

business insurance

Administration wants rules limiting pension terminations

WASHINGTON—The Reagan administration wants legislation that would make it more difficult for employers to dump their underfunded pension plans onto the Pension Benefit Guaranty Corp.

The administration last week proposed that before an employer would be allowed to terminate an underfunded plan, it would have to prove that it needed to fold the plan to stay

Continued on next page

Reporting weekly for corporate risk, employee benefit and financial executives/\$1 a copy; \$40 a year

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Mail-order drugs can cut the cost of prescription plans

By SALLIE J. DRURY

Employers can deliver lower-cost prescription drug benefits by having pharmaceuticals mailed to their employees' homes.

The mail-order plans, which supply maintenance drugs used to treat conditions like high blood pressure or diabetes, have cost-saving potential for both employer and employee. And, they are attracting the attention of a growing number of employers.

This is how it works: An active employee or retiree receives a prescription for a maintenance drug from his or her physician. Ordinarily, the employee would take the prescription to a local pharmacy and receive a 30-day supply. But, with a mail-order plan, the prescription is sent to a distribution house, which provides a 90-day supply. The employee receives the medication about a week after he sends in his order.

In most cases, an employer's prescription drug plan administrator also administers the mail-order plan.

Mail-order plans can save employers money in three ways.

First, the drugs usually cost less through the distribution houses because they order in bulk. This cuts the cost of the drugs and these savings are passed on to the employers providing drug benefits.

The distribution houses also generally use generic drugs, which are traditionally less costly than brand-name drugs.

Additionally, the employer pays less in dispensing fees when 90-day supplies of drugs are dispensed. If the employee only received a 30-day supply, the employer would have to pay three dispensing fees every 90 days; with a 90-day supply, it pays only once.

The employee also saves because typically he pays a \$1 or \$2 deductible on every prescription filled. With a 90-day prescription, he would pay two fewer deductibles than with three 30-day refills. He also has the convenience of home delivery.

"It's one of the few benefits we are able to give our employees that doesn't cost the company any money—in fact, saves the company money," said David Viall, corporate manager of employee benefits for Outboard Marine Corp. in Waukegan, Ill. "We've been on the plan six or seven months, and every three months, we save between \$7 and \$9 per employee using the system."

Outboard Marine's prescription drug plan is administered by PAID Prescriptions of Paramus, N.J. PAID is just one of several companies involved in the administration of mail-order prescription benefits (see related story, page 30).

Because the amount a company can save using a mail-order drug plan is directly related to the

Continued on page 30

MGM sues Hall, insurers over back-dated policies

By STEPHEN TARNOFF

LAS VEGAS, Nev.—MGM Grand Hotels Inc. is ready to borrow \$25 million to fund the next installment of its \$75 million settlement of claims from the 1980 Las Vegas MGM hotel fire because the lead underwriter on its controversial back-dated liability insurance has stopped paying claims.

The hotel company is suing its broker, Frank B. Hall & Co. Inc. of Briarcliff Manor, N.Y., and 21 insurers of the first \$95 million of the \$170 million back-dated liability insurance coverage to force them to pay. But, no one expects a decision before this second \$25 million installment payment is due next month.

A final \$25 million is to be paid over a two-year period in two installments.

MGM Grand also had to borrow to pay the first \$25 million installment in January after its lead insurer, Union International Ltd., stopped paying claims shortly after the settlement with fire victims was announced, MGM Grand contends in its suit.

The MGM Grand lawsuit over its back-dated liability insurance adds to the controversy that erupted in early 1981 after *Business Insurance* reported that MGM Grand had purchased back-dated policies. At that time, some hailed the policies as innovative and others criticized them as ignoring the basic principles of insurance.

Union International, a Hall subsidiary that issued a policy for the first \$35 million of back-dated insurance excess of \$30 million in existing coverage, already has paid an estimated \$8 million to \$10 million to cover earlier settlements and litigation costs before the January settlement.

Bernard Segelin, MGM Grand vp and general counsel, said last week that MGM Grand is committed to paying the \$75 million

settlement with fire victims while vigorously pursuing its suit against its broker and insurers.

The suit, filed March 10 in the 8th Judicial District for the State of Nevada, asks the court to rule on the extent of coverage provided by the back-dated liability insurance and contains numerous charges against Hall and the insurers for failing to respond under the back-dated liability insurance policies.

It also seeks \$1.6 million to cover litigation expenses incurred in the settlement process.

"We will pay the \$75 million," Mr. Segelin said. "We are committed to pay the \$75 million." The company already has loan commitments from banks, he said.

The interest charges MGM Grand will have to pay on the loans are one element of the unspecified amount of general, actual and punitive damages sought.

MGM Grand and others close to the case say the unexpected speed of the settlement with the fire victims caught Union International by surprise.

The settlement, expected to be finalized April 1, is to cover the remaining 450 outstanding cases stemming from the November 1980 fire that killed 85 people and injured 591. More than 2,200 cases already have been settled.

The quick \$75 million settlement of the 450 remaining suits would force Union International to pay its remaining \$25 million exposure before the \$25 million premium paid by MGM for the \$35 million in coverage could generate enough investment income to cover the exposure.

Officials at Frank B. Hall, however, say they are contesting liability for their share of the \$75 million settlement because they contend it includes punitive damages, which are excluded under the coverage, and that they are not convinced the exact amount

Continued on page 34



Graphic: Amy Palmer

Could the value of MGM's pioneer policy go up in smoke?

Reinsurance renewals signal higher rates

By STACY SHAPIRO

LONDON—Many insurers will offer buyers lower limits at increased premium rates for many classes of business by the end of the year, sources in the London market predict.

Underwriters will also be forced to retain higher percentages of their risks rather than cede them to reinsurers, the London sources say.

The only factor that could delay these events, they explain, is the world economic slump that is reducing the value of many exposures, thus creating extra capacity.

But, all signs in London point to reduced capacity for many aviation, marine and non-marine risks, which could make rates turn sharply upward.

These predictions come from Lloyd's of London brokers and underwriters who have recently experienced one of the most grueling renewal seasons on record for proportional reinsurance.

Proportional reinsurance, also known as pro rata reinsurance, describes all forms of reinsurance in which the reinsurer shares a proportion of the original premium and the losses of the ceding company. Quota-share reinsurance is a form of proportional reinsurance in which the reinsurer assumes an agreed percentage of the ceding company's premiums and losses.

"I have just emerged from possibly the most exacting renewal

season since 1968—and some will say of all time," said David King, chairman of D.G. King & Others, a Lloyd's underwriting agency, in a speech at the Third Annual Changing World Insurance Markets Conference held earlier this month (see stories starting on page 28).

Underwriters from Singapore to South America scrambled through the recent reinsurance renewals searching for someone to accept their proportional treaties, but many were not very successful. And, many who did manage to place treaties indicated that negotiations sometimes took months longer than usual.

Brokers failed to find reinsurers accepting the high percentages that many insurers hope to cede on a proportional basis. So, instead of ceding 70% to 80% of their portfolios as in recent years, some insurers could only cede 50% to 60% and were forced to retain the rest.

"It's been the worst season ever," said Malcolm Rumsey, chairman of the Lloyd's Underwriters Assn. "And next year, the medicine will be worse... more proportional treaties will be eliminated."

"The whole reinsurance scene is tightening up like mad," he says.

"People in the London market suddenly decided that they were losing money in proportional treaties and began saying 'no'

Continued on page 33

INSIDE:

EEOC says employers must include older workers in health plans

Page 2

Many Japanese firms unable to buy full quake coverage

Page 3

update

New PBGC regulations offered

Continued from previous page in business.

In addition, the administration said an employer and the PBGC would have to agree ahead of time on the net worth of the company before the PBGC would take over the firm's pension plan.

The administration also agrees that the annual termination insurance premium be raised to \$6 per participant.

Sears agrees to settlement

CHICAGO—Sears, Roebuck & Co., through its subsidiary Allstate Insurance Co., will set aside \$15 million in a trust fund to settle a 6-year-old class-action suit that could affect more than 350,000 current and former Sears employees. Sears agreed to the March 11 settlement in a Cook County Circuit Court ruling.

