

*Adopted by Receivership Large Deductible Worker’s Compensation (E) Working Group on 10/14/19.  
Adopted by Receivership & Insolvency (E) Task Force 12/8/19.  
Adopted by Financial Condition (E) Committee 12/9/19.*

**Proposed Changes to Receiver’s Handbook for Insurance Company Insolvencies**

**RE: Large Deductible Worker’s Compensation**

Inserts into Existing Handbook shown in “tracked” change.

Text between sections/pages eliminated to conserve space.

*Chapter 1 – Takeover & Administration (Page 30)*

**VIII. CLAIMS**

**A. Control the Claim Department’s Records**

Obtain copies of the insurer’s claim policies and procedures manuals. Review them to determine if the insurer has formal procedures that address the following areas:

- Actual claim processing flow;
- The level of claim file documentation required;
- The coverage confirmation process;
- Claims reserving and settlement philosophy;
- Claims settlement authority;
- Litigated claims;
- Aggregate policy procedures;
- Large Deductible Policy Procedures including collection, collateral and aggregates;
- Reinsurance recovery procedures;
- Theories relevant to property/casualty insurers, such as trigger theories for asbestos and environmental claims; and
- The insurer’s relationships with and responsibilities to managing general agents, TPAs, outside claim adjusters, reinsurance intermediaries and other outside parties.

*Chapter 1 – Takeover & Administration (Page 79)*

Checklist 6—Underwriting	Project Assigned To	Date Completed	Completed By	Notes
<b><i>Insurance</i></b>				
Locate, obtain copies and review all insurance policies and contracts: <ul style="list-style-type: none"> <li>• General Liability</li> <li>▪ Property</li> <li>▪ Auto</li> <li>▪ Workers’ Compensation</li> <li>▪ Fidelity Bond</li> </ul>				

Checklist 6—Underwriting	Project Assigned To	Date Completed	Completed By	Notes
<ul style="list-style-type: none"> <li>▪ Directors and Officers</li> <li>▪ <u>Large Deductible Endorsements</u></li> <li>▪ Errors and Omissions</li> <li>▪ Professional Liability</li> </ul>				

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Checklist 6—Underwriting	Project Assigned To	Date Completed	Completed By	Notes
<u><b>Large Deductible Policies</b></u>				
<u>Review underwriting, billing and collateral records to determine which policies have large deductible endorsements and the status of collateral held, billings, and reserve calculations</u>				

*Chapter 1 – Takeover & Administration (Page 102)*

Checklist 8—Accounting	Project Assigned To	Date Completed	Completed By	Notes
<b>Securities</b>				
<u>Identify letters of credit, trust agreements and other collateral held to secure obligations of policyholders under large deductible endorsements, and review and/or establish procedures for reviewing the adequacy of such collateral</u>				

*Chapter 1 – Takeover & Administration (Page 105)*

Checklist 8—Accounting	Project Assigned To	Date Completed	Completed By	Notes
<b>Receivables</b>				
<u>Review large deductible billing procedures to determine that all amounts are billed timely. Determine that there are no outstanding items for billing and obtain an aging of outstanding receivables.</u>				

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<b>[Insert After Checklist 10 and Renumber] Large Deductible Policies</b>	<b>Project Assigned To</b>	<b>Date Completed</b>	<b>Completed By</b>	<b>Notes</b>
<p><b><u>Overview</u></b></p> <ul style="list-style-type: none"> <li>• <u>Meet with Manager of Large Deductible Collections (and/or other appropriate personnel) to discuss large deductible Collection procedures, personnel and responsibilities, staffing and what will be required from staff as a result of the order</u></li> <li>• <u>Conduct interviews of appropriate large deductible collection department personnel to determine policies and procedures. Document same.</u></li> <li>• <u>Establish a large deductible recoverable balance as of the receivership date</u></li> </ul>				
<p><b><u>Gathering Documentation</u></b></p> <ul style="list-style-type: none"> <li>• <u>Determine location of large deductible records – secure and inventory. This should include:</u></li> <li>• <u>All policies containing large deductible endorsements</u></li> <li>• <u>Claims files arising under such policies</u></li> <li>• <u>Correspondence files</u></li> <li>• <u>Billing records</u> <ul style="list-style-type: none"> <li>○ <u>Letters of credit, trust agreements, deductible reimbursement policies or other collateral</u></li> </ul> </li> <li>• <u>For all LOCs, trust accounts, funds withheld:</u> <ul style="list-style-type: none"> <li>○ <u>Secure all originals</u></li> <li>○ <u>Notify all banks and trustees of the order</u></li> </ul> </li> </ul>				
<p><b><u>Documenting Large Deductible Collection Procedures</u></b></p> <ul style="list-style-type: none"> <li>• <u>Review recent billings for all large deductible policies</u></li> <li>• <u>Obtain a list of large deductible payment history and determine whether insured payments have been ongoing or if payment from collateral has been required.</u></li> <li>• <u>Obtain a list of paid and unpaid bills updated after liquidation</u></li> <li>• <u>Obtain claim documentation for claims arising under large deductible policies</u> <ul style="list-style-type: none"> <li>○ <u>By paid loss and loss reserves and ALAE paid and reserves</u></li> <li>○ <u>List of claims in litigation/arbitration</u></li> </ul> </li> <li>• <u>Review large deductible billing system; determine that all paid losses arising under large deductible policies have been billed.</u></li> </ul>				

