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Resurgence of the Retro Premium

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While most would agree that the recent trend toward consolidation in the insurance industry has affected policyholders in a myriad of unquantifiable ways, at least one development has been decidedly quantifiable—the resurgence of the retrospective premium.

Like any post–merger and acquisition entity, insurance company successors to legacy coverage seek to maximize the value of the deal by identifying business synergies and other ways to reduce costs. What might not be immediately intuitive is that these successor insurer entities are also seeking to increase revenues, despite the fact that many of them are not actively writing new premiums. One major way, made famous by Berkshire Hathaway's insurance arm, is the float—paid-in premiums that can be invested until claims have to be paid. As of the third quarter of 2016, Berkshire was sitting on over $90 *billion* of float. While these aren't profits per se, the funds can be used to fund investment opportunities and generate earnings.

A much less publicized revenue source for insurance company successors to legacy coverage is retrospective premiums. Many have cited insurance market consolidation trends as the reason so many policyholders have recently found themselves on the receiving end of an unexpected retrospective premium bill. The theory goes that the new insurance company gives the claim files a fresh look, finds evidence that policies were retrospectively rated, and begins issuing bills based on an "updated" analysis. Depending on the coverage, premium language, and the size of the underlying liabilities, these bills can range from tens of thousands to tens of millions.

What Are Retro Premiums?

Retrospectively rated premiums—more commonly referred to as "retro premiums" or simply "retros"—represent a bet by an insured on its future losses. A retro premium program provides a company with the ability to pay a reduced premium up front with the understanding that additional premiums may become due at a later date based on the company's actual loss activity. The retro premiums can remain open for years or even decades after the policy was purchased. If loss activity is low, the policyholder actually saves money in the long run compared with a standard flat premium program. The flipside is that if loss activity is *not* low, the policyholder may ultimately pay more over the long run than if the policyholder had paid a flat premium up front. In retrospect, this presents a classic agency problem—the company's insurance buyer reaps the internal political rewards of reducing costs, while the company may be left paying the price long after the purchaser is gone. While retro premium agreements can have temporal contractual limitations, they normally remain open indefinitely.

Little guidance exists to educate an attorney on the workings of retrospective premiums. The retro agreements usually call for arbitration, resulting in very little case law on the topic. Moreover, the language contained within the retro agreements is often manuscripted, making it opaque and inaccessible to the ordinary reader and challenging to follow even for seasoned coverage attorneys.

Although retro agreements are typically effected through an endorsement attached to the underlying insurance policy, policyholders and insurance companies sometimes entered into entirely separate agreements, referred to as "indemnity agreements," which may not be attached to the policy. Historically, retro premium agreements are most common in workers' compensation; however, they are found in many lines of coverage. A company may have, for example, a single retro program that includes workers' compensation, employers' liability, general liability, and auto liability coverages. As many types of claims typically develop during or soon after the policy period, recent retro premium controversies generally arise out of long-tail claims falling under the general liability coverage (such as asbestos claims and environmental exposures). While these long-tail exposures may precipitate the retro premium dispute because they give rise to more recent claims, ultimately all covered claim types filed since the policy inception are relevant due to the cumulative nature of most retro calculations.

How Do Retro Premiums Work?

Generally, retro premiums include two main components: (1) a basic or fixed premium, typically paid up-front and reflective of some percentage of the "standard premium" that would have been paid if the policy was not retrospectively rated (e.g., 30 percent of the standard premium), and (2) an additional premium calculated based on the policyholder's actual losses. A typical retro formula might look something like the following (although the contract is rarely written this clearly):

*Retro Premium = [(Basic or Fixed Premium) + (Incurred Losses * Loss Conversion Factor)] * Tax Multiplier*

The basic or fixed Premium, loss conversion factor, and tax multiplier are typically laid out in the retro agreement. The loss conversion factor generally exceeds 1, which means any losses included in the retro formula are completely passed through to the policyholder, along with some small additional premium (e.g., a loss conversion factor of 1.1 would mean that the policyholder is paying at least a 10 percent markup on losses in exchange for "claims handling"). The tax multiplier often varies by state, which generates added complexity to the application of the formula. This leaves incurred losses as the key variable in the amount of retro premium due.

The terms of the policy dictate that the premium is to be recalculated at regular intervals, often every 12 months. At each interval, the insurance company calculates the aggregate premium due under the policy since its inception (including amounts

paid up-front or in prior periods) and then deducts total premium paid to date. The resulting figure becomes the invoiced amount for that 12-month period. Invoices are generated in regular intervals until claims cease or until the insurance company and policyholder agree to an alternative arrangement.