The lawsuit stems from a complaint lodged by two former employees who questioned whether any profit made by Allstate should have been returned to members of Sears' employee-subsidized life and health insurance plans, which were underwritten by Allstate. The suit only questioned funds earned by Allstate prior to enactment of the Employee Retirement Income Security Act of 1974.

A court-appointed trustee will make a computer search of the company's records to find employees eligible to file a claim.

States offer cost-control plans

MADISON, Wis.—Gov. Anthony Earl last week proposed the creation of an independent hospital rate-setting commission to replace the state's Hospital Rate Review Program to help contain health care costs.

According to the proposal, the new commission would have broad authority in setting hospital rates, including establishing revenue ceilings. The group would set rates prospectively with no provision for year-end adjustments. Rates would be set on a flat per-patient basis according to diagnosis-related groups.

In Florida, Insurance Commissioner Bill Gunter earlier this month also presented a House Commerce subcommittee with a series of reforms to control rising health costs. One element would require that health insurance policies, except for Medicare supplemental plans, have deductibles of at least \$200 per person and \$350 per family.

Bermuda regulators act

HAMILTON, Bermuda—The Minister of Finance of Bermuda has for the first time exercised his power under the Bermuda Insurance Act to direct an insurance company to stop underwriting.

The minister directed Ajax Insurance Co. Ltd. to stop underwriting on the basis of its statutory return filed with the government. The government had been monitoring the run-off of Ajax's business by chartered accountants in London but wanted to formalize the run-off with its order, regulators in Bermuda explained.

Ajax, owned by Greek shipping interests, began winding down its marine business in 1981 and its non-marine business in early 1982.

The Bermuda government also moved last month to liquidate Dover Insurance Co. Ltd. The financial status of Dover, which underwrote medical malpractice insurance for podiatrists in New York, has been of concern since last September when the New York Insurance Department ordered surplus lines agents to stop placing business with Dover. Since then the Bermuda government investigated and the New York Insurance Department has liquidated Dover's \$1.6 million trust fund in New York.

Social Security differences seen

WASHINGTON—The Senate late last week was on the verge of passing legislation, S. 1, to shore up the Social Security program.

However, after the Senate approves the bill, a conference committee will probably have to iron out differences between Senate and House versions of the bill. Key differences that must be settled include when and by how much the retirement age should be increased and whether contributions to some flexible benefit plans should be subject to the FICA tax (BI, March 14).

Space object may be Satcom III

PRINCETON, N.J.—RCA Corp. believes an object recently discovered in Earth orbit may be its wayward Satcom III communications satellite, lost in space after its December 1979 launch.

"Nobody's prepared to swear on a stack of Bibles that it's Satcom III," but the odds are in its favor, said a spokesman for RCA American Communications Inc., RCA's satellite communications unit.

The discovery probably comes too late to be of anything but passing interest to Lloyd's of London, Lexington Insurance Co. and Skandia Group, which paid a \$77 million total loss on the orbiter. The RCA spokesman said no further efforts are planned to positively identify the object, nor will any attempt be made to retrieve it.

index

Benefit beat	4
Classifieds	32
Datebook	32
Insurance services guide	34
Letters	6
Opinions	6
Perspectives	25
Ticker	35

Vol. 17, No. 12—Business Insur-

ance (ISSN 0007-6864) is published weekly at 740 Rush St., Chicago, Ill. 60611. Second-class postage is paid at Chicago, Ill., and at additional mailing offices. Postmaster: Send address changes to Business Insurance, circulation department, 740 Rush St., Chicago, Ill., 60611; 312-649-5221. Copyright 1983 by Crain Communications Inc.

EEOC says employer plans must cover older workers

By JERRY GEISEL

WASHINGTON—Employers should now include workers between the ages of 65 and 69 in their group health insurance plans, the federal government says.

In an abrupt change of position, the Equal Employment Opportunity Commission is telling employers that company health care plans—not the federal Medicare program—have been the primary payers of older workers' medical bills since Jan. 1.

In addition, the Health Care Financing Administration, the federal agency that administers the Medicare program, says employer health plans for older workers that supplement Medicare, such as by picking up Medicare deductibles and copayments, should have been terminated on Jan. 1.

"We expect the employer plan to be primary and provide the same benefits as those offered to younger employees," an HCFA official said.

However, it isn't clear yet how HCFA will require employers to pick up older workers' medical bills incurred after Jan. 1.

The EEOC earlier this year told employers that they should offer the same health insurance plans to older workers that they had offered prior to Jan. 1, until new rules are published on how employer health plans should be coordinated with Medicare coverage.

The rules are needed to explain how employers are to comply with a provision in the 1982 tax law that requires them to offer workers aged 65 through 69 a choice of either enrolling in the employer's group health plan or retaining Medicare as their primary health insurer.

Those rules were to have originally been published in December so that older employees who wanted to enroll in their employer's group health plans could do

so by Jan. 1, the effective date of the provision in the Tax Equity and Fiscal Responsibility Act of 1982.

However, the EEOC was forced to scrap its first set of proposed rules after they were rejected by the Office of Management and Budget. The OMB said those rules would have encouraged older workers to stay in the Medicare program (BI, Jan. 31).

That would have defeated Congress' intent when it passed TEFRA—to encourage older workers to enroll in their company's health insurance plans, thereby trimming Medicare costs by about \$350 million.

Many companies have been waiting for the new EEOC rules—which are still not expected to be officially published until late April—before covering older

Continued on page 31

Directory deadline extended

The deadline for captive managers to return questionnaires to be included in the annual Business Insurance captive management directory has been extended to March 28.

The directory will be published in the April 25 issue, which will spotlight the offshore insurance market, captives and the growth of U.S. captives and be distributed to participants at the annual Risk & Insurance Management Society Conference in Los Angeles.

If your questionnaire will be late because of international mail, or you have not received a captive management questionnaire, please contact Claudette Dampier, Assistant Copy Editor, Business Insurance, 740 N. Rush St., Chicago, Ill. 60611; 312-649-5282.

National to share pension costs with employee-owned company

By BILL DENSMORE

WEIRTON, W. Va.—National Steel Corp. will spend an estimated \$151 million on benefits for retired and current employees as part of the proposed sale of its Weirton Steel plant to current employees.

The bulk of the \$151 million is the cost to National of continuing life and health benefits for approximately 4,000 retired workers. A small portion of the sum will be needed to round out the cost of pension benefits for current employees.

Under the sale agreement, the cost of pension benefits for current employees will be divided proportionally between National and the newly formed company based on the number of years of service an employee had with each company.

Most of National's pension liabilities are already funded, but the company has promised to recognize Weirton employees' future years of service with the new company when calculating pension benefits accrued while they worked at National.

The new employee-owned company, which would be the largest in the nation, will establish a benefit pro-

gram for its current employees, as well as a pension plan separate from National's, that also credits the employees for the years they worked at National.

Although National's promise to recognize continued years of service with the employee-owned company when calculating pension benefits will not be especially costly, it was a key to the agreement that could create the nation's largest employee-owned enterprise and the largest ever financed through a leveraged Employee Stock Ownership Trust.

"We have a mature workforce down here, so the pension questions were very important," adds Eugene L. West, vp/controller of National's Weirton Steel division.

"This is by far the biggest part," says Howard A. Lidtke, controller of Pittsburgh-based National.

National and the lawyers representing the union-management Weirton Steel Joint Study Committee Inc., which is representing the buyers, announced agreement a week ago on a plan under which National will sell the plant within a month to the ESOT.

The new company to be created by the transaction,

Continued on page 31

Lloyd's says policies were altered

By STACY SHAPIRO

LONDON—Lloyd's of London says someone altered extended warranty insurance policies underwritten by Lloyd's syndicates and is asking the City of London Fraud Squad and the Department of Trade to investigate the matter.