<ul style="list-style-type: none"> <li>• <u>Determine whether large deductible endorsements provide that losses within the deductible are limited in the aggregate</u></li> <li>• <u>Evaluate recovery processes and determine if new procedures are appropriate</u></li> <li>• <u>Determine whether collateral is held by affiliated/unaffiliated third party via large deductible reimbursement policy, trust agreement or other vehicle, and evaluate whether collateral can be transferred to the receivership</u></li> <li>• <u>Document insured collection disputes</u></li> <li>• <u>Determine which functional group handles disputes</u></li> <li>• <u>Interview members of each group responsible for coordinating, monitoring and controlling large deductible collection disputes</u></li> <li>• <u>Audit large deductible collection-specific systems. Track data from source to final product to verify billings are correct and inclusive and internal controls are adequate</u></li> </ul>				
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*Chapter 2- Information System (Page 139)*

**H. Common Systems Applications**

8. Email

Virtually every insurer uses an industry standard email system. Emails are important company records that must be preserved. In addition to performing a backup of the email server at the start of the receivership, it is also good practice to extract individual email boxes of key employees at that time as well. Consideration should be given to periodically backing-up these files throughout the receivership to insure preservation of communications. Email backup restoration often requires the use of outsource computer forensic experts. Extracting email boxes in readable format at the outset of a receivership will save costs down the road should email records be required for litigation purposes,

9. Large deductible recoverables can be a large asset of the receivership, and, like reinsurance, collection is highly dependent on reliable policy and loss information. Use of information systems in recording and tracking this information is fairly common. As with reinsurance, this system may be a part of, or at least closely connected with, the accounting or claims systems

109. Other

*Chapter 2- Information System (Page 141)*

**C. Types of Business Written**

Initially, it will be necessary to identify general characteristics of the insurer’s business practices. This analysis will provide a general idea of systems sizing and related requirements and should include an analysis of:

- Lines of business – The lines of business underwritten and the characteristics of this business may have a substantial impact on information systems requirements. If it is a business in which claims will develop quickly, the requirement may be quite different from long-tail business in which claims will take a long time to develop. If the business included large-deductible or loss-sensitive features such a retrospectively rated premiums, there will be additional system demands. This also will impact the amount of historical information that must be maintained in the systems.

*Chapter 2- Information System (Page 142)*

**I. Existing Systems**

The receiver’s staff (or an independent consultant) needs to determine if the existing systems adequately process the business or if those systems must be supplemented with manual processing. If it is the latter, the receiver should then determine whether the level of supplemental manual processing required is acceptable, in terms of accuracy and the cost of processing. This will establish whether the existing system(s) are adequate to provide the receiver with the amount and types of information required.

The receiver may require various types of information in the administration of an estate. Especially with systems that do not permit online inquiry, it is imperative that reports which are adequate for the receiver’s purposes be produced. At a minimum, the existing systems should have the capability of generating a wide variety of reports. The receiver’s staff should carefully examine the available reports to determine whether they are adequate or if custom reports need to be developed, assuming the data stored in the systems can support custom reports. Reports are normally required for the following types of information:

- Policies and contracts;
- Accounting;
- Claims;
- Accounts receivable/payable;
- Cash;
- Reinsurance;
- Guaranty fund claims counts and reserves by state; and
- Earned and unearned premium.
- Large Deductible Collections and Collateral

*Chapter 3 – Accounting and Financial Analysis (Page 194)*

**D. Salvage and Subrogation (Property/Casualty Only)**

**5. Salvage and Subrogation (Property/Casualty- Large Deductible Recoveries - Only)**

**a. Large Deductible Recoveries**

Large deductible recoveries are amounts received by an insurer from an insured covered under a policy having an endorsement providing that the insured is responsible to indemnify the insurer for certain losses and LAE incurred. While these policies share some characteristics with retrospectively rated policies, the accounting treatment of recoveries under the two types of policies is different.

b. Accounting Practices

Under statutory accounting practices, recoveries under large deductible policies are not treated as premium. Unpaid losses are booked net of the deductible, except where the deductible is deemed not to be collectible, in which case the losses are booked on a gross basis. Because losses within the large deductible limit are not booked, it is important that the receiver examine the records, systems and procedures to identify and follow up large deductible recoveries on both paid and unpaid claims. Because these recoverables do not appear on the balance sheet unless uncollectible, but may be a significant recoverable amount, the receiver should examine the scope of the large deductible business written, and the collection and collateral procedures employed by the company. The High Deductible Disclosures, Note 31 in the Annual Statement Disclosure should aid the regulator in this review.

