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INSURANCE FRAUD

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Retrospective Premium Policies And The Emergence Of A New Burden For Workers' Compensation Insurers

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Over recent years, workers' compensation insurers have experienced a surge in bad faith claims based on their use of policies containing a retrospective insurance premium feature.¹ Reasons for this surge include that insured employers have seen their premium payments explode to over \$70 billion annually, their average claim quadruple over the past 10 years to \$20 thousand per claim and the cost of fraud mushroom to an astounding 20-25 cents of every claim dollar paid by their insurers.

With projections for premiums, claims settlements and workers' compensation fraud not expected to ebb anytime soon, employers are looking to their workers' compensation carriers for answers. Indeed, insured employers are increasingly questioning the manner and vigor in which their carriers conduct claims investigations, set reserves and make settlements pursuant to such policies of insurance. The civil action that results, whether grounded in contract or tort, raises substantially the same allegation: the insurer's breach of the implied covenant of good faith and fair dealing contained in its policy of insurance.

COMMENTARY

Based on reported cases, to date, only nine states have decided whether an employer's allegations of such a breach states a cause of action or defense.² In each instance, the state courts have uniformly recognized the employer's right to sue or defend an action based on the claimed breach of the implied covenant of good faith and fair dealing.³

Generally, in finding for the employer, the courts have recognized that insurance policies containing retrospective premiums create an inherent conflict of interest between the insurer and its insured. The conflict emanates from two sources. First, since the amount of the retrospective premium due the insurer depends upon the amount of the settlements and administrative expenses incurred in the previous year, the plan provides the unscrupulous insurer with a financial incentive to settle claims for unreasonable amounts, and therefore lends itself to abuse.⁴ In short, the more the insurer pays, the more the insured owes in retrospective premiums.⁵

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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.⁶ 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, courts have had little trouble imposing a duty upon insurers to act reasonably in settling claims and setting reserves. 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 settling claims within policy limits.⁷

Although the state courts have been unanimous in upholding 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.

The Seminal Decision

The first reported case dealing with retrospective premiums is found in the seminal decision of Transport Indemnity Co. v. Dahlen Transport, Inc.⁸, where the Minnesota Supreme Court held that an insurer suing to recover additional premiums under a retrospective premium plan bears the burden of demonstrating that the amount it paid for losses and expenses was reasonable in amount and made in good faith.⁹ After noting the inherent conflict of interest created by such policies, the court stated that placing the burden upon the insurer is fair, especially considering it possesses "the information pertinent to the reasonableness and good faith of the settlement. . . ."¹⁰ Under the Transport Indemnity view, the insurer must come forward with proof concerning the reasonableness and good faith of any particular settlement.

Descendants of the Seminal Case

Over recent years, two different jurisdictional views have emerged from various state courts purporting to follow the seminal decision. While both views wholly adopt the rationale articulated in Transport Indemnity, they reach different conclusions with respect to its procedural underpinnings, particularly how the burden of proof and burden of production should be allocated in retrospective premium cases. The views adopted by these seminal case descendants will be referred to as the restrictive and expansive approach, respectively.

The issues confronted by these courts were confounding. For example, when a carrier sues its insured to recover retrospective premiums, does it bear the burden of proving good faith and the reasonableness of each claim it settled? And if so, does that mean the insurer must affirmatively plead reasonableness and good faith in its complaint? Or, should the insurer bear the burden of proving good faith and reasonableness only after the insured has placed in issue the question of the reasonableness of the insurers' settlements? Moreover, if the insured does put in issue the reasonableness of the insurers' settlements, does that mean that the insurer must prove the good faith and reasonableness of each claim settled or does it only bear the burden of proof with respect to particular claims the insured has disputed and placed in issue?

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The Expansive Approach

The expansive approach embodied in the Kansas' Court of Appeals decision in Transit Cas. Co. v. Topeka Transp. Co., Inc.¹¹, resolved the procedural issue by holding that the insurer, as part of its case in chief, must bear the burden of demonstrating probable liability for each claim and that the amounts paid were reasonable. Presumably, under this view, an insurer would have to plead in its complaint (as well as prove at trial) that it acted reasonably and in good faith in settling each claim processed for its insured. A complaint failing to make these central allegations would be subject to dismissal for failure to state a cause of action.¹²