If it's proven that the policies were illegally altered, Lloyd's says it will void the coverage, which it says was written to indemnify manufacturers and retailers for warranty claims made by consumers for up to four years after a product's original one-year warranty ex-

pires.

Lloyd's says that manufacturers and retailers could have to pay up to \$5 million in claims if the policies are voided.

Lloyd's underwriters originally discovered the discrepancies in the policies, marketed and managed by a British company called Multi-Guarantee Ltd., late last year. However, a variety of intermediaries also handled the placement of the coverage, including Lloyd's broker Robert Morris Bray Ltd., non-Lloyd's broker Campbell Roberts (Insurance Brokers) Ltd. and brokers for the individual retailers and manufacturers.

Among the firms that bought the policies are Electrolux Ltd. and Hoover Ltd., which make vacuum cleaners and other household products, and Telefusion P.L.C., a British discount retail chain.

After the underwriters discovered the alleged alterations, they asked the accounting firm of Peat, Marwick & Mitchell and Robert Bishop Adjusters Ltd., a claims adjuster, to investigate the matter and submit reports to the Council of Lloyd's.

Lloyd's says the underwriters had agreed to indemnify manufacturers and retailers wanting to extend normal one-year warranties for household products for another four years.

Under the policy terms, Lloyd's says the insurers said

Continued on page 8

errors & omissions

• An article on Marsh & McLennan Cos. Inc.'s proposed sale of its underwriting subsidiaries, published Feb. 21, incorrectly stated that Terra Nova Insurance Co. Ltd. was located in Bermuda. The company is based in London.

• In the risk management consultants listing in the Feb. 21 issue, the name of the president of Aldrich & Cox Inc., Herbert Cox, was omitted.

Many firms in quake-prone Japan offered only low coverage levels

By WILLIAM BOOTH

TOKYO—With a short parable characteristic of the Orient, Katsuji Ishida, financial director of Polaroid Corp. of Japan, explains the Japanese approach to earthquake insurance.

"In the old days," Mr. Ishida says, "we Japanese built our houses of paper and wood. Never stone. Never brick. Because the house was flexible, it had a chance of surviving an earthquake. If it didn't, if the house fell down, it could still be quickly and cheaply rebuilt."

"That is how Japanese insure themselves."

This lesson in pragmatism needs to be updated, observers of the Japanese insurance industry say.

The Japanese no longer live in houses of paper and wood, but in high-rises of glass and steel. And, in the event of a major quake in the highly industrialized Tokyo area, the entire country would be temporarily crippled, with projected losses soaring above the \$100 billion mark.

As one local insurer says, "The exposures are unbelievable."

But what may be even more unbelievable is that the majority of these potential losses is not covered by earthquake insurance. Because of the colossal exposures involved, Japanese industries can only purchase coverage on a fraction of their property values from domestic insurers, leaving them drastically underinsured by Western standards.

It is a textbook case of supply and demand, explains Takashi Kumakiri, general manager of the Marine & Fire Insurance Assn. of Japan, an Japanese insurance trade group.

Because of the size of potential losses and the increasing demand for earthquake coverage, the Japanese insurance cartel in 1964 tacitly agreed to limit the amount of earthquake coverage available, Mr. Kumakiri said.

The insurers divided the country into 12 "accumulation" zones; buyers in the areas with the greatest industrial concentration can only buy the lowest levels of coverage to

reduce the financial impact of a disaster on the insurers.

For example, in the "Notorious Five," the zone that includes Tokyo and Yokohama, Japanese companies can only insure 15% of their earthquake exposures.

"Everybody knows it's dangerous to write earthquake risks," says Mr. Kumakiri. "Nobody wants the business. It's almost suicide."

According to seismologists, a major earthquake jolts the Japanese archipelago on an average of every 60 years, making catastrophic losses inevitable. Japanese insurers are particularly jumpy now, since this year marks the 60th anniversary of the great Kanto quake of 1923 that killed 140,000 people and destroyed some 580,000 buildings.

Because of the probability of a quake, Japanese insurers reinsure almost 90% of their earthquake risks with overseas underwriters, while they retain large portions of their more lucrative fire business. (In Japan, earthquake insurance is always written as an endorsement to a standard fire policy.)

This selective retention, some sources suggest, may be a reason the Japanese are finding it more and more difficult to place earthquake reinsurance abroad. Japanese insurers often cite the saturated reinsurance market as one of the major reasons they are reluctant to offer higher levels of coverage.

Because Japanese insurers are reluctant to provide earthquake coverage, the government allows foreign corporations in Japan to purchase policies from foreign underwriters at much greater coverage levels than are available in the domestic market.

For example, a foreign-owned company operating in a highly industrialized accumulation zone, like Tokyo, can insure up to 60% of its property value through a non-Japanese underwriter.

In addition, the government allows foreign companies to insure the remainder of the earthquake exposure through the parent company's global wrap-up policy, says William Smith, managing vp for Alexander & Alexander Inc. in Japan.



Graphic: Jim Bakasetas

"It's not really the best (financial) deal in the world," explains Mr. Smith, "but it's what's available now in Japan for someone who wants complete coverage."

Polaroid Corp. of Japan is a typical example of how a foreign company protects itself against earthquake losses in Tokyo. Insuring properties valued at more than \$1 million, Polaroid obtains the maximum coverage of 60% of property value, or about \$700,000, through an earthquake endorsement written by American International Underwriters, Mr. Ishida says.

Because Polaroid's risk manager in the United States wanted full earthquake coverage, the company is covering the remaining 40% with a worldwide insurance program, which includes a difference-in-conditions endorsement covering earthquake damage.

In another case, the I.P.I. Corp., a subsidiary of Interna-

Continued on page 32

Insuring oil and gas risks

Lloyd's well-control policy doesn't cover all exposures facing operators: Broker

By DOUGLAS McLEOD

NEW ORLEANS—Operators of oil and gas wells may find that some of their exposures aren't covered under the standard Lloyd's of London well-control policy, one expert says.

Operators who want the broadest possible coverage should examine their policies carefully, advises Edward W. Cooke, executive vp of Global Special Risks Inc. of Metairie, La.

They should also consider purchasing a number of specialty coverage endorsements designed to pick up exposures not included in the standard well-control policy, Mr. Cooke told an audience at the Fourth Annual Petroleum Insurance Conference, held earlier this month in New Orleans.

Lloyd's and other London markets provide 60% to 75% of all well-control coverage, he said, adding the markets have a total premium volume of as much as \$180 million.

The standard Lloyd's well-control policy—also known as an operator's extra-exposure policy—indemnifies the buyer for the following exposures:

- The costs of bringing a well under control after a blowout, a gusher of oil or gas that results when the operator loses control of the flow from the well.

This coverage includes the costs of extinguishing a well fire and of drilling a so-called relief well near the blown-out well to bring it under control.

With a relief well, operators actually drill into the casing of the wild well as deep as 16,000 feet, injecting heavy mud and cement to shut off the flow of oil or gas.

- The cost of redrilling a well that's been damaged either because of a blowout or because of cratering of the land around the well that can result from damage to the underground reservoir.

- Expenses resulting from seepage, pol-

lution or contamination from a well. This includes liability for third-party bodily injury and property damage, as well as the costs of voluntary cleanup operations to avoid further liability.

The most important thing to look at in a well-control policy is the definition of blowout, Mr. Cooke says.

"If you don't have a blowout, you don't have a claim," he explained.

The Lloyd's policy defines blowout as a "continuous uncontrolled flow from the well of oil, gas or water above the surface of the ground or water bottom... which cannot be promptly controlled by the well-control appliances installed on the casing."

Well-control appliances, or so-called blowout preventers, are designed to choke off the flow of oil or gas from the well-head before the well gets out of control.

In some instances, the standard definition of blowout may be too narrow and may result in uninsured losses, Mr. Cooke said. In one case, he said, a gas well blew for 10 seconds before a rig hand closed a valve, shutting it off. The damages, amounting to \$6 million, would not have

Continued on page 17

Competition in oil, insurance industries could endanger drillers suffering a loss

By DOUGLAS McLEOD

NEW ORLEANS—Growing competition among world oil producers and continuing competition in the insurance industry constitute a double whammy for drilling equipment owners, one expert says.