*Chapter 4 – Investigation and Asset Recovery (Page 225)*

**VI. OTHER SIGNIFICANT TRANSACTIONS**

**B. Large Deductible Policies**

Large deductible recoveries can represent a significant source of recoveries for insolvent companies, especially those property and casualty companies that wrote workers' compensation insurance. Because these recoverables do not appear on the balance sheet unless uncollectible, but may be a significant recoverable amount, the receiver should examine the scope of the large deductible business written, and the collection and collateral procedures employed by the company

1. General Considerations

- a. The receiver's recovery of large deductible recoverables is dependent on the claims handling and reporting of both claims covered and those not covered by guaranty funds.
- b. The key to effective collection and collateral administration is ensuring that the historical records for paid losses under the deductible policies and the program design are maintained and available. Another key is retaining the personnel that have knowledge and history of the insurer's deductible business operations.
- c. Collateral for Large Deductible Balances.
  - The importance of collateral cannot be overstated. But adequate collateral must be established prior to liquidation as it is unlikely to be collected after liquidation.
  - Large Deductible balances frequently will be secured to ensure collectability and preserve the insurer's statutory accounting credit. The receiver should identify and closely review these security arrangements early in the receivership. Particular attention should be paid to security arrangements where the insured's collateral is held by third parties, especially affiliates of the insurer.
  - Notices to financial institutions or others involved in security arrangements are critical to preserve the security by ensuring compliance with terms of the security arrangements and the exercise of any related rights or obligations

## 2. Communication

Deductible collection, in addition to requiring collateral, is dependent on communication of all parties (i.e., between receiver and insured, receiver and guaranty associations, guaranty association and insured). It must be quickly established with insured as to procedure for ongoing claim processing, continuation of their responsibility to reimburse the deductible payments and responsibility to maintain appropriate collateral. Guaranty associations must also recognize that they will be required at times to communicate with insureds regarding claims handling. All parties should be mindful of security concerns related to communication of sensitive claims data. The SUDS server hosted by NCIGF is a useful tool for communication between receivers and guaranty associations. guaranty funds may opt for telephonic communication with insureds. The collection process should proceed with minimal delay as the passage of time will impact success of collection efforts. In these efforts it is imperative that the guaranty associations and the receiver work together and offer consistent messages to the insured regarding any collection issues. It should also be noted that the release of collateral from a receiver to a guaranty association may not fully satisfy the policyholder's obligation for costs related to the claim under a state's guaranty association law.

## 3. Deductible Collection Procedure

- a. A working process must also be established quickly between the receiver and the guaranty associations to provide claim handling, payment information and all other required claim financials to allow the receiver to bill and collect loss payments.
- b. The information would include the receiver providing the guaranty associations all pertinent information to establish the policies that are deductibles along with effective dates, deductible limits, treatment of ALAE and deductible aggregates where available.
- c. Copies of deductible policies should be made available if required.
- d. Guaranty Association's will provide, through the establishment of UDS data feed, all financial information regarding deductible claims that they are handling.
- e. Receiver will collate data from guaranty associations and review historical billing information to invoice the insureds on a monthly or quarterly basis.
- f. Receiver will calculate and track the payment history pre-liquidation and post Liquidation within the deductible and within a deductible aggregate for the policy if applicable. This ensures that the insured is only billed for amounts that remain within their deductible.
- g. To assist in the collection process receiver and guaranty association should work to provide sufficient information and explanation to allow the insured to recognize its obligation. In the event where the insured refuses to pay, the receiver will either begin litigation or draw on collateral or both. This should be coordinated with the guaranty associations.

## 4. Professional Employer Organizations ("PEOs")

- a. Policies issued to PEOs often have large deductible endorsements.
- a.b. Because of the prevalence of abuse in the underwriting of PEOs, post-liquidation collection of deductible payments may be challenging.

- c. Clients may have been added without notice (or payment) to the insurer; Client class of business may have been misrepresented or expanded to include riskier classes of business – all of which may lead to inadequate or exhausted collateral.
- d. Client companies of PEO may not have received notice of cancelation, leading to coverage disputes. If collateral is inadequate and the PEO does not have assets to pay the deductible reimbursement in full, the policy terms might make the client companies liable for the shortfall, either for their own exposure or on a joint-and-several basis. However, this might not be a meaningful source of recovery, because it could be impractical, inappropriate, or impossible to collect significant amounts from the clients.

#### 5. Commutations

- a. Generally, commutations are negotiated terminations of the rights and liabilities between insurers and large deductible insureds. A commutation is a settlement of all obligations, both current and future, between the parties for a lump sum payment.
- b. There are many valid reasons for commutations of large deductibles. They may provide immediate cash for the receivership estate, avoid future uncertainties, resolve disputes between insurer and insured, and provide some protection or limitation of exposure from the insolvency of the insured. Commutations of long tail business (i.e., workers' compensation) may be essential for the early termination of the receivership.
- c. Commutations, however, may be a detriment to the receivership if the commutation is consummated for less than fair consideration. A receiver should carefully review the commutation to determine whether the benefit to the insurer outweighs the disadvantages.

### *Chapter 5 – Claims (Page 288)*

## **V. PAYMENT OF APPROVED CLAIMS**

### **A. Priority of Distribution in Receiverships**

- 5. Class 3 and 4 – Claims for Policy Benefits
  - a. Deductible and Limits

The policyholder's claim is for the amount that the insurer should have paid. For some policies (e.g., workers' compensation policies), the insurer is required to pay the claim and seek the deductible from the insured (thereafter, known as "Large Deductible Policies"). It is common for insureds to post collateral with the insurer for deductible payments that may be made by the insurer, for which the insurer then seeks reimbursement from the insureds. With other policies, the insurer's liability attaches after the deductible has been paid by the insured ("Non Advancement Policies"). IRMA Section 712 provides for the disposition of Large Deductible Policy ~~or Loss Reimbursement Policy~~ recoveries between receivers and guaranty associations. Individual state statutes (see, for example, 40 PA §221.43a) differ from IRMA Section 712 in certain respects."