The Kansas court's approach is expansive because it places an affirmative burden upon the insurer to prove good faith and the reasonableness of its settlements with respect to every claim, even those not in dispute. Under this approach, even if the insured does not question the reasonableness of any particular settlement, the insurer must lay bear all of its files and prove the reasonableness of all of its settlements to prevail in court. Thus, rather than narrowing the scope of the litigation to questioned claims, the expansive view casts a wide net around all of the insurer's settlements. To satisfy this heavy burden, the insurer, at great expense, must introduce into evidence every file that factored into its claim for retrospective premiums. It is of no consequence that it may require the production of hundreds of files, many of which may not be in dispute.¹³

The Restrictive Approach

Perhaps seeing the inequities engendered by the expansive approach, a second jurisdictional view has emerged that restricts the scope of retrospective premium litigation. Under the restrictive approach, the insurer continues to bear the burden of proof, but only once the insured places in issue the reasonableness of specific settlements.¹⁴ In other words, it is not until the insured, who bears the burden of production, raises the defense of unreasonableness to a particular settlement that the burden shifts to the insurer to prove good faith and that the settlement was made on reasonable terms.

Once the insured properly places in issue the reasonableness of specific claim settlements made by the insurer, the burden shifts to the insurer to show it is entitled to the premiums sought.¹⁵ To satisfy its burden in this regard, it is incumbent upon the insurer to produce evidence demonstrating there was good a faith belief of probable liability and that the amount of each disputed settlement was reasonable.

The insurer's files will be the likely source of its evidence. Indeed, the medical records, investigative reports, accident reports, adjusters' recommendations and lawyers' recommendations contained in its files will usually bear strongly on the issue of its good faith belief of probable liability.¹⁶ As for the reasonableness of any particular settlement, the insurer generally will have to prove that the amount of the settlement was reasonable.

Moreover, if the insured has introduced evidence that the insurer was negligent in handling its investigation, the insurer must show that the amount of its settlement did not "exceed the highest reasonable amount at which the claim would probably have been settled if the claim had been properly investigated."¹⁷ Presumably, proof of settlement of similar claims for similar amounts within the company and the industry would satisfy this burden.

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By placing the burden of production in retrospective premium cases on the insured, the restrictive approach streamlines the litigation to only those claims that are actually questioned. In addition, it achieves a fair compromise between the parties. While the insured bears the burden of production and must come forward with evidence of unreasonableness, it is the insurer, as the plaintiff, that ultimately bears the burden of proof. In keeping the burden of proof with the plaintiff, the restrictive approach conforms to the underlying rationale found in the seminal decision, to wit: it requires the insurer to come forward with the documents in its possession and imposes the burden on the plaintiff, the party who traditionally bears the burden of proof.

The Minority View

Finally, there is a third jurisdictional view that substantially follows the restrictive approach, with one notable exception: it creates a presumption of good faith and reasonableness in favor of the insurer. This view, set forth by the Louisiana Court of Appeals in Insurance Co. of No. Amer. v. Binnings Const. Co., Inc., holds that once an insurer in an action to recover retrospective premiums shows payment of settlements, it is entitled to a presumption of good faith in making the settlements. Once the insurer makes this *de minimis prima facie* showing, the burden shifts to the insured to cast "sufficient doubt" on the reasonableness of any particular settlement. If the insured is successful in this endeavor the burden shifts back to the insurer to demonstrate the reasonableness of the settlements contested by the insured.¹⁸

The Louisiana view reflects the minority view and its presumption of good faith standard has not been adopted by any other court. The reason is simple. The creation of the presumption represents only one method of allocating the burden of production to the insured. If a court wishes to saddle the insured with the burden of production, a presumption in law is not necessary to accomplish that objective.

Moreover, such presumptions are often difficult to administer fairly. In declining to adopt the presumption in law standard enunciated by the Louisiana Court of Appeals, the Supreme Court of Maryland stated: "because the creation of a presumption carries with it potential complications . . . , we elect to fix this burden of production without accompanying it with a presumption. The allocation is simply a device for predetermining who shall have the burden of producing sufficient evidence to legitimately create an issue. When the burden of production is satisfied, and the issue is therefore properly before the trier of fact, the plaintiff insurer will shoulder the burden of persuasion on the issue." After rejecting the presumption in law view, the court proceeded to follow the restrictive approach; the insured bears the burden of production and, if properly placed in issue, the insurer bears the burden of proof.