Equipment owners face the possibility of uninsured losses for two different reasons, according to Ralph C. Hamm Jr., president of Ralph Hamm Insurance, a Dallas brokerage specializing in the oil and gas industry.

An oversupply of oil has depressed the values of drilling rigs and equipment, Mr. Hamm said, explaining this means that a drilling contractor with a total loss may not recoup his initial investment under a policy that only covers replacement costs.

Also, rate cutting by underwriters and the decline in equipment values on which rates are based are combining to reduce underwriters' premium income.

With deteriorating loss experience and declining investment income, this could spell insurer insolvency, Mr. Hamm told an audience at the Fourth Annual Petroleum

Insurance Conference.

Most insurance covering drilling rigs and equipment is written on "unvalued" forms attached to property or inland marine policies, Mr. Hamm said. He cited a number of oil and gas equipment floater policies, all of which limit insurers' liability for total losses to the cost of repair or replacement of the equipment or its actual cash value at the time of loss.

The underwriters' reason for offering unvalued policies, Mr. Hamm explained, is to avoid the "moral hazard" that might exist if a well owner could collect more from the insurance on a total loss than the equipment is actually worth.

The problem with this type of policy, though, is that rig utilization rates and oil and gas equipment values, which skyrocketed in the 1970s, have fallen drastically as a result of the much-ballyhooed oil glut.

Rig utilization—the rate at which existing rigs are being used to drill wells—stood at 62% in 1970 and was generally on the rise throughout the decade, peaking at 99% in 1981. By last January, utilization had dropped to 56%, Mr. Hamm said.

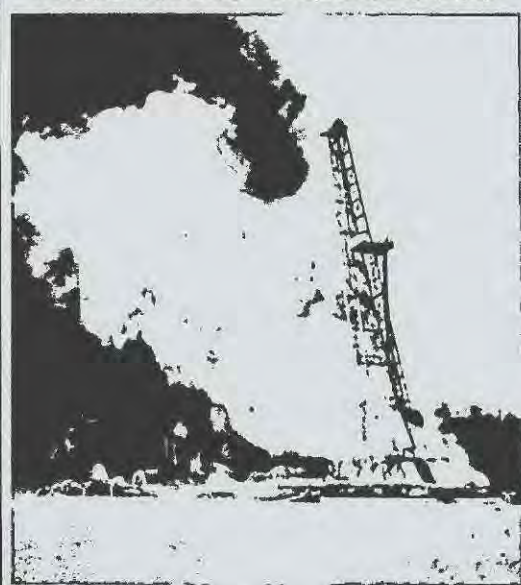
The value of an individual rig has similarly declined. Mr. Hamm cited as an example a drilling rig that was operated in the Rocky Mountains, the value of which climbed from \$320,000 in 1970 to a peak of \$2.9 million in 1981. As of last January, the rig's value had fallen to \$1.75 million.

This type of fluctuation means that a contractor that buys a rig in a period of high demand and high values may have a problem recouping the investment if the rig is lost during a period of weak demand and declining values.

Mr. Hamm put forth the hypothetical case of a rig that is purchased for \$3 million—with the help of a \$2 million loan—and which declines in value during a period of weak demand for equipment to \$1 million.

Continued on page 20

Petroleum Insurance Conference



The other 26% of Crusader South Africa is owned by South African investors, while the remaining 25% of Crusader Insurance P.L.C. is owned by Fireman's Fund Insurance Cos.

opinions



Backing the benefits cause

THE LAST-MINUTE legislative meddlers who don't understand employee benefits plans were at it again this month.

This time, they went after flexible benefits plans with an 11th-hour amendment to the Social Security legislation as it moved out of the House Ways & Means Committee. The amendment, part of the Social Security reform bill approved by the House, would slap the FICA tax on the entire value of a flexible benefits plan if there were any cash or taxable benefits options in the plan.

Thankfully, the Senate isn't taking this approach as it deliberates its version of the bill. We hope that the conference committee that will meet to iron out differences in the Social Security bills passed by the two chambers will quickly ax any new tax on flexible benefits plans.

Not only would such a tax discriminate against workers whose employers have developed benefits plans that allow them to select benefits that fit their needs, it also would start a piecemeal attack on the tax-free status of employee benefits.

This has to be stopped now.

While we are opposed to taxing group health insurance plans, as we have said in the past (*BI*, Dec. 13, 1982), we also realize those health plans and other benefits look to many revenue seekers as an untapped source of funds to help reduce the federal deficit.

With this hard realization, we submit that the only logical approach is a concentrated study by congressional committees on the issues. There must be hearings at which employee benefit experts, as well as tax experts, testify on the advantages, disadvantages and potential consequences of taxing benefit plans.

Predicting and analyzing the consequences is most important. Too much benefits legislation has been adopted without adequate analysis of its impact.

Given the desperate search for new sources of federal revenue, a broad examination of the issues before changes are implemented is the best for which we can

hope. Such an examination, we believe, will convince lawmakers that the best economic and social interests of business and workers are served by reserving the tax-free status of employee benefit plans.

Convincing Congress, however, will require that the most intelligent and articulate experts in the employee benefits field have the time and the money—the backing—to present their arguments. The best way for business to provide that backing is to support one of the several organizations based in Washington that specialize in lobbying on benefit issues.

Last week, Washington Editor Jerry Geisel presented you with a guide to the groups that lobby on benefits issues. If you aren't supporting one of these groups now, we strongly urge that you become involved and join one or more of these organizations.

We believe that benefit issues often get a short shrift in Washington because so few people understand the topic and because the lobbying groups still don't have enough members to exercise the clout needed to fend off last-minute legislative attacks on benefits plans. Whether anyone likes it or not, special interest groups can make or break legislation. Benefit managers need strong special interest groups that are knowledgeable and effective lobbyists on employee benefits issues. Do your part to support them.

Savings in the mail

HERE IS health care cost-control suggestion No. 17. Sign up for your employees to order their maintenance drugs by mail (see story, page 1).

The savings from this program alone will not cap your group health insurance costs. But it is one more tactic to bring new economies to health care.

You'll net the greatest savings if all eligible employees use mail-order drug delivery. But to get them to do that, you may have to sweeten the pot by dropping the employee's deductible on prescriptions if he uses the mail-order plan. Your final results may be worth it.

letters

Another consultant to add to risk managers' list

To the editor: You failed to include our risk management consulting company in the Feb. 21 consultants' directory:

American Risk Services Inc.
6600 France Ave. S., Minneapolis, Minn.
55435; 612-920-0106

Year founded: 1979.
Independent.

Services provided: 10% continuous consulting; 60% risk management audits; 30% special projects, including frequent risk retention analysis (including self-insurance studies), captive insurance subsidiary studies, risk management organization studies, preparation of

specifications for bidding, legal contract review, mergers and acquisitions review, cost-effectiveness studies, fee negotiations, foreign insurance studies, cash-flow utilization studies, accounting systems analysis.

Staff: Eight total staff members; six professionals, including three principal consultants. Professional designations held by staff include one CPP.

Clients: 30 total clients; 76% with risk and insurance budgets less than \$1 million; 20% \$1 million to \$5 million; 4% \$5 million to \$10 million.

Compensation: By the project; on retainer; by the hour; senior consultant, \$100; consultant, \$60.