### *Chapter 9 – Legal Considerations (Page 518)*

## **G. Assets that are not General Assets, Special Deposits and Letters of Credit**



### 3. Letters of Credit

There has been some controversy surrounding the rights and obligations of receivers regarding letters of credit (LOCs). LOCs are typically used to support reinsurance and large deductible obligations. Letters of credit issued in connection with reinsurance transactions are discussed in detail in Chapter 7, Section VIII and in connection with large deductible transactions in Chapter 4, Section A.

## Chapter 9 – Legal Considerations (Page 539)

### I. Large Deductibles

~~Many liability policies for large commercial insureds are being written with deductible limits that may exceed \$100,000.~~ The purpose of these large deductible amounts is to reduce premiums for the insured while permitting the insured to meet statutory or regulatory insurance requirements. Large deductible policies are most common in the workers' compensation area but may be found in other types of liability insurance.

Typically, a large deductible policy provides that the insurer will pay claims in full and then collect the deductible amount from the insured (~~first dollar coverage~~). Conversely, first party claims against an auto policy with a deductible are paid minus the amount of the deductible. To ensure that the deductible will be paid, most insurers that write this type of policy will require the insured to post some form of security. This can be a letter of credit ~~or~~, securities placed in a trust or escrow account for the benefit of the insurer, or some other form of a third-party commitment to reimburse for claims within the large deductible, such as a bond or large deductible reimbursement insurance policy. When the insurer pays a claim, depending on the agreement with the insured, the insurer may either submit a bill to the insured for the amount of the claim paid within the deductible or collect directly from the collateral.

As long as the insurer and the insured remain solvent, there are seldom any difficulties with large deductible arrangements. If the insured becomes insolvent and stops paying the deductible billings and if the collateral held is insufficient to pay current and future billings, the insurer's ability to collect the amounts due will be adversely affected. ~~Or funding the collateral account, the insurer remains liable for injuries sustained prior to the termination of the policy.~~

**Proposed Changes to Receiver’s Handbook for Insurance Company Insolvencies**  
**RE: Large Deductibles**

(NEW SECTION IN EXISTING HANDBOOK)

*Chapter 5 – Claims (Page 304)*

**VIII. BEST PRACTICES FOR SUCCESSFUL BILLING AND COLLECTION OF LARGE DEDUCTIBLE PROGRAMS IN LIQUIDATION**

**A. Overview of Large Deductible Worker’s Compensation**

A large deductible worker’s compensation policy or program is a method of insuring workers’ compensation risk with the employer assuming some of that risk in a deductible of \$100,00, \$250,000, or even higher per claim (varies by state) and an insurer taking on the remaining risk. In states that permit professional employer organizations (PEOs), PEO’s often operate large deductible programs. A PEO is an outsourcing firm which provides services to small and medium sized businesses. The PEO enters into a contractual co-employment agreement with its clientele. If the employer or PEO fails to pay for any reason, the insurer incurs an unexpected liability, and the failure of the claim reimbursement mechanism has been a significant factor in a number of insurer insolvencies.

**B. Administration of Large Deductible Plans**

The administration of large deductible plans is impacted by entry of an order of liquidation. In such cases, there are two options available regarding statutory authority concerning Large Deductible Worker’s Compensation, namely:

- 1) *Insurer Receivership Model Act (Model #555—IRMA) Section 712 Administration of Loss Reimbursement Policies; or*
- 2) *National Conference of Insurance Guaranty Funds (NCIGF) Model Large Deductible Act.*

Both provide statutory guidance that articulates the respective rights and responsibilities of the various parties, which would greatly enhance the ability to manage complex large deductible programs post-liquidation. Generally, both approaches provide for the collection of large deductible reimbursements from policyholders, clarify entitlement to reimbursement, and ensure that the claimants are paid. The provisions in each of the two options generally complement each other except for conflicting provisions regarding the issue of the ultimate ownership of and entitlement to the deductible recoveries and collateral as between the estate and the guaranty fund.

**C. Communication and Reporting Between the Liquidator, Policyholders and Guaranty Associations, Including Administration of Self-Funded Policyholder Programs**

1. *Claim payment, reserve, and reimbursement reporting.*

The administration of large deductible programs requires strong communication and reporting programs between the Liquidator, guaranty associations and policyholders. Under the both Model Acts, the Liquidator is required to administer large deductible programs, and related collateral securing large deductible obligations, consistent with the policyholder’s policy provisions and large deductible agreement (“LDA”) as amended by the provisions of the Model Act. Both Model Acts make provision for two types of LDAs, those that permit self-funding by the policyholder, and those that require initial payment by the insurer or guaranty association with reimbursement by the policyholder. Both arrangements necessitate the reporting of claim payments and outstanding claim reserves to the Liquidator for billing, guaranty association reimbursement, and establishing

collateral need requirements. The Liquidator's uniform data standard or UDS should be deployed as the reporting protocol for guaranty association claim payments and outstanding claim reserves. Policyholders that continue self-funding under their LDA will need to continue or establish a claim information reporting protocol with the Liquidator through the policyholder's third-party claim administrator or through a proprietary claim information aggregator. Both Model Acts require the Liquidator to form an independent opinion on outstanding claim reserves reported by policyholders and guaranty associations, including a safety factor and incurred but not reported liability to ensure that collateral remains adequate throughout the administration of the program.