In synthesizing the various approaches, insurers utilizing a retrospective premium plan would be well advised to heed the following words of caution. First, they must be cognizant of the fact that they bear the ultimate burden of proof in any action to recover retrospective premiums. Consequently, the insurer must be prepared to open its files to the insured and eventually the jury. Therefore, as unpleasant as it may be, its files must be maintained with a view toward litigation and must support a finding of probable liability. This means maintaining investigative reports and other documents from which a jury could reasonably make such a finding. Moreover, the file must contain adjusters' recommendations and evaluations bearing on the reasonableness of the settlement. Absent either one of these showings, the insurer will not recover its retrospective premiums.

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Second, to accomplish the above, insurers must let go of traditional positions that find no support in law. For example, because of the inherent conflict found in retrospective premium policies, insurers can no longer maintain they have the sole, unfettered right to settle claims. The courts readily distinguish these policies from those that have policy limits in which insurers usually enjoy absolute control over settlements.¹⁹ Indeed, when the fact that workers' compensation policies do not have limits is considered in conjunction with the nature of retrospective premium plan, courts have been quick to hold that insurers owe a duty to their insureds to settle claims for reasonable amounts and in good faith. Consequently, an insurer cannot expect to recover additional premiums by merely showing claims were made and paid. As indicated above, more is required and only the foolhardy would ignore this fact.

The Insured May Maintain a Direct Cause of Action For Breach of its Duty of Good Faith

The jurisdictional views delineated above relate to instances where the insurer sues its insured to recover premium payments due under a retrospective premium policy. In these cases, the insured may raise the unreasonableness of a particular claim as an affirmative defense. It is important to note that insureds may maintain, and have increasingly been maintaining, direct causes of actions against their insurers for overpayment of premiums.²⁰

While in these cases it is the insured that bears the burden of proof, there is one important distinction. The insured need only prove that the insurer was negligent in the handling or investigating of particular claims, which as a result of the retrospective premium feature, could have subjected it to higher premiums. Once proven by the insured, the burden shifts to the insurer to prove "that the settlement made on the claim did not exceed the highest reasonable amount at which the claim would have been probably settled if it had been investigated properly."²¹

At first blush, shifting the burden of proof to the insurer would appear to run afoul of the well established principle that the plaintiff should ultimately bear the burden of proving its case. However, when examined within the context of its progeny, the burden placed on the insurer is consistent with previous precedents. Indeed, the insurer is only being required to prove "that it is entitled to [the premium payments] under its policy of insurance and that it has met its obligation, imposed by law, to act reasonably in making settlements where the money of the insured is involved."²²

In defending an action brought by its insured, the insurer should be prepared to prove the reasonableness of its settlements. Absent such proof, it may find itself refunding premiums to its insured.

Conclusion

As the toll of workers' compensation fraud increases the cost of doing business, employers will continue to seek to hold their carriers accountable. Stripped of their once unfettered right to settle claims, at least where retrospective premium arrangements are concerned, insurers will have to do battle on two fronts. First, insurers must increase their fraud detection and prevention systems to combat the impact of fraud. Second, they must ensure proper investigation of claims, document their findings, achieve reasonable settlements and set reserves that may not be attacked in court.

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ENDNOTES

1. A retrospective premium clause, found in the standard workers' compensation policy, allows the insurer to charge additional premiums beyond the amount originally paid at the inception of the policy based upon actual costs experienced by the carrier during the period covered by the original premium. Generally, the amount of additional premiums, if any, are based on a number of factors, including administrative expenses incurred in processing and investigating a claim, the amount paid for losses and profit.

2. See Transport Indemnity Co. v. Dahlen Transport, Inc., 161 N.W.2d 546 (Minn. S.Ct. 1968); Insurance Co. of No. Amer. v. Binnings Const. Co., Inc., 288 So.2d 359 (La. Ct. App. 1974); Transit Cas. Co. v. Topeka Transp. Co., Inc., 8 Kan. App.2d 597, 663 P.2d 308 (Kan. Ct. App. 1983); Deerfield Plastics v. Hartford Ins., 404 Mass 484, 536 N.2d 322 (S. Ct. 1989); Corrado Bros. v. Twin City Fire Ins. Co., 562 A.2d 1188 (Del. 1989); Austin Co. v. Royal Ins. Co., 842 S.W.2d 608 (Tenn. App. 1992); National Sur. Corp. v. Fast Motor Serv., 213 Ill. App.3d 500, 572 N.2d 1083 (Ill. App. Ct. 1991); Port East Transfer v. Liberty Mutual, 330 Md. 376, 624 A.2d. 520 (Md. 1993); Security Officers Service v. S.C.I.F., 21 Cal.2d 653, 17 Cal. App.4th 887 (Cal. Ct. App. 1993).