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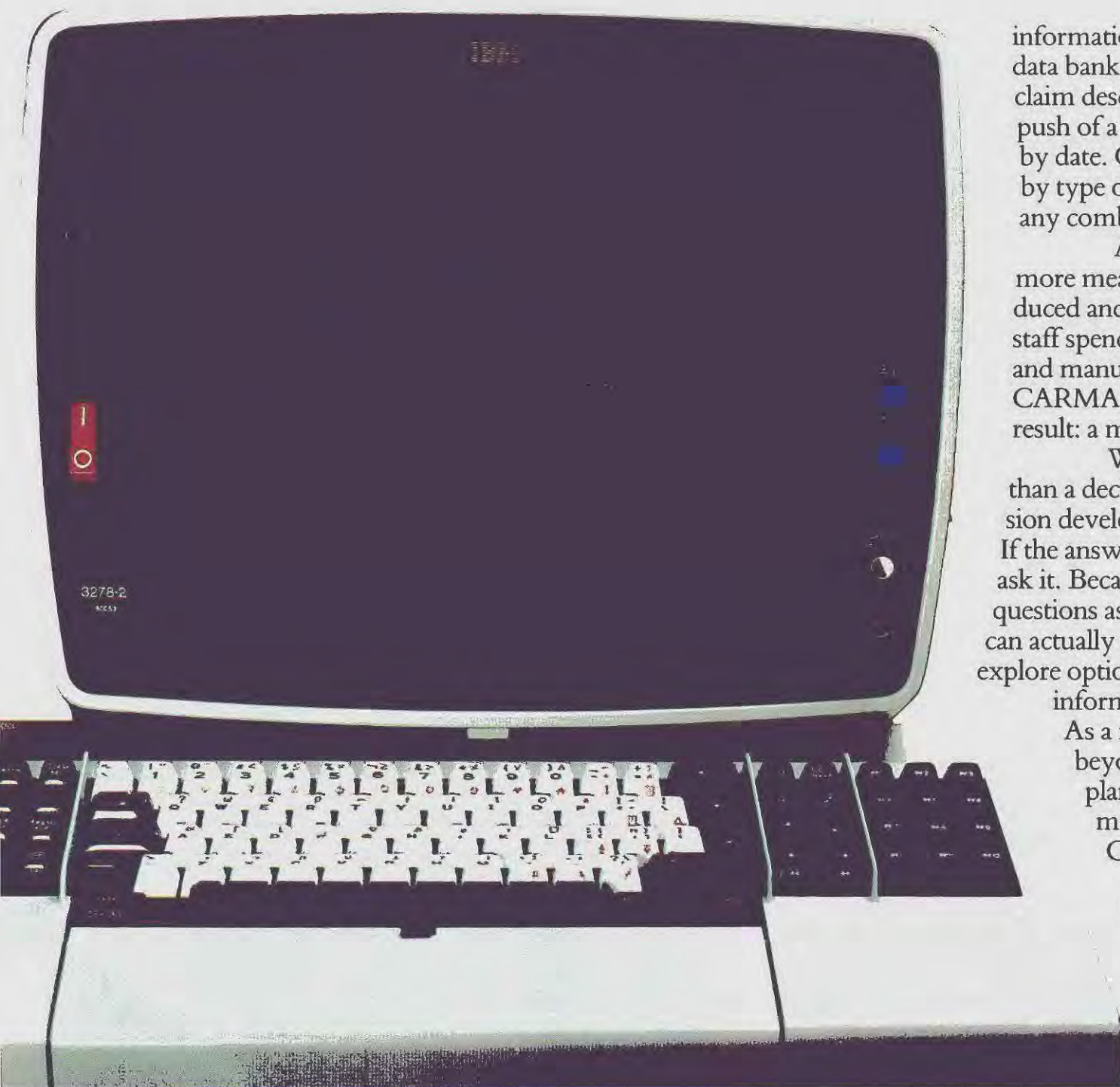
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Lloyd's asks for investigation into altered warranty policies

Continued from page 2

the manufacturer or retailer, not the consumer, was to be the named insured on the coverage and the coverage for each product was to have a maximum 500,000-pound (approximately \$755,000) limit.

In addition, Lloyd's name was not to be printed on the policy or on material marketing it since the coverage was marketed and managed by a firm not affiliated with Lloyd's.

But by the time the policies passed from the underwriters to the Lloyd's broker, Robert Morris Bray, to the non-Lloyd's broker, Campbell Roberts, to Multi-Guarantee and then to the manufactur-

ers and retailers, the coverage terms had been changed, Lloyd's claims. Specifically:

- Policies were sold to individual consumers with the consumers listed as the named insured.
- Some of the policies did not contain limits.
- Lloyd's name was used on some of the policies and on marketing devices.

John Hayhurst, group secretary at Telefusio, says that his company sold the extended warranty policies, marketed by Multi-Guarantee, to consumers at the company's 100 retail outlets beginning in October 1981.

"Then we charged the premium

to the customer," he added.

Mr. Hayhurst indicated that the coverage supplied by Multi-Guarantee conformed to Telefusio's specifications, adding that the coverage was intended to be sold to individual consumers buying household appliances sold by the British retailer.

When Telefusio learned that Lloyd's underwriters were disputing the policies, "we took alternative action," Mr. Hayhurst explained.

For example, Telefusio purchased retroactive coverage to indemnify it from any warranty claims not paid by Lloyd's, he said, adding that the back-dated coverage was purchased from the London branch of The Home Insurance Co.

Mr. Hayhurst said that Telefusio is not paying for the back-dated coverage, but he would not reveal what party is picking up the tab.

In addition, the extended warranty coverage currently being sold to buyers by Telefusio is underwritten by Sentry (U.K.) Insurance Co. Ltd., he said.

Customers are now starting to file claims on the policies underwritten by Lloyd's, he said, adding that "our customers have so far had their claims met."

Lloyd's also says that it is paying all valid claims until it can be decided who altered the policies, although it said that it would take the matter to court if it cannot get any answers.

"The irregularity of any purported alterations to insurance documents will be most rigorously pursued by Lloyd's," it announced last week.

Mr. Hayhurst will not say if his company will take legal action if the coverage is voided or if Telefusio will be liable for any of the claims.

Multi-Guarantee Chairman Ronald Meddes was not available for comment last week, but a spokesman for the company said, "We are currently consulting our lawyers and are flabbergasted by the reports. We have been in contact with Lloyd's and they have said that they are not talking to the Department of Trade or the Fraud Squad."

Lloyd's, however, confirmed that it had contacted both authorities in connection with the case.

A spokesman for Robert Morris Bray said that his company only served as a link between Lloyd's and non-Lloyd's broker Campbell Roberts, which acted as Multi-Guarantee's broker. "There were no discrepancies at Robert Morris Bray," he said.

A spokesman for Campbell Roberts stated simply that his company did not alter the coverage. He said that Campbell Roberts had acted as Multi-Guarantee's broker until last November.

Some of the confusion over the policies, sources in the market say, may have been caused by the Lloyd's underwriting system.

When Lloyd's underwriters accept risks from Lloyd's brokers, they agree to terms and conditions on an underwriting slip, not on the policies themselves, which are issued by brokers or marketers.

As a result, Lloyd's underwriters sometimes do not see the actual policy until claims roll in.

In the case of the extended warranty policies, some of the underwriters never saw the policies, one Lloyd's underwriter said. "The brokers did."

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About the Speaker

Dr. Kenneth R. Oppenheimer, President of Decision and Risk Analysis, Inc., of Palo Alto, California, specializes in executive education and the application of decision and risk analysis to corporate decisions in the insurance, fire protection, banking, wood and paper products, data processing, cattle feeding, and oil and gas drilling industries. Prior to founding Decision and Risk Analysis, Inc., he spent five years with the Decision Analysis Group at S.R.I. International (formerly Stanford Research Institute). His academic background includes a B.S. in mathematics from Tufts University, and a M.S. and Ph.D. in Engineering-Economic Systems from Stanford University. While at Stanford, he was a member of the Decision Analysis Group at Xerox Corporation.

Seminar Dates

May 16	New York	Grand Hyatt
May 18	Dallas	Doubletree Inn
May 23	Los Angeles	The Biltmore
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June 15	Chicago	Ritz Carlton
June 20	San Francisco	The Fairmont

Agenda

1. Introduction to decision and risk analysis
2. A risk management decision: (case study)
3. Assessing the probabilities of loss
4. Assessing the corporate attitude toward risk
5. Analyzing risk transfer alternatives (case study)
6. Analyzing risk control alternatives (case study)
7. Conclusion

Well-control cover often has gaps

Continued from page 3 —
been covered under the standard Lloyd's policy because the blowout had been "promptly controlled."

