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Client Alert

Business Litigation Practice Group

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Tips for Negotiating Collateral Agreements to Workers' Compensation Insurance Policies

When purchasing, or considering the purchase of, large deductible (LD) workers' compensation, auto, and other policies, insurance companies often require the policyholder to post collateral to secure the risk. This collateral will often be governed by a separate "collateral agreement." Included below are a few important tips to consider when entering into, and negotiating the terms of, any such collateral agreement:

- Make sure to request a copy of the insurer's proposed collateral agreement early on in the process of negotiating the underlying LD policy. The policyholder should have ample time to review, analyze, and negotiate the terms of the collateral agreement in conjunction with the purchase of the policy itself.
- Collateral agreements often include provisions allowing an insurance company to apply the collateral to any existing or past insurance policy issued by the same insurance company, not just the workers' compensation policy itself. Make sure to negotiate terms that tie the policyholder's right to collateral *solely* to the workers' compensation policy at issue, and not to any other types of insurance policies.
- Many collateral agreements permit an annual collateral review process, or will allow review only when the insurance company, in its unilateral discretion deems it necessary. Consider including a provision that the policyholder has its own right to request an interim review of collateral, for instance where a change in the policyholder's business has likely diminished its workers' compensation risk. Also, require an annual audit by the insurer with notice of the findings to the policyholder so that the policyholder can rely upon annual audits to dispute unexpected requests for increased collateral, or reduce the amount of collateral if appropriate.
- Ensure that any collateral agreement provides ample time for the policyholder to provide any required additional collateral to the insurer. Many collateral agreements will only provide the policyholder 30 days in which to provide such additional collateral in the event an insurer determines a collateral increase is warranted. Consider negotiating a longer 60 or 90 day time period.
- Conversely, many agreements state that in the event a return of collateral is deemed appropriate, an insurer is only required to return collateral on an annual basis. Consider including a provision that the insurer must return such collateral to the policyholder within a similar 60 or 90 day time period.

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- In the event an insurer asserts that it intends to draw down on the provided collateral, the policyholder will want to obtain review by an independent expert. The policyholder will want to ensure that the insurance company is complying with any notice provisions in the collateral agreement, and that the policyholder has a full and complete understanding of why the insurer believes it is entitled to the draw down.
- Many collateral agreements contain strict provisions regarding default by a policyholder. Given that default can have severe consequences, make sure to negotiate the most favorable terms in this regard. For instance, consider negotiating terms that allow the policyholder to dispute an insurer's demand for additional collateral without triggering a default of the agreement. In addition, seek to limit the consequences of a default by limiting any damages to the amount of the collateral actually at issue.
- Insurers often rely on industry-wide data in calculating the "loss pick," *i.e.*, the number that is used as the basis for the initial collateral calculation. However, the policyholder's claims history may be significantly better than the industry-wide average. Consider retaining an independent actuary to calculate an appropriate loss-pick to counter the insurer's figure.
- Insurers will often use a loss development factor (LDF), *i.e.*, the number used to project additional expected costs on claims, that is more conservative than an independent actuary might use. Consider retaining an independent actuary to assess the reasonableness of insurers' LDF number to ensure the insurers' LDF is not artificially high, and always insist on disclosure of the LDF number within the collateral agreement itself.
- Because collateral agreements eliminate LD insurers' exposure to claims falling within a large policy deductible, LD insurers arguably have incentives to settle claims within the deductible, but for more than they are worth, to develop an artificially high loss history that an insurer can later use to justify demands for higher premiums or increased collateral. Policyholders should be aware of this risk, develop a good working relationship with their claims administrators, and insist on the right to be involved in decisions regarding the settlement of claims.
- Many collateral agreements include arbitration clauses. Policyholders should in general avoid any such clauses. At a minimum, the policyholder should avoid any arbitration clause that requires the use of retired insurance executives as arbitrators.
- Collateral should be clearly defined as such in the collateral agreement itself to guard against bankruptcy risks, such as an argument by an insurance company's bankruptcy trustee or a state insurance department that the policyholder's collateral is somehow the property of an insurance company's estate in the event the insurer enters bankruptcy.
- If and when a dispute arises with an insurer over collateral, the policyholder should obtain advice from coverage counsel and seek to have an independent expert review the collateral agreement requirements with counsel's advice so that the policyholder can appropriately respond to the insurance company.