by insurers. At the time of its decision, all other state courts having been confronted with the issue favored imposing such a duty upon insurers.

The *Hartford* decision, however, is silent as to those other decisions, perhaps because the court believed it was deciding the case on procedural grounds.

Whatever the true holding of *Hartford*, one thing is clear. When the principles espoused by the *Pavia* Court are combined with the precept that the insurer may be held liable for settling claims within the deductible in bad faith, it is apparent that other New York courts may apply the same analysis to retrospective premium litigation cases and find that employers are required to investigate and settle claims in good faith.

In doing so, these courts will find support under the New York bad faith rule that imposes a duty of good faith upon the insurer in most instances where a genuine conflict exists between it and its insured.

Conclusion

Although there have been few reported cases in New York involving retrospective premium litigation, the nationwide trend suggests that soon may change.

In anticipation of a maelstrom of new court filings, in-house and outside counsel for New York insurers need to reacquaint themselves with the law governing retrospective premium litigation in the state.

The law in New York is less than certain. Nevertheless, by assimilating the cases touched upon in this article, counsel will be able to form opinions and advise their clients accordingly.

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(1) See *Transport Indemnity Co. v. Dahlen Transport Inc.*, 161 NW2d 546 (Minn. S.Ct. 1968); *Insurance Co. of No. Amer. v. Binnings Const. Co. Inc.*, 288 So2d 359 (La. Ct.App. 1974); *Transit Cas. Co. v. Topeka Transp. Co. Inc.*, 8 Kan. App2d 597, 663 P.2d 308 (Kan. Ct.App. 1983); *Deerfield Plastics v. Hartford Ins.*, 404 Mass 484, 536 NE2d 322 (S.Ct. 1989); *Corrado Bros. v. Twin City Fire Ins. Co.*, 562 A2d 1188 (Del. 1989); *Austin Co. v. Royal Ins. Co.*, 842 SW2d 608 (Tenn. App. 1992); *National Sur. Corp. v. Fast Motor Serv.*, 213 Ill. App3d 500, 572 NE2d 1083 (Ill. App.Ct. 1991); *Port East Transfer v. Liberty Mutual*, 330 Md. 376, 624 A2d. 520 (Md. 1993); *Security Officers Service v. S.C.I.F.*, 21 Cal2d 653, 17 Cal. App. 4th 887 (Cal. Ct.App. 1993).

(2) See *Hartford Acc. & Indem. v. Coastal Dry Dock*, 97 AD2d 724, 468 NYS2d 876 (App. Div. 1st Dept. 1983).

(3) See generally *Transport Indemnity Co. v. Dahlen Transport Inc.*, 161 NW2d 546 (Minn. S.Ct. 1968); *National Sur. Corp. v. Fast Motor Serv.*, 213 Ill. App3d 500, 572 NE2d 1083 (Ill. App.Ct. 1991); *Binnings Const. Co. Inc.*, 288 So2d 359 (La. Ct.App. 1974); *Transit Cas. Co. v. Topeka Transp. Co. Inc.*, 8 Kan. App2d 597, 663 P2d 308 (Kan. Ct.App. 1983); *Port East Transfer v. Liberty Mutual*, 330 Md. 376, 624 A2d 520 (Md. 1993).

(4) *Marten Transport v. Hartford Specialty*, 21 Cal2d 653, 17 Cal. App. 4th 887 (Cal. 2d Dist. 1993).

(5) *Port East Transfer v. Liberty Mutual*, 330 Md. 376, 62 A2d 520 (Md. Ct.App. 1993).

(6) Although, with the exception of New York, the state courts have uniformly upheld an insured's right to sue or defend an action based on its carrier's failure to reasonably settle claims and reserves, they are sharply divided on the issue of who bears the burden of persuasion or production. See compare cases found in n.2.

(7) *National Sur. Corp. v. Fast Motor Serv.*, 213 Ill. App3d 500, 572 NE2d 1083 (App. Ct. 5th Dist. 1991).

(8) 97 AD2d 724, 468 NYS2d 876 (App. Div. 1st Dept. 1983): See also *Midland Ins. Co. v. Sealand Term. Corp.*, No. 82 Civ. 4744 (SDNY, March 14, 1984) (LEXIS, Genfed library, Dist. File) (following Hartford and granting summary judgment to insurer in retrospective premium action).

(9) 82 NY2d 45, 626 NE2d 445, 605 NYS2d 208 (Ct.App. 1993).

(10) *Hartford* at 725, 468 NYS2d at 877.

(11) Id.

(12) Id.

(13) Id.

(14) See *David Graubard, Inc. v. Bank Leumi Trust*, 48 NY2d 554, 399 NE2d 930, 423 NYS2d 819 (Ct.App. 1979) (holding that attorney's affirmation made without personal knowledge of the facts is incompetent to defeat motion for summary judgment).

(15) *Hartford* at 725, 468 NYS2d at 877.

(16) 82 NY2d 45, 626 NE2d 445, 605 NYS2d 208 (Ct.App. 1993). See also *Sota v. State Farm Ins. Company*, 882 NY2d 719, 635 NE2d 1222, 613 NY2d 352 (Ct.App. 1994).

(17) *Pavia*, at 45, 626 NE2d 445, 605 NYS2d 208.

(18) Id.

(19) *Commerce & Indus. Ins. Co. v. North Shore Towers Mgt. Inc. NYLJ*, Oct. __, 1994, at __, col. __ (citing *Orion Ins. Co. v. General Electric Co.*, 129 Misc2d. 466 (S.Ct. 1985); *United States Aviation Underwriters Inc. v. General Electric Co.* 125 AD2d 428; *Guarantee Ins. Co. v. City of Long Beach*, 106 AD2d 428 (App. Div. 2d Dept. 1984).

(20) Id.

(21) *Pavia*, at 45, 626 NE2d 445, 605 NYS2d 208.

(22) Id.

(23) Id.

(24) *Commerce & Indus. Ins. Co.* at page __, col. __.

(25) Id.