Mr. Cooke advised members of the audience to try to delete the reference to "prompt control by well-control appliances" from their policies.

He also noted that the definition refers only to blowouts that occur "above the surface of the ground" and would exclude underground blowouts, in which there's an uncontrolled flow of oil or gas from one underground reservoir and into another.

Coverage for underground blowouts can be added simply by changing the definition to cover blowouts "above or below the surface of the ground or water bottom," Mr. Cooke said.

The addition is expensive, though. For land wells, underwriters may tack on a 30% additional premium for covering underground blowouts. For offshore rigs, the additional premium may reach 40%, Mr. Cooke said.

Coverage for redrilling expenses includes only the cost of restoring the well mechanically to its condition prior to the blowout and does not include coverage for the value of the oil or gas lost, Mr. Cooke said.

Redrilling coverage can be obtained in two forms, he added. Unlimited coverage allows the total well-control claim to include any amount of redrilling expenses, as long as the total claim doesn't exceed policy limits. Limited coverage places a sublimit on the costs that can be claimed for redrilling, usually 100% or 200% of the original cost of the rig.

Unlimited coverage can cost 10% to 15% more than the limited form, Mr. Cooke said.

He also advised buyers to try to negotiate the broadest possible coverage under the pollution-liability section of the policy. The definition of insured, for example, should include directors and officers of the company, as well as the company's agents and subsidiaries, so no one will be caught uninsured by a pollution lawsuit.

Many well-control policies don't cover pollution liability unless a blowout occurs, Mr. Cooke added. Policy language should be broadened to cover any pollution liability that "results from operations of the wells insured."

Another item for operators to watch out for is the so-called Blowout Preventer Warranty, which requires that blowout preventers be installed and tested on all wells "in accordance with usual practice."

"What the heck is 'usual practice'?" Mr. Cooke wondered, adding that he'd heard of one well, partially owned—but not operated—by a major oil company, where the blowout preventer had been installed upside down.

Since violating a warranty technically allows the insurer to cancel the policy, Mr. Cooke suggested that the warranty be replaced with a blowout-preventer clause, which would require installation and testing of the devices only where the policyholder is the direct operator of the well.

Another problem can crop up under what are known as turnkey contracts, under which the well operator (the company that owns an interest

in the well and oversees its operations) holds the drilling contractor (the company that actually does the drilling) responsible for well-control expenses in case of a blowout.

There is no standard turnkey contract and in many such agreements, financial responsibility for a blowout can shift unexpectedly back to the operator under certain conditions. Under some contracts, for example, responsibility reverts to the operator if the drilling contractor has to drill to "abnormal pressures" or encounters "abnormal drilling conditions."

"Well, try to define that," Mr. Cooke told the audience.

He advised adding a turnkey endorsement to the well-control policy that will automatically cover the operator in case the burden of responsibility shifts back to it under the contract.

Additional premium for covering turnkey wells is usually figured at a percentage of the applicable drilling rate, Mr. Cooke said.

A number of additional exposures not covered by the standard well-control policy can be picked up with special endorsements, Mr. Cooke pointed out.

These endorsements include the:

- **Stuck Drill Stem Endorsement**, which insures the well operator's liability to the drilling contractor in case the contractor's drilling equipment is stuck in the well or damaged during drilling operations. The standard Lloyd's endorsement covers the equipment only against named perils like blowouts, kicks (an impending blowout or temporary uncontrolled flow of oil or gas), cratering, fires or windstorms.

All-risks stuck drill stem coverage is available, but can cost as much as 15% additional to the standard well-control insurance premium, while the named perils form may cost half that, Mr. Cooke said.

- **Care, Custody and Control Endorsement**, which is meant to pick up the insured's legal or contractual liability for damage to property of others that is in the insured's care, custody and control. This liability insurance is not included in the well-control form and is specifically excluded from most comprehensive general liability policies (see story, page 21).

- **Evacuation Expense Endorsement**, designed to cover the insured's liability for costs of evacuating people and livestock from the area around a well that, for example, is emitting poisonous gas. The insurance also covers the costs of sheltering and feeding the evacuees.

London underwriters often say that coverage for these expenses is not included in the seepage and pollution section of the basic policy and may charge an additional 5% or 10% for the endorsement, Mr. Cooke said.

- **Contingent Control of Well Endorsement**. Oil and gas wells, though operated by only one company, are often owned and insured by several parties in varying shares. The endorsement covers the extra share of well-control costs one partner might be forced by regulatory authorities to pay if another partner becomes insolvent or has no insurance.

Mr. Cooke recommended, in order to avoid confusion over who has placed insurance, that well operators write to their co-venturers to tell them they will be insured under the operator's policy unless they inform the operator otherwise.

- **Loss of Production Income Endorsement**, a form of business interruption insurance designed to cover lost revenues from producing wells in case of a blowout or other insured peril.

Mr. Cooke said he knew of one

case, for example, in which a well on an offshore platform blew out and knocked out two other wells on the same platform, resulting in lost income for the operator of \$150,000 per day.

- **OCSLA Endorsement**, which provides the \$35 million in pollution liability insurance required for offshore wells by the Outer Continental Shelf Lands Act Amendment of 1978.

OCSLA, as currently written, also makes well owners liable without limit for pollution cleanup costs, Mr. Cooke points out, and underwriters have refused to write unlimited coverage for the well owners.

Congress is now considering an amendment to OCSLA that would eliminate the unlimited liability for cleanup costs while raising the statutory liability requirement for all pollution exposures to \$75 million from \$35 million, Mr. Cooke said.

"We expect that to be passed very, very soon," he said.

Meanwhile, the Coast Guard is accepting as a demonstration of good faith a letter saying that the well owner was unable to find an insurer willing to guarantee financial responsibility for unlimited cleanup liability, Mr. Cooke said. ■

CGL form contains limitations, exclusions that affect oil risks

NEW ORLEANS—The basic comprehensive general liability insurance policy contains a number of coverage exclusions and limitations that apply to oilfield risks, a risk management consultant points out.

Companies with oilfield exposures should give their CGL policies a close look to make sure these exclusions and limitations have been removed, says Keith C. Kakacek, president of RIMCO Risk Management Inc. of Dallas, which was acquired earlier this month by Tillinghast, Nelson & Warren (BN, March 14).

Attention should also be paid to policy conditions that can't be circumvented but can limit coverage if overlooked, Mr. Kakacek told an audience at the Fourth Annual Petroleum Insurance Conference in New Orleans.

According to Mr. Kakacek, exclusions and limitations in the comprehensive general liability form that can affect oil and gas operators include:

- **Contractual liability**. With few exceptions, the basic CGL policy will not pay for third-party bodily injuries or property damage liabilities that the policyholder assumes under contracts.

Operating agreements, drilling contracts and other such contracts are common in the oil industry, Mr. Kakacek pointed out. A drilling contract, for example, may require that the drilling contractor be "held harmless" in third-party damage suits.

Thus, contractual liability coverage is essential, he said, and can be added either by purchasing separate contractual liability insurance or by adding the Broad Form Comprehensive General Liability Endorsement, which includes the contractual liability coverage as a standard provision, Mr. Kakacek said.

- **Cross-liabilities**. The CGL coverage applies "separately to each

Continued on next page

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Pay attention to CGL exclusions: Consultant

Continued from previous page insured against whom claim is made or suit is brought." This means that a suit brought by one named insured against another insured under the same policy will be covered, Mr. Kakacek said. But a cross-liability exclusion is sometimes attached to oilfield policies eliminating coverage for liabilities among insureds.

This exclusion should be eliminated, he advised.

• Partnerships and joint ventures, which are usually excluded

from coverage under the basic CGL form unless the partnership or joint venture is designated in the policy as a named insured.

