The Good, The Bad, and The Ugly of Workers' Compensation Group Self Insurance Funds

(Also Known As: Self Insured Trusts)

Workers' Compensation Group Self Insurance Funds (SIF) are available and popular in many states throughout the country. They serve as an alternative to standard insurance companies for Workers' Compensation Insurance. In some market conditions, they may be the only means available to employers to meet their Workers' Compensation obligations.

The concept of a SIF is clean and simple and typically operates, as follows:

- A group of employers pool their premium into a fund.

- Injury costs, reinsurance costs, and administration expenses are paid from that fund.

- Money that is left over after injury costs and expenses are distributed as dividends on a pro-rata basis back to the employers.

The purpose of this paper is to present a balanced representation of the SIF option. When done right, and under the right market conditions. SIFs can be an effective financing mechanism for Workers' Compensation Insurance. A SIF can prove to be a practical, long standing and valuable alternative for employers.

However, serious problems can and do occur. When they do, employers are exposed to significant financial losses. The financial risk to employers will be addressed later in this paper. For the purpose of disclosure, the writer of this paper represents a SIF on behalf of client employers.

The SIF Sale

Why would an employer choose to enter a SIF when one or more standard insurance companies are available and willing to accept their business? When asked, employers often say, "they saved me money." In addition, the SIF concept makes sense to the employer. Few employers are big fans of insurance companies and an alternative with an intuitive story is appealing.

There are two primary players in the selling of the SIF, the Program Manager and the agent. The Program Manager conceives, builds, markets, and oversees the operational functions of the SIF. While some SIFs sell direct to employers with their own employees, most use the independent agency system to distribute their product and services.

Promoters of a SIF often emphasize the following selling points. They say that dividends are distributed back to employers instead of going to the stockholders of an insurance company. They may also say that their premiums are lower because of lower overhead, better claims service, better underwriting, better loss control, smarter people, and on and on. Since there are inherent risks with a

SIF, they must provide compelling reasons for the employer to choose this option instead of a standard insurance company.

The Risks

To an employer, the SIF engagement looks and feels like a relationship with a standard insurance company. The employer pays their premium, claims are paid, and evidence of insurance is provided to their customers. However, that is where the primary similarities end.

As mentioned above, in exchange for the promise of reduced costs and the payment of dividends, the employer, sometimes unknowingly, accepts a significant financial risk. The employer shares ownership of the Fund with all of the members of the Fund. Each member of the Fund is liable if resources are insufficient for operations.

As a member of a SIF, the employer agrees to be jointly and severally liable to pay assessments when the Fund is unable to meet their claims and expense obligations. Joint and several liability is a legal expression meaning all the members of the Fund jointly are liable or each person individually is liable for repayment of a debt or obligation. Thus, each individual who signed the obligation could be required to repay part or the entire obligation.

In some states, you may be exposed to blanket joint and several liability. This provision could trigger an assessment to you, even if your SIF is financially stable, but another one in the state is not.

In addition, corporate officers or stockholders are usually required to sign personal guarantees. The intent of the personal guarantee is to prevent the employer from declaring corporate bankruptcy to avoid assessments. By signing the personal guarantee, corporate officers or stockholders pledge their personal assets to the Fund, if needed.

It is critical for employers to understand that even though dividends are returned to them on a pro-rata basis, debt obligations are not apportioned in the same manner. Some employers assume that if their premium is 1% of the total premium, then their debt obligation would be 1% of any assessments. When assessments are ordered, the initial demands are issued on a pro-rata basis. However, joint and several liability may and usually do obligate some employers for more than their pro-rata share of outstanding obligations.

Some smaller employers, who are already in financial distress, and have little to no personal assets often just close up shop and walk away from their debt to the Fund. Collection efforts are made, but often unsuccessful. Thus, their share of the assessment is distributed to the other members who have the ability to pay. Larger, more financially sound employers with officers and stockholders of substantial means, carry a greater financial risk.

As with signing of any contract, it is prudent to scrutinize all of the provisions. You may find termination provisions that may make it difficult for you to leave the Fund.