What losses are included in incurred losses? The definition of incurred losses varies among retro agreements. At a minimum, retro premium calculations include historical indemnity spending for claim types covered by the retro agreement. Oftentimes the retro premium calculation also includes historical defense spending as well. Because retro premiums are most commonly found in primary (first-dollar) coverage, inclusion of defense costs in the retro can be particularly problematic for policyholders as defense costs are typically uncapped by the terms of the policy itself.

Can the insurance company bill for future exposures? In many cases, the definition of incurred losses includes reserves for future losses on the same basis as historical claim payments, meaning that if an insurance company sets a reserve for $2.5 million of future exposure related to asbestos claims, the terms of the retro agreement may allow it to include the full amount of those reserves in the retro premium calculation. Even if no claims are paid over a 12-month period, a new $2.5 million reserve can result in the policyholder receiving a retro premium invoice on the full $2.5 million or more, and the policyholder has an obligation to pay the invoice under the terms of the agreement. In turn, if that reserve is later reduced, the policyholder is due a refund from the insurance company.

Do policies with retro premiums provide any real insurance? The short answer is yes, but they typically provide much less coverage than the written limits indicate. At the highest level, many retro agreements include a maximum retro premium amount (also known as a plan maximum). Once the maximum retro amount is billed and paid, the policy continues to provide coverage for the policyholder until the applicable policy limits are reached. Many retro agreements also incorporate what's referred to as "loss limitations" or "loss limits," limits on the amount of losses, by claim or coverage type, that can be included in the retro premium calculation.

Challenges Presented by Retro Premiums

Retrospective premiums represent a major burden on policyholder counsel handling long-tail claims. Usually, the policyholder has limited institutional memory over the retrospective premiums. The risk manager who arranged for the program many years earlier to get a lower initial premium probably is long gone. The best case scenario, though still one that requires an investment of resources, is that the policyholder maintained its records such that it is able to evaluate the policy and the retro premium provisions, and make educated and strategic decisions about if and how to tender claims. In a less ideal scenario, the policyholder first seeks coverage and is then left to deal with the consequences. For example, a policyholder and its attorney may have no idea that the policies on which they are suing are retrospectively rated,

and the insurance company may not tell them before claims are paid. In this case, the policyholder counsel may resolve the coverage litigation and look like a hero—until the insurance company sends a retro bill to the policyholder for an amount greater than the coverage settlement.

The situation described above may sound like an extreme scenario; however, it is a familiar one. Once dealt the unfortunate hand of an unexpected retro premium bill, counsel has many challenges ahead to assessing the accuracy and reasonableness of the amounts billed, but successful navigation of the issues may result in a reduced or entirely eliminated retro premium.

Arbitration. Essentially all retro agreements contain an arbitration provision. This can be harsh for the policyholder. Typically, each side to the arbitration selects one arbitrator, and those two select an umpire. The agreement may require that the party arbitrators must be existing or former executives of an insurance company or insurance brokerage. Finding such an individual is likely not a burden for the attorney representing the insurance company. Insurance companies frequently find themselves in retro arbitrations, and they may have a stable of potentially qualified arbitrators on which they can rely. Unfortunately, the challenge faced by the policyholder in identifying and retaining a qualified arbitrator is decidedly different. Many (and perhaps most) qualified individuals with retro experience who worked for an insurance company may not want to serve as party arbitrator for a policyholder. One source for policyholders may be the risk manager or chief financial officer who served as an executive of a captive insurance company. Generally, though, it is difficult for a policyholder to find a former or existing executive from an insurance company or broker, experienced in retrospective premiums, to serve as party arbitrator.

Prevailing law in arbitration. Typically, there isn't any. Although a retro agreement may have a choice of law provision (usually New York), it is generally ruled by equitable considerations. For example, the retro language from one policy states that disputes should be settled "according to an equitable rather than a strictly legal interpretation." Difficulty in interpretation of retro agreements is exacerbated because the terms used in the agreement do not always match the terms of "standard" insurance coverage parlance. For example, the key term in a retro agreement may be "incurred losses," which may counterintuitively be defined to include reserves for future losses and insurance incurred but not reported.

Legacy coverage with multiple corporate entities. Policies with retro premium provisions often were issued 20, 30, or 40 years ago. Much likely has changed in the intervening period, including the corporate structure of the named insured. For example, a subsidiary entity included as an additional named insured on a policy in the 1970s may have been sold or spun-out at some point since, and depending on the terms of the underlying separation agreement, both entities may have rights to the coverage. This presents at least two potential issues. First, the motivations of the two

entities may no longer be aligned; each insured will likely seek to maximize the value of its respective insurance asset. Assuming the retro is capped at some maximum, the timing of when claims are presented under the policy becomes extremely important. Depending on the separation agreement between the companies, the entity to tender its claims under the policy first may be stuck holding the bag for the retro premiums, while the other insured may tender later claims and potentially reap the benefits of the "real" insurance. Second, the insurance company generally doesn't track the corporate succession of the various named insureds on its policies, so it may pay claims for a subsidiary that was spun-out and then send the retro premium invoice to the old corporate parent. Given the opacity of most retro premium invoices, the old corporate parent may pay the bill without realizing it's paying another entity's claims.