Since most oil and gas drilling involves some form of partnership, this exclusion is critical, Mr. Kakacek said, noting that an endorsement should be added to pick up liabilities arising from participation in such an arrangement.

Another endorsement can be added to a well operator's policy extending coverage to partners, co-venturers and parties with non-

operating working interests in a well, he added.

• Special hazards. The CGL underwriter can designate a particular risk as presenting certain special hazards. And, the presence of these special hazards allows the underwriter to attach provisions excluding them from coverage and to charge an additional premium to remove the exclusions.

Most oilfield risks, for example, are classified as presenting the so-called "xcu" hazards: explosion, collapse and underground property

damage.

These risks are automatically excluded under the CGL policy and represent a "substantial reduction" of coverage, Mr. Kakacek said. Coverage for these exposures should be bought back by the insured, he suggested.

Product liability and completed operations are also deemed special hazards, and many companies in the oil and gas business don't realize the extent of their exposures in these areas, Mr. Kakacek said. Any worker who comes into contact

with a petroleum product in the workplace and is injured may file a product liability suit against the oil or gas well operator or contractor, he pointed out.

Operators and contractors may also face completed operations-type losses from property damage or bodily injury that occurs after the contractor has finished well-servicing activities or after the well has been plugged and abandoned, he added.

Other special hazards typically excluded for oilfield risks are underground resources and equipment, defined as property damage to untapped oil or gas reserves, the well or other underground property and drilling equipment; saline contamination, defined as property damage to oil, gas or water from a saline substance; blowouts or cratering; and general contamination. Coverage for these special hazards can be bought back with policy endorsements, Mr. Kakacek noted.

• Watercraft. Liability arising from the use of boats or other watercraft is normally excluded, which can create problems for offshore oil and gas operators and contractors.

Mr. Kakacek advised that the exclusion be removed or that coverage be added under the broad-form endorsement.

• Pollution. Bodily injury and property damage liability resulting from pollution is usually excluded on a CGL form, unless the incident is sudden and accidental. Well operators should coordinate the coverage provided under the CGL policy with that available under the Operator's Extra Expense policy, he suggested.

• Alienated premises. This exclusion applies to liability for damages arising out of premises the insured has sold. Some adjusters have tried to apply the exclusion to plugged and abandoned wells, Mr. Kakacek said, but "it doesn't apply."

Mr. Kakacek also suggested that well operators either obtain a blanket waiver of subrogation covering their drilling contractors or convince the underwriter to agree to subrogation waivers for individual contractors.

That would prevent a situation in which the underwriter sues the contractor to recover on a claim paid to the operator, and the contractor then sues the operator for breach of contract in violating the hold-harmless provision of the drilling agreement.

He also advised that the 10-day cancellation provision common to CGL policies be extended to 60 or 90 days. This will give the insured time to replace the policy in case the underwriter cancels, Mr. Kakacek said.

Such cancellations have been known to occur, he added. For example, in 1975 and 1976, many stock insurance companies decided they didn't want to underwrite oil and gas risks and canceled entire books of business on 10 days' notice.

Mr. Kakacek also advised the audience to follow the schedule established for payment of deposit premiums and the requirement that policyholders inform the CGL and umbrella underwriters of losses "as soon as practicable."

"You can void coverage if you take the cash-flow approach (to premium payment)," he warned. "Hold back on the premium and you could get a cancellation notice for non-payment."

"You (also) don't want to lose coverage because a loss you thought was simple deteriorates and deteriorates and deteriorates, and you haven't bothered to tell the umbrella carriers," he added. ■

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Q. How do insurance buyers benefit from the specialized training of Hartford underwriters?



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Competitive oil, insurance markets hurt drillers

Continued from page 3

If the rig is a total loss and is covered by an unvalued indemnity policy, the rig owner is left with a totally destroyed rig, a \$1 million shortfall for payment of the loan, and an additional \$1 million shortfall in recovering the original cost the company paid for the equipment.

Given the current state of the oil and gas market, the contractor also faces "dismal prospects" for steady work if it decides to buy a replacement rig, Mr. Hamm added.

"With little or no prospects for steady work, there is little reason to repair or replace a rig, and the insurance settlement could be significantly less than cost or even the loan value of the rig," he said.

The same decline in equipment values increases the possibility of a

'With little or no prospects for steady work, there is little reason to repair or replace a rig, and the settlement could be significantly less than cost or even the loan value of the rig,' Ralph Hamm says.

damaged rig being declared a constructive total loss, where the cost of repairs exceeds the value after the repairs are completed, Mr. Hamm added. If an underwriter declares a rig a constructive total loss and indemnifies the contractor for the equipment's depressed actual value, the contractor faces the same shortfall problems, Mr. Hamm pointed out.

However, current market conditions and policy language would

not have an adverse effect on partial-loss claims, he added.

The solution to these problems, Mr. Hamm suggested, is to purchase agreed-value coverage for drilling rigs and equipment. In the case of a total loss, this type of policy would pay out an amount the underwriter and insured have agreed to prior to the loss, Mr. Hamm explained. The policyholder would not be prey to fluctuating market conditions.

The problem with placing an agreed-value policy, he said, is convincing the underwriter that no moral hazard exists.

Most underwriters are willing to offer the coverage if the buyer and its broker make an effort to convince the insurer that the valuations requested are fair, he said.

Equipment owners are faced with a second problem, Mr. Hamm added. They must find insurers that, in the face of steadily declining rates and rising losses, will be able to pay claims and pay them promptly, Mr. Hamm said.

Rates for each \$100 of coverage for the Rocky Mountain rig cited earlier declined from a peak of \$3.50 in 1972 to 15 cents in January, he said.

"The brokerage community is

hamming with stories about rig insurance quotes for 10 cents to 20 cents per \$100 of values even on relatively small equipment schedules," he said.

In light of declining rig values and declining rates, it doesn't take actuarial training to realize that premiums and investment income will not be able to keep pace with losses, Mr. Hamm told the audience.

Claim payments from weak insurers may be slow, and this alone could hurt rig owners who are facing difficult financial times themselves. And, claims payments may not come at all from some underwriters.

Drilling contractors should therefore evaluate their insurers carefully, Mr. Hamm advised, looking at each underwriter's:

- Financial strength.
- Length of time in the rig insurance marketplace.
- Share of the market over the past several years.
- Reinsurance program. Insurers should not rely too heavily on reinsurance that might dry up and should retain at least \$1 million of each loss, Mr. Hamm said.
- Attitude toward loss adjustment. Insurers should be willing to use experienced, known adjusters and pay proven claims within 60 days.
- Reputation among other drilling contractors.

Contractors should also be prepared to pay slightly higher rates for coverage from a solid underwriter, Mr. Hamm said.

"Generally speaking, an insurer who fits these criteria doesn't have the lowest price," he explained.

When losses begin to catch up with the rig insurance industry, Mr. Hamm added, contractors should expect to see "substantial" rate increases, a shrinking of insurance capacity and increasingly close evaluation of losses. ■

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Care, custody or control question has no sure-fire answer: Experts

NEW ORLEANS—Who is in control of the drilling rig and other equipment at an oil or gas drilling site: the company that operates the well, the drilling contractor or other well-servicing contractors?

The answer is not clear on many drilling sites, creating problems for companies wanting to insure their liability for damage to another company's property, several experts say.

The problems stem from the fact that most liability policies exclude coverage for damage to the property of others that is in the policyholder's care, custody or control.

Many courts have decided in favor of the insured when underwriters have denied coverage on the grounds of a care, custody or control exclusion, but these rulings can hardly be seen as a surefire solution to the problem, experts say.

The basic comprehensive general liability policy, they say, excludes damage to:

- Property owned, occupied by or rented to the insured.
- Property used by the insured.
- Property in the care, custody or control of the insured or over which the insured is for any purpose exercising physical control.

Underwriters invoking this type of exclusion have not fared well in the courts, according to Richard B. Wilkins Jr., an attorney who is a vp with Diamond M Co., a drilling and exploration subsidiary of Houston-based Kaneb Services Inc.