3. Id.

4. See generally Transport Indemnity Co. v. Dahlen Transport, Inc., 161 N.W.2d 546 (Minn. S.Ct. 1968); National Sur. Corp. v. Fast Motor Serv., 213 Ill. App.3d 500, 572 N.2d 1083 (Ill. App. Ct. 1991); Binnings Const. Co., Inc., 288 So.2d 359 (La. Ct. App. 1974); Transit Cas. Co. v. Topeka Transp. Co., Inc., 8 Kan. App.2d 597, 663 P.2d 308 (Kan. Ct. App. 1983); Port East Transfer v. Liberty Mutual, 330 Md. 376, 624 A.2d. 520 (Md. 1993)

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

6. Port East Transfer v. Liberty Mutual, 330 Md. 376, 62 A.2d 520 (Md. Ct. App. 1993).

7. National Sur. Corp. v. Fast Motor Serv., 213 Ill.App.3d 500, 572 N.2d 1083 (App. Ct. 5th Dist. 1991).

8. 161 NW2d 546 (Minn. Sup. Ct. 1968)

9. Id.

10. Id. According to the Minnesota Supreme Court, this is so because, under the policy, the insurer is the party charged with investigating and adjusting losses and therefore it will have in its possession all relevant information relating to claims made thereunder. Similarly, by delegating the responsibility for investigating and adjusting claims to the insurer, the court also found that the insured had "put the information critical to the issue of reasonableness and good faith in the exclusive possession of the insurer.

11. Transit Cas. Co. v. Topeka Transp. Co., Inc., 8 Kan.App.2d 597, 663 P2d 308 (Ct. App. 1983)

12. Cf. Port East Transfer v. Liberty Mutual, 330 Md. 376, 624 A.2d. 520 (Md. 1993) (declining to require the insurer to specifically allege in its complaint or prove as part of its case in chief the reasonableness and good faith of settlements made).

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13. The court brushed aside arguments that requiring the insurer to prove reasonableness and good faith as part of its case in chief overburdened the insurer and was imprudent use of judicial resources. The court found such fears to be exaggerated, since all of the evidence needed to prove these two factors should be in their files and therefore readily available.

14. See Deerfield Plastics v. Hartford Ins., 404 Mass 484, 536 N.2d 322 (S. Ct. 1989); Corrado Bros. v. Twin City Fire Ins. Co., 562 A.2d 1188 (Del. 1989); National Sur. Corp. v. Fast Motor Serv., 213 Ill. App.3d 500, 572 N.2d 1083 (Ill. App. Ct. 1991); Port East Transfer v. Liberty Mutual, 330 Md. 376, 624 A.2d. 520 (Md. 1993); Security Officers Service v. S.C.I.E., 21 Cal.2d 653, 17 Cal. App.4th 887 (Cal. Ct. App. 1993).

15. Id.

16. See Transp. Cas. Co. v. Topeka Transp. Co., Inc., 8 Kan.App.2d 597, 663 P2d 308 (Ct. App. 1983).

17. Deerfield Plastics v. Hartford Ins., 404 Mass. 484, 536 N.2d 322.

18. See Binnings Const. Co., Inc., 288 So.2d 359 (La. Ct. App. 1974).

19. See National Sur. Corp. v. Fast Motor Serv., 213 Ill. App.3d 500, 572 N.2d 1083 (Ill. App. Ct. 1991) (stating that the general rule that the insurer is given broad discretion in adjusting claims as long as the settlement does not exceed policy limits is irrelevant where the policy limits are not a set figure). See generally Port East Transfer v. Liberty Mutual, 330 Md. 376, 624 A.2d. 520 (Md. 1993); Transport Indemnity Co. v. Dahlen Transport, Inc., 161 NW2d 546 (Minn. Sup. Ct. 1968).

20. See Deerfield Plastics v. Hartford Ins., 404 Mass. 484, 536 N.2d 322 (S. Ct. 1989); National Sur. Corp. v. Fast Motor Serv., 213 Ill. App.3d 500, 572 N.2d 1083 (Ill. App. Ct. 1991).

21. Id.

22. Id.



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