## 2. Agreements between Liquidator and guaranty associations.

For states that have enacted the either of the two Model Acts or similar statutory framework for the Liquidator's administration of large deductible programs an agreement between the Liquidator and the guaranty associations is not necessary. The Models provide a comprehensive framework for administration of the program. For states that have not enacted either Model, an agreement between the Liquidator and guaranty associations may be advisable. The Models can serve as an outline for the issues that should be addressed in such an agreement. Among other things, an agreement should address: whether large deductible recoveries are estate assets subject to the Liquidator's distribution regime or directly pass-through to the guaranty association on account of its prior claim payments, claim reporting protocols, frequency of collateral review and reimbursement activity, and administration of collateral for under collateralized non-performing policyholder accounts.

## 4.3. Converting policyholder accounts from an incurred to paid basis under the Model Act.

The NCIGF Model Act provides for the conversion of a policyholder's LDA at liquidation from an "incurred" to a "paid" basis. Conversion is beneficial to policyholders in several ways. Most importantly, conversion at liquidation treats pre-liquidation incurred loss payments made by the policyholder to the insurer as collateral, and thus property of the policyholder pledged to the insurer and restricted to the satisfaction of that policyholder's claims, rather than as a general asset of the liquidation estate. Conversion also offers flexibility to a policyholder as to the type of security provided to an insurer in satisfaction of the collateral requirement. Conversion affords policyholders the ability to utilize a letter of credit to secure an insurer for the outstanding portion of their loss, rather than payment of cash, since the outstanding bill after conversion is reflected in the Liquidator's collateral need analysis, rather than an incurred loss billing.

The NCIGF Model Act recognizes these important policyholder rights and provides incentive to policyholders to cooperate with the Liquidator's administration of large deductible programs and guaranty association reimbursement. The Liquidator should consider notifying large deductible policyholders of these important policyholder rights at the inception of a liquidation proceeding and offer policyholders the opportunity to elect to convert their large deductible programs from an incurred to paid basis in accordance with the NCIGF Model Act, memorializing any elections with an endorsement that otherwise follows and requires the policyholder to adhere to the provisions of the NCIGF Model Act.

## 2.4. Large deductible billing by Liquidator.

The Liquidator should establish a large deductible billing and collection program that bills policyholders on a periodic basis, e.g., quarterly, that meets Liquidator and policyholder expectations for claim payments made by the estate prior to liquidation and by guaranty associations after liquidation. The Liquidator's invoice to policyholders should communicate a claim payment summary that includes detail such as the insurer or guaranty association's check number, date of payment, payee, account year, and remaining large deductible limits. Large deductible programs that are self-funded by policyholders should also report their claim payments to the Liquidator on a similar periodic basis, so that the Liquidator can establish appropriate claim reserves, track the exhaustion of the policyholder's deductible limits, report to reinsurers and collect reinsurance. Consideration should be given to using one of many proprietary billing and collection software programs to automate the large deductible billing and collection process. Large deductible recoveries that are subject to

guaranty association reimbursements should be aggregated and distributed on a quarterly or other periodic basis that balances the Liquidator's accounting requirements and the guaranty associations' reimbursement needs.

### 3.5. Annual collateral review by Liquidator.

The NCIGF Model Act, consistent with the typical LDA, requires the Liquidator to perform an annual collateral review for each policyholder account to ensure that the Liquidator holds adequate collateral to support a policyholder's large deductible obligations and to release any excess collateral held back to the policyholder. This review should include a report to the policyholder on total incurred claims, claims paid, outstanding reserves, any additional safety factor and total collateral need. The Liquidator's collateral review should result in a report to the policyholder and an invoice for additional collateral need or a release and distribution of excess collateral. The Liquidator should consider whether any additional safety factor should be included for non-performing policyholder accounts. The NCIGF Model Act provides flexibility on the timing of the annual review, enabling the Liquidator to perform the annual review process throughout the calendar year so that all policyholder account reviews are not due at the same time.

## **D. Administration Fees**

Section 712 (G) OF IRMA provides:

The receiver is entitled to recover through billings to the insured or from large deductible policy collateral all reasonable expenses that the receiver or guaranty associations incur in fulfilling their responsibilities under this Section. All such deductions or charges shall be in addition to the insured's obligation to reimburse claims and related expenses and shall not diminish the rights of claimants.

Further, Section 712(F) provides, in part:

The expenses incurred by a guaranty association in pursuing reimbursement shall not be permitted as a claim in the delinquency proceeding at any priority; however, a guaranty association may net the expenses incurred in collecting any reimbursement against that reimbursement.

Several states have adopted statutory provisions similar to the IRMA provisions regarding handling of large deductibles in an insolvency and provide for the Receiver to retain reasonable actual expenses incurred from the reimbursement to the guaranty association(s). Similarly, statutes may provide for the guaranty association to net expenses incurred in collecting a reimbursement.

When there is no statutory guidance, receivers should include a provision for reimbursement of reasonable actual expenses in an agreement with the guaranty associations regarding the collection and allocation of large deductibles.