If your employees ever travel out of your company's domicile state, in the course of their employment, it is unlikely the Fund's coverage will follow them. Most Funds can not offer out of state

coverage. Be extremely cautious if your employees ever cross state lines. Their coverage may cease at the border and leave the employer to pay the cost of the injury.

Historical Examples of Problems

In a recent and much publicized case, the meltdown of the Associated Industries of Kentucky Self Insurance Fund provides valuable insight into what can go wrong. AIK Comp was paying members advance discounts to attract business, when rates were inadequate to fund reserves, according to press reports about the contents of a private consulting firm's audit. Insurance Journal reported that $38.6 million in discounts over a three-year period led to a shortfall at AIK Comp, forcing it to assess 3,700 member employers.

According to the Kentucky Post, the Office of Workers' Claims received a report from a private consulting firm, York Consulting, on the status of AIK Comp. "Giving discounted premiums to members before loss reserves can be reasonably established appears to be a key factor in the current financial distress of the fund," said the York Consulting report, according to the Post. "The current deficiency could have been partially or completely offset had the trustees allowed for time to see losses develop prior to returning any potential excess premiums to members," the York report added, according to the Post.

A "lack of appropriate oversight" by the Kentucky Office of Workers' Claims allowed the situation to continue until a cash crisis forced the situation to the surface, according to a F.A.Q. on the website of the Office of Workers' Claims. Ernest Dye, the Kentucky Office of Insurance appointee running the company said AIK's problems were caused by setting premiums too low to cover claims and then "not reacting fast enough."

The financial problems prompted numerous lawsuits and accusations of fraud and misrepresentation. Several attorneys are seeking class-action lawsuit status. The outstanding assessment at this writing approaches $100,000,000.

In a September 16, 2005 report, the New York State Workers' Compensation Board stated that nearly half of New York's 62 workers' compensation group self-insurance funds were categorized as "under funded on a regulatory basis." According to the report, a trust is under funded if its liabilities exceed its assets, based on a number of factors, including the most recent annual financial exam and definitions of admitted assets and liabilities.

These problems are not unique to New York and Kentucky. Funds in other states have experienced similar financial problems. A SIF can experience financial challenges for the reasons stated above as well as many more. The reasons range, but are not limited to, rapidly changing market conditions, political changes and pressures, incompetence, and malfeasance.

The Risks vs. Reward Decision

Employers face and make risk management decisions every day. Some have potentially more serious consequences than others. Entering into an agreement with a SIF has potentially serious financial and emotional consequences. It is critical for employers to make the most informed decision possible.

President Harry Truman had a decision making process that started with, "What is the worst thing that can happen, and if the worst happens, can I live with it?" Determining what the worst case may be arising from a relationship with a SIF is challenging. Certainly, careful due diligence must be part of the process.

Employers should investigate a series of questions. They would include, but are not limited to the following:

- What government authority, if any, is responsible for oversight of the Fund's financials, rates, rules, forms, endorsements, and conditions?
- How long has the Fund been in operation?
- Who conducts audits of the financial stability of the Fund, including an analysis of loss reserves? What is their experience level?
- Is the Fund required to follow the same Manuals and Rules as standard insurance companies?
- How the reinsurance is structured and is it adequate?
- Is Fund charging "adequate" premium to its members?
- Who is administering the underwriting and claims adjudication? What is their experience level?
- What additional services are offered by the Fund, such as Return to Work Programs, medical provider profiling, field case management, loss control engineering, and other cost reduction strategies?
- Does the Program Manager have a financial risk, other than closing their operation; should the Fund experience financial difficulties? If so, is their risk collateralized?
- How fast is the Fund growing and are they chasing market share beyond their capabilities to administer and financially support?

Upon completing the due diligence process, the employer must determine if the promised rewards of entering a SIF are worth the risks.

Summary

As stated at the beginning of this paper, Group Self Insurance Funds can prove to be a viable Workers' Compensation alternative for employers. Employers need to understand their concept, how they are managed, and how they are different from a standard insurance company. Joint and several liability agreements combined with personal asset guarantees should not be entered into without a clear understanding and diligence. An employer's engagement with a SIF may be the most important risk management decision they will make.