Trigger and allocation. For reasons in addition to those described above, retro premiums are particularly problematic for defendants of long-tail claims because these claim types often have open questions related to trigger and allocation. For example, depending on a given state's prevailing case law, losses related to asbestos claims may trigger several years of coverage. Retro provisions contained in primary policies often have terms that vary from year to year, even if issued by the same insurance company. Thus, primary carriers handling the claims are then presented with a decision about how to allocate the claims in question among carriers or among policy years, which is often done without the policyholder's knowledge or input. It's also possible that a single insurance company issued coverage with retros in certain years and without retros in others. This also results in misaligned incentives between the insurance company and policyholder—the insurance company may have an incentive to allocate losses against years with retros or with retro terms most favorable to it, whereas the policyholder may have "real" coverage elsewhere in the program. Due to the misaligned incentives, it is especially important when retros are involved for counsel to have a seat at the table when discussing how losses should be allocated over multiple periods.

The role of reserves. As mentioned above, claim reserves (as set by the insurance company) are often billable to the policyholder under the terms of the retro agreement. While this may be entirely within the rights of the insurance company subject to the terms and conditions of a particular retro agreement, it is important that such reserves are tracked over time so that they can be adjusted to match actual claims experience. For example, if a reserve of $500,000 is set for an asbestos claimant that ultimately settles years later for $200,000, the insurance company is obligated to apply a $300,000 credit to the incurred loss total on the subsequent invoice—which could result in a refund to the policyholder if there is no offsetting claims activity. Similarly, the insurance company may set a reserve not at the claim level but at the claim-type level (e.g., a large single reserve for asbestos claims instead individual reserves by claimant). These are even more difficult for the policyholder to track over time and easier for the insurance company to leave in place unless it has a sufficiently convincing basis to believe there will be no future

liabilities. Counsel have had some success challenging those reserves for reasonableness as the policyholder's docket matures.

Insurance company obligations and retro expiration. In the most straightforward of retro agreements, the terms clearly lay out exactly how many retro invoices are to be issued at regular intervals until the retro is considered "final" and no more invoices may be issued. In the more typical retro agreements, the insurance company has an obligation to issue an open-ended number of invoices at regular intervals, typically every 12 months. Many of the more recent retro premium disputes relate to retros that have been dormant for many years, often long forgotten by a legacy insurance company only to be revived by its successor. The question arises as to whether the insurance company breached the retro agreement in its failure to issue invoices as regularly as required. If the insurance company fails to issue invoices as regularly as obligated under the agreement, has it breached its obligations such that the policyholder no longer has an obligation to pay?

Loss limits as distinct from policy limits. As discussed above, retros often employ loss limits to limit the amount of losses that can be included in the retro premium. Loss limits are typically less than the stated policy limits, resulting in real insurance for losses in excess of the loss limits. For example, a retro agreement might have a loss limit of $150,000 per person on workers' compensation coverage, but the policy limits may be $250,000 per person. On the general liability side, loss limits can be stated with or without aggregate limits but aren't necessarily always reflective of the aggregate features of the underlying policy. For example, a policy may be strictly without aggregate limits for non-products property damage, but the retro may step in and impose an aggregate loss limit for non-products property damage. Similarly, a three-year policy may provide an annual aggregate for claims falling within the products hazard, but the retro may step in and have a single aggregate loss limit for the entire three-year period. Keeping track of the various ways the retro agreement's loss limits may diverge from the underlying policy limits creates substantial challenges to accurate retro premium calculations.

Lessons Learned

While the commentary above should give counsel a working knowledge of the typical retro premium and a sense for the common challenges retro premiums present, it should be considered a primer. Each new retro dispute brings with it a new set of facts and circumstances and, as a result, a unique set of issues. Above all, counsel should be proactive in its approach to retro premiums:

- Review policies for retro premium language—becoming aware of retro language prior to tendering claims will have counsel ahead of the game.
- Seek to understand how each policy's specific retro premium is calculated—most importantly, what types of losses are subject to the retro and whether they are capped.

- If possible, review prior retro invoices sent by the insurance company—when compared with the terms of the retro, these invoices will inform counsel whether loss limits or plan maximums (or both) have been met, which will be a key determinant to assessing the availability of coverage.

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