## **E. Policy and Collateral Definitions**

It is important that state laws define large deductible workers' compensation policies and large deductible collateral. Defining the treatment of such policies and associated collateral is imperative for developing policies and processes for administering the collection of assets. For purposes of this handbook, "Large deductible policy" means any combination of one or more workers compensation policies and endorsements issued to an insured, and contracts or security agreements entered into between an insured and the insurer in which the insured has agreed with the insurer to:

(a) Pay directly the initial portion of any claim under the policy up to a specified dollar amount, or the expenses related to any claim; or

(b) Reimburse the insurer for its payment of any claim or related expenses under the policy up to the specified dollar amount of the deductible.

The term “large deductible policy” also includes policies which contain an aggregate limit on the insured’s liability for all deductible claims in addition to a per claim deductible limit. The primary purpose and distinguishing characteristic of a large deductible policy is the shifting of a portion of the ultimate financial responsibility under the large deductible policy to pay claims from the insurer to the insured, even though the obligation to initially pay claims may remain with the insurer. The dollar amount of “large” will vary by state law. While many states might associate a minimum financial threshold, it is more important to consider the administration of the policy compared to a traditional policy. Deductible amounts can include claim-related payments by the insurer for medical and indemnity benefits, allocated loss adjustment expenses, such as medical case management expenses, legal defense fees and independent medical exam expenses. It is critical that the policy specify the claim-related payments that are the responsibility of the policyholder and not be inside agreements or other agreements outside of the policy. Collateral held by the insurer should be defined as amounts held for large deductible policy. The policy should provide acceptable financial instruments that can be held for large deductible policy. Typical collateral requirements include: cash, letters of credit, surety bonds or other liquid financial means held for the benefit of the insurer.

#### **F. ~~Whether receiver or guaranty fund should~~ Responsible Party For Collection of Large Deductible Reimbursements**

It is critical to immediately establish the party responsible for billing and collecting large deductibles. While some states might have specific statutory language that specifies the entity responsible, some statutes might be silent. In the case where the statutes do not specify responsibility, it is recommended that the receivers and guaranty associations enter into an agreement that allows for the most efficient administration of the large deductible collections.

Specific consideration should be given to large deductible policies that provide coverage in multiple states and have claimants subject to the jurisdiction of multiple guaranty funds. If feasible, the most efficient approach for such policies would likely be for the receiver to administer the deductible billing and collection process. Throughout the life of the estate, claimants continue to incur benefit payments and expenses and deductible collection efforts may last beyond the life of the estate. The party responsible for collections needs the ability to compromise and settle the future obligations.

The receiver should make provisions in its discharge motion and Court order, to the extent possible, regarding the transition of ongoing deductible collections to the guaranty as well as the disposition of any collateral being held by the receiver.

#### **G. Treatment of Collateral in Receivership**

When collateral has been posted by or on behalf of a large deductible policyholder, what does the receivership estate actually own? The answer is generally found in the documents pledging the collateral to the insurer.

The Insurance Receivership Model Act, NAIC Model Law # 555 (“IRMA”) defines “property of the estate” to include “all right, title and interest in property ... includ[ing] choses in action, contract rights, and any other interest recognized under the laws of this state.”<sup>1</sup> In states without an explicit statutory definition, the common-law definition is substantially similar.

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<sup>1</sup> IRMA § 104(V)(1).

This means that the insurer’s right to draw on the collateral automatically becomes an asset of the receivership estate, but the collateral itself is not an estate asset unless and until it is drawn. In the first instance, the conditions and procedures for drawing the collateral should be spelled out in the relevant contract documents (which could include third-party instruments such as letters of credit or surety bonds), but state law could provide additional rights,<sup>2</sup> and will specify what the receiver may do when the documents are silent, incomplete, or missing.

Possession and control over the collateral are distinct from ownership. The insurer could already be in possession of the collateral before the receivership, or the receiver might act to take possession by enforcing applicable contract rights or by negotiating an agreement. Nevertheless, this does not immediately give the receiver the right to use the collateral to pay claims. The defining characteristic of collateral is that it is intended to serve as a backstop in case the policyholder does not meet its obligations to pay all reimbursements promptly and in full. Commonly, the right to draw on collateral only attaches after the policyholder has defaulted or has consented to a draw, or, if the collateral is a letter of credit, after the issuer has given notice of nonrenewal (in which case the receiver must act promptly to call the LOC or obtain replacement collateral). There could also be the opportunity to negotiate an agreement under which the policyholder turns over the collateral and makes a lump-sum payment to commute any further reimbursement obligations, or the collateral might have been structured from the outset as a “working” loss fund from which the insurer was expected to pay claims in the ordinary course of business.

In any case, while it is essential for the receiver to preserve and exercise the right to access the collateral as needed, it is also essential to ensure that collateral is not dissipated to pay claims that the policyholder should be funding. Special consideration needs to be given in situations where the policyholder is at risk of being or becoming judgment-proof, or where rights to the collateral are shared with other creditors of the policyholder and prompt action is necessary to preserve the receiver’s priority.

When the guaranty association is paying the claims, it is generally entitled to receive the proceeds of any policyholder reimbursements, including draws on the collateral. Under laws substantially similar to IRMA, these payments are considered early access distributions (but without the necessity for court approval) which may be subject to subsequent clawback, while laws substantially similar to the NCIGF Model treat them as the ultimate source of funding for the underlying claims, so that they belong unconditionally to the guaranty association.<sup>3</sup> Either way, however, it is the receiver rather than the guaranty association that has the right and obligation to draw on the collateral,<sup>4</sup> unless there is a formal written agreement assigning that right to the guaranty association.

