Insurance & Risk Management Update - Summer 2006

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MINNESOTA ATTORNEY GENERAL REPORT CRITICIZES BLUE CROSS AND BLUE SHIELD FOR EXCESSIVE RESERVES/SURPLUSES AND EXECUTIVE COMPENSATION

Health care costs represent about a sixth of the U.S. gross domestic product. And, the costs keep going up - even faster than the economy itself. Most people get health care insurance through their employers. Historically, health care coverage was an economical way for employers to attract and retain quality employees. That is now changing. Exploding health care costs are of increasing concern to employers. In fact, Minnesota employers have seen double-digit premium increases for a number of years. As a result, many employers are evaluating ways to control or reduce those costs, including shifting more of the costs to employees.

Many large employers no longer utilize traditional health care insurance for their employees. Instead they are "self-insuring." Nearly half of the of the health insurers in the United States are "self-insuring" employers, not insurance companies. To protect their employees, small to mid-sized employers continue to utilize health care insurers such as Blue Cross and Blue Shield of Minnesota (BCBSM) - one of Minnesota's largest health care insurers.

In the face of ever-rising health care costs, the Minnesota Attorney General issued a report in April of this year critical of BCBSM. A significant part of the Report deals with BCBSM's surplus and reserves. An insurer's "surplus" is the amount that remains when an insurer's liabilities are subtracted from its assets. It is intended to ensure solvency and the ability to meet long-term contractual obligations. An insurer establishes "reserves" based on estimates of what will be necessary to cover future liabilities. These include such things as claims reserves, premium reserves and operating reserves.

The Report contends that BCBSM artificially underreports its surplus through a number of "unusual accounting maneuvers," has over-reserved claims and adopted policy reserve practices that are inconsistent with statutory accounting practices.

Most states, including Minnesota, have enacted variations of the National Association of Insurance Commissioners (NAIC) model Health Risk-Based Capital Act to regulate the financial solvency of insurers. That legislation establishes a number of trigger points for intervention based on a risk-based capital (RBC) formula. The Report contends that BCBSM's surplus, as adjusted by the Report, exceeds 1200% of RBC;

whereas under Minnesota law BCBSM is only required to maintain a surplus equal to 200% of its RBC. The Report concludes that "BCBSM's ratio between its RBC and its current net worth, as adjusted by this report, appears to be the largest in the country." Ultimately, the Report concludes that there was no attempt to lower premiums or even keep those premiums down. A significant part of those premiums are paid for by small to mid-sized employers.

BCBSM disputes the Report's conclusions contending that its reserves are "entirely appropriate" for the size and nature of its business. It further contends that its reserve practices have been confirmed by outside auditors and regulators.

Many Blue affiliates in other states have been criticized for excessive surpluses and reserves. This has spawned litigation, regulatory proceedings and legislative initiatives aimed at trying to identify and assess the appropriate level of surpluses and reserves, and, in some instances, seeking return of excess surpluses and reserves to policyholders and others. In that regard, the Report recommends that at least $400 million in BCBSM's excess net worth be returned to policyholders and that the Minnesota Department of Commerce undertake a comprehensive audit of BCBSM's contracting practices and be more diligent in its oversight. The Minnesota Department of Commerce has concluded that there is no excess surplus/reserve because the Attorney General's analysis included for-profit HMOs and proceeds from tobacco litigation, which it views as inappropriate. The Department of Commerce does not plan on taking any action in response to the Attorney General's Report.

JOB-SITE DEATHS PROMPT "CLOSEST TO THE RISK" TEST INVOLVING "ADDITIONAL INSURED" COVERAGE

It is now a standard practice in the construction industry for contractors and subcontractors to negotiate risk transfer provisions addressing project-related injuries and damages. The most common examples are provisions requiring indemnification and naming other contractors as "additional insureds." Sorting out insurance coverage in the wake of a serious accident can very quickly become complicated by potential conflicts between the indemnity provisions and additional insured endorsements. *Westchester Fire Ins. Co. v. Continental Causality Co*., 2006 WL 786866 (Minn. Ct. App. March 28, 2006) addressed the availability of insurance coverage under an additional insured endorsement in the context of two job-site deaths arising from the operation of a crane. After ruling that the subcontractor was entitled to coverage under the general contractor's liability policy, the court was faced with the question whether the general contractor's policy or the subcontractor's policy would be primary and which would be excess with respect to the claim. The court applied the "closest to the risk" test, which considers "the primary policy risks upon which each policy's premiums were based and as determined by the primary function of each policy." Id. at *9, (citing *Integrity Mut. Ins. Co. v. State Auto. & Cas. Underwriters Ins. Co*., 239 N.W.2d 445, 446 (Minn. 1976)). Since the general contractor's policy included an endorsement referencing leased equipment (i.e., the crane involved

in the accident), the court determined that the general contractor's policy was primary to this risk. In addition, the court found that the general contractor's umbrella policy also covered the subcontractor. In reaching that conclusion, the court focused on the language in the umbrella policy extending the coverage to "persons or organizations included as an insured under the provisions of the 'scheduled underlying insurance'." Id. at * 10. The court determined that the subcontractor's status as an additional insured qualified it for coverage under the umbrella policy. This determination opened up literally tens of millions in additional insurance to the subcontractor.

DO GENERAL LIABILITY POLICIES COVER PUNITIVE DAMAGES?

Many insureds assume that once a claim falls within the coverage afforded under the insurance policy, the insurer must then pay all types of damages arising from that claim. The Minnesota Court of Appeals recently revisited the question whether an insured is entitled to a defense and indemnity with respect to punitive damages. In *Seren Innovations, Inc. v. Transcontinental Ins. Co*., 2006 WL 1390262 (Minn. Ct. App. May 23, 2006), the insured and its subcontractor where sued as a result of a natural gas line explosion that resulted in the death of four people and damage to nearby property. The plaintiffs' claimed that the insured (Seren) was liable for compensatory and punitive damages arising from its alleged failure to take adequate safety measures and to provide adequate training to its agents (the subcontractor). Id. at *4. Seren settled the claims, including the punitive damage claims. The insurer refused to participate in a settlement, taking the position that punitive damages are not covered under Seren's general liability policy. The Minnesota Court of Appeals agreed, observing that "[g]enerally, insurance coverage for punitive damages is contrary to public policy because it would defeat the purpose of punishing wrongdoers." Id. at *3, citing *Wojciak v. N. Package Corp*., 310 N.W.2d 675, 680 (Minn. 1981). The court acknowledged a recognized exception to this rule for claims alleging punitive damages based on vicarious liability. Id. at *3, citing *Pearl v. St. Paul Fire & Marine Ins. Co*., 345 N.W.2d 209, 216 (Minn. 1984). See Minn. Stat. § 60a.06, subd. 4 (2004) (allowing insurance companies to insure against vicarious liability for punitive damages). The court found that plaintiffs had asserted direct claims against Seren, but there would have been no coverage even if only vicarious liability had been alleged. The court held that the terms of the insurance policy must expressly provide coverage for punitive damages arising from vicarious liability in order for coverage to exist. Seren's policy (like most general liability policies) contained no such express grant of coverage.

For More Information

If you have additional questions on these or other insurance or risk management issues, please feel free to contact Nick Nierengarten or Rick Kubler.

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