Finally, there is always the hope that the policyholder’s reimbursement obligations will be oversecured or will become oversecured as claims are run off. In that case, any excess collateral will revert to the policyholder or the policyholder’s guarantor. State law might expressly provide a process for determining when excess collateral is being held by or on behalf of the receiver,<sup>5</sup> or the ability to return collateral before the estate is closed might be part of the general powers of the receiver. However, because workers’ compensation is a long-tail exposure with significant risk of adverse reserve development, receivers must take great care not to make premature or excessive return distributions.

#### **H. Issues Raised by Net Worth Exclusions and Deductible Exclusions**

Unlike other lines of insurance, workers’ compensation insurance is generally exempt from the statutory caps on guaranty association coverage, so that the guaranty fund is usually obligated to pay workers’ compensation claims

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<sup>2</sup> For example, IRMA § 712(D) specifically provides that the relevant provisions of the policy are not controlling “where the loss reimbursement policy conflicts with this section.”

<sup>3</sup> Compare IRMA § 712(C)(3) with NCIGFMA § 712(C).

<sup>4</sup> See NCIGFMA § 712(E)(3).

<sup>5</sup> See, e.g., NCIGFMA § 712(E)(5).

in full. However individual states may have adopted caps on guaranty association coverage.<sup>6</sup> States have created this exception to honor their state’s promise that injured workers will be paid the full benefits to which they are entitled. The general purpose of these exclusions is to avoid any obligation for the guaranty association to pay losses that can and should be borne by the policyholder. Net worth exclusions make guaranty association protection unavailable to policyholders with net worth above a specified threshold, while deductible exclusions expressly prohibit guaranty association coverage for amounts within a policy deductible.

Unless these exclusions are drafted and implemented carefully, there is a risk that they could result in delays in claims payments or even a complete loss of coverage. In some states, claimants might be protected by an uninsured employer fund, but that is not the purpose of those funds, so even if such a fund exists in your state, it should be a priority to ensure that however it is done, the estate, employer, or guaranty association will provide for payment in full of all benefits due under the state’s workers’ compensation laws. If this is not possible under current law, regulators should advocate for a change in the law. A variety of successful approaches are available; there is not a single one-size-fits-all solution that is best for every state.

### I. Net Worth Exclusions:

The PC GA Act contains an optional section, with a variety of alternative provisions states can select, excluding coverage for high-net-worth insureds, whether they are individuals or business entities.<sup>7</sup> The base version sets the threshold at \$50 million, while one of the alternatives sets the threshold at \$25 million. Many states have enacted some version of this clause or some comparable net worth exclusion.

The impact on workers’ compensation coverage depends on how the exclusion is structured. In states with provisions substantially similar to any of the three alternatives under the PC GA Act, coverage is excluded completely for first-party claims by high-net-worth insureds, but workers’ compensation claims against high-net-worth policyholders are administered by the guaranty association on a “pay-and-recover” basis: that is, the guaranty association has the obligation to pay the claim in the first instance, and the right to be reimbursed by the policyholder.<sup>8</sup> Thus, claimants are fully protected, and for large deductible policies, this mirrors the structure of the policy for claims within the deductible. In states with guaranty association laws similar to the NCIGF Model, this is the same reimbursement right the guaranty association would have in the absence of the exclusion as the insurer’s successor.

If the policyholder is cooperative, the guaranty association has the option of negotiating an agreement where the policyholder advances funding for claims within the deductible. However, if the policyholder is not cooperative, guaranty associations have expressed concern that the pay-and-recover framework is burdensome and gives the policyholder too much leverage to avoid or delay paying its obligations in full. If PC GA Act’s Alternative 2 is modified to treat workers’ compensation claims the same as other third-party claims, then the guaranty association has no obligation unless the formerly high-net-worth policyholder has become insolvent.<sup>9</sup> Otherwise, the claimant’s

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<sup>6</sup> See Property and Casualty Insurance Guaranty Association Model Act, NAIC Model Law # 540 (“PC GA Act”), § 8(A)(1)(a)(i). Almost all states have some provision requiring payment in full of workers’ compensation claims, but some states might have caps or other limitations on coverage.

<sup>7</sup> PC GA Act, § 13.

<sup>8</sup> Alternative 1 applies the pay-and-recover obligation to all third-party claims. Alternative 2 excludes most third-party claims as well as all first-party claims, but requires the guaranty association to pay workers’ compensation claims, statutory automobile insurance claims, and other claims for ongoing medical payments. Alternative 3 excludes only first-party claims and claims by out-of-state claimants that are subject to a net worth exclusion in the claimant’s home state; this alternative does not create any statutory right of recovery when the guaranty association is obligated to pay a third-party claim.

<sup>9</sup> PC GA Act, § 13(B)(2) Alternative 2.

only recourse is against the policyholder or the insured's estate. As stated above, the injured worker should be protected by some means in these cases.

When a guaranty association net worth exclusion and a large deductible both come in to play on the same claim, it is imperative that the receiver and guaranty association stay in close communication in order to avoid any confusion regarding which entity is responsible for the collection. In both IRMA 712 and the NCIGF large deductible model statute, the guaranty fund is entitled to collect net worth reimbursements. Coordination of these collections with receiver efforts to collect on high deductible will do much to avoid duplication of billings and potential resulting collection delays.

## 2. Deductible Exclusions:

The PC GA Act does not contain any explicit deductible exclusion. Instead, it simply provides that "In no event shall the association be obligated to pay a claimant an amount in excess of the obligation of the insolvent insurer under the policy or coverage from which the claim arises."<sup>10</sup> However, some states have enacted explicit language further clarifying that there is no guaranty association coverage for amounts within a policy's deductible or self-insured retention.<sup>11</sup> For example, Minnesota law excludes "any claims under a policy written by an insolvent insurer with a deductible or self-insured retention of \$300,000 or more, nor that portion of a claim that is within an insured's deductible or self-insured retention" from coverage by the property and casualty guaranty association.<sup>12</sup> A Minnesota employer entered into an employee leasing arrangement with a PEO, which obtained a workers' compensation policy with a \$1 million deductible. Both the PEO and the insurer became insolvent, and the Minnesota Court of Appeals held that there was no guaranty association coverage for workers' compensation claims against the client employer because of the statutory deductible exclusion.<sup>13</sup> The court observed that the Legislature deliberately chose to protect the guaranty association from unlimited exposure, without mentioning that the Legislature also deliberately created an exception making the cap on coverage inapplicable to workers' compensation claims (which strongly suggests that the statute in question, which is tied to the statutory \$300,000 cap on coverage, was not written with workers' compensation in mind).<sup>14</sup> Likewise, the court took for granted that the statute's undefined term "deductible" included the contract provision at issue in the case, even though the insurer had assumed the unconditional liability to pay all claims in full. The opinion did not consider the possibility that the Legislature's intent was simply to clarify that the guaranty association has no obligation to drop down and pay claims from the first dollar if the insurer would have had no obligation to pay those claims.

Therefore, if states determine that there is a need to include express provisions addressing deductibles and self-insured retentions in their guaranty association laws, it is essential to avoid unintended consequences. In particular, the key terms should not be left undefined. For this reason, IRMA coined the term "loss reimbursement policy" in its section addressing these types of policies, to distinguish them from true deductibles, where the insurer has no obligation to pay anything except the portion of the loss that exceeds the deductible.<sup>15</sup>

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<sup>10</sup> PC GA Act, § 8(A)(1)(b). Compare LH GA Act, § 3(B)(2)(a), expressly excluding from life and health guaranty association coverage "A portion of a policy or contract not guaranteed by the member insurer, or under which the risk is borne by the policy or contract owner."

<sup>11</sup> Currently, the only states with language specifically excluding claims within policy "deductibles" are Iowa, Louisiana, Minnesota, Missouri, and Nevada. Louisiana's exclusion applies only to policies issued to group self-insurance funds, and Missouri's does not apply to workers' compensation claims.

<sup>12</sup> Minn. Stat. § 60C.09(2)(4).

<sup>13</sup> *Terminal Transport v. Minnesota Ins. Guar. Ass'n*, 862 N.W.2d 487 (Minn. App. 2015), review denied June 30, 2015.

<sup>14</sup> Minn. Stat. § 60C.09(3).

<sup>15</sup> For example, if a consumer has an auto policy with a collision deductible of \$1,000, and the repair costs \$5,000, the insurer's liability is limited to \$4,000. "Self-insured retentions" (SIRs) in commercial excess policies are designed to function the same



This is the crucial difference between a “large deductible” workers’ compensation policy and an excess policy. Although “large deductible” policies transfer a significant amount of risk back to the policyholder, they do not extinguish the insurer’s liability. That is why “large deductible” policies, in states that allow them, are accepted as a mechanism for satisfying the policyholder’s compulsory coverage obligations, while excess policies generally are not. Usually, excess workers’ compensation policies may only be issued to self-insurers that have been approved by the state. It is the approved self-insurance program, not the excess policy, that satisfies the employer’s compulsory coverage obligation, and the insurer has no liability for any portion of a claim that falls within the employer’s self-insured retention.<sup>16</sup> Thus, despite the terminology that is commonly used, it is the excess policy, not the large deductible policy, that functions as a “deductible” in the traditional sense of the term.

It is worth noting, however, that commercial self-insured retention and large deductible policies can vary widely in policy terms and sometimes “side agreements” supplement the policies. Arrangements can contain aggregate limits, can vary on the obligation for defense cost and expenses and, in some cases permit the insured to “self-fund” its claims with an account in the possession of the TPA which is handling the claims. Because of these complexities, policy terms and any related endorsements and side agreements should be carefully reviewed. Whether such side agreements are legally enforceable requires a thorough case-by-case analysis in light of applicable state laws.

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way on a larger scale. If a business is found liable (or a third-party claim is settled) for \$500,000, and its liability policy has an SIR of \$300,000, the insurer is never responsible for more than the remaining \$200,000, even if the policyholder is bankrupt.  
<sup>16</sup> In many states, a separate self-insurance guaranty fund protects claimants if a self-insured employer becomes insolvent. Those funds typically operate entirely under the state’s workers’ compensation laws, not the state’s insurance receivership or insurance guaranty fund laws.