Alabama courts have ruled that care, custody or control exclusions are "inherently ambiguous" and unenforceable, while other courts have found numerous means of getting around the exclusion to rule in the insured's favor, he said.

For example, Mr. Wilkins said, one Louisiana case resulted in what has come to be known as the "merely incidental" rule.

A well operator sued a drilling contractor for damages done to the well during a blowout. The contractor's liability insurer denied the claim, arguing that the well was in the contractor's care, custody or control. The court found against the insurer, saying that while the contractor was in control of the drilling equipment, it was not in control of the well itself and that damages to the well were "merely incidental" to the function the contractor was performing, he said.

In another case, a drilling contractor was working on an offshore well using a barge full of drilling mud provided by the well operator, Mr. Wilkins said. In the course of the work, the barge and mud sank. When the contractor sued the liability insurer after the claim was denied, the court ruled that the barge and mud were incidental to the contractor's drilling work and that the care, custody or control exclusion did not apply.

The effect of all these decisions is more to confuse than to clarify the scope of the exclusion, he said.

"When you go through all these things, you're going to throw up your hands and say, 'Where are we going with this?'"

It's not necessarily a safe bet to assume that court rulings on the exclusion will always be favorable to the insured, warns Douglas B. Owen, president of Arthur L. Owen Co. Inc., a Dallas-based brokerage specializing in oil and gas industry risks.

Claims paid after a court ruling in the policyholder's favor represent only a small fraction of total claims where the care, custody or control exclusion has been invoked, Mr. Owen added. In most cases, the policyholder doesn't bother to challenge the exclusion in court, he said.

Mr. Owen suggested that policies

always be amended to cover damage to the property of others while in the insured's care, custody or control. This can be done in a number of ways, Mr. Owen noted, depending on which party to an oil or gas risk is being covered:

- The coverage can be added to CGL forms either by deleting the care, custody or control exclusion or by adding a Broad Form Property Damage endorsement.

- For operators, the endorsement can be added to the Operators' Extra Expense policy. The endorsement covers various items of drilling equipment against named perils listed on the form.

- For contractors, the coverage can be added by attaching a care, custody or control endorsement to the Rig Physical Damage policy. ■



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Make sure insurers are solvent: Risk manager

NEW ORLEANS—In today's highly competitive property/casualty insurance market, risk managers should take a close look at their insurers' financial strength, one risk manager advises.

The capacity glut that has led to wild property/casualty rate cutting will leave some insurers and reinsurers unable to meet their obligations, warns S. Peter Law, risk manager for New York-based Schlumberger Ltd., a heavy equipment manufacturer.

"As the red ink keeps bubbling up, insolvency is not a problem to be ignored," Mr. Law told an audience at the Fourth Annual Petroleum Insurance Conference earlier this month.

Losses and expenses incurred by the property/casualty industry are rising at a faster rate than written

premiums, and spiraling combined ratios are gradually outstripping the ability of investment income to keep some companies in the black, Mr. Law suggested.

The industry suffered underwriting losses of \$10.4 billion in 1982, which were compensated by investment income of \$14.9 billion. But declining interest rates and rising loss ratios may push some insurers under, he warned (*BI*, March 14).

Industrywide combined ratios rose to 109.54% in 1982 from 106.01% in 1981 and 103.13% in 1980. For 1983, the ratio could jump to 114%, he said.

"This year may be the cruncher if we get to that 114%," Mr. Law advised.

Risk managers should be looking

at the financial stability of their insurers to be certain that insurer insolvency won't leave holes in their companies' insurance programs.

"Risk managers have an obligation, especially in a period of uncertainty, to monitor the condition of these companies," Mr. Law explained.

Mr. Law suggested that risk managers apply a number of tests to the financial information their insurers provide to assess the strength of the companies. The tests are designed to measure the insurers' overall stability, profitability, liquidity and their accuracy in forecasting reserve requirements.

Mr. Law noted five overall financial strength tests:

- Loss reserves plus policyhold-

ers' surplus should be at least 2.5 times written premiums.

- Admitted assets should be at least 1.25 times written premiums.

- Net premiums should not be more than three times policyholders' surplus.

- Net premiums written in the current year less those written in the prior year should not exceed the prior year's net premiums by more than 33%.

This test checks for sudden increases in net premiums written from one year to the next, which could signal a greater risk of instability, Mr. Law noted.

- Surplus aid—the amount added to surplus in a given year—should not be more than 25% of total surplus.

A company may fail one or two of these tests in a given year, but

consistent failures should serve as a warning to risk managers.

"If the company has a history of (failing these) tests and there's no corrective action taken, it could be spelling trouble," Mr. Law explained.

Two tests might be used to measure profitability, he said:

- Net investment income should be greater than 5% of average invested assets. This test simply measures a company's return on its investments.

Mr. Law added that the investment income figure should not include realized capital gains, since investing for capital gains should be considered too risky for an insurer to engage in.

- The insurer's two-year overall operating ratio should be less than 100%. An insurer's operating ratio is found by adding the average loss ratio and underwriting expense ratio for two years and then subtracting the two-year investment income ratio.

The investment income ratio is defined as 100 times the net investment income earned over two years divided by premiums earned over the same two years.

This test is one of operating profitability, Mr. Law says. If an insurer's losses and expenses exceed its investment income over two years, "it makes you wonder how long they can keep it up."

An insurer's liquidity can be measured by four tests, Mr. Law said:

- Cash plus invested assets (at market value) should at least equal unearned premium reserves plus loss and expense reserves.

- Liabilities, including loss reserves, should be less than 105% of liquid assets, including cash and invested assets at market value.

- Agent's balances (premiums that the insurer is in the course of collecting from its agents) should be less than 40% of total assets.

"If it's too high, they probably have a lot of uncollectible balances in there," Mr. Law explained.

- Increases in the current year's adjusted surplus should be less than 50% of the prior year's adjusted surplus. Decreases should not be more than 10%.

This test simply determines if the insurer has made any drastic moves up or down in its surplus account. If such a move is detected, a risk manager should find out from the insurer why it was made, Mr. Law suggested.

Risk managers can determine the accuracy of an insurer's reserving practices with one test: An insurer's one-year reserve development—the amount added to reserves—should not be more than 25% of the prior year's reserves. The reserve development figure can be found by adding current reserves and payments made from the reserves during the year, then subtracting the prior year's reserves.

If there is too big a change in reserves from one year to the next, it might indicate inadequate forecasting of losses by the insurer, Mr. Law pointed out.

The same test can be applied to prior years' reserves to determine the company's history of reserving accuracy, he added.

In addition to performing these tests, a risk manager who is wondering about the solvency of an insurer should ask his state insurance commissioner, his broker and even the insurance company itself, Mr. Law advised.

"Given the state of the market today, it's important for a risk manager to be sure he isn't wasting his company's premium dollars," Mr. Law said.

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Blowouts often preceded by warning signals

By DOUGLAS McLEOD

NEW ORLEANS—Although blowouts come in all shapes and severities and can be caused in a variety of ways, certain signals can serve as reliable indicators of an impending crisis, an oilfield expert explains.

In addition, a number of steps can be taken to prevent a blowout or, if it's too late, to bring a wild well under control, says E. Gary Keen, president of Oklahoma Petroleum Training Corp. of Norman, Okla.

A blowout occurs when the flow of oil or gas in a well reaches pressures that can't be controlled, Mr. Keen told an audience at the Fourth Annual Petroleum Insurance Conference earlier this month. Oil or gas then rises uncontrolled above ground into the atmosphere or spreads underground into the strata, he explained.

A blowout's "undesirable" effects, as Mr. Keen put it, include:

- Endangering the safety of well workers and nearby residents, especially if the well is blowing "sour," or emitting poisonous gas.
- Destruction of the drilling rig and equipment.
- Loss of oil or gas.
- Possible pollution of the surrounding area.

One further undesirable effect, Mr. Keen added, is that blowouts tend to prompt government authorities to more strictly regulate oil and gas drilling operations.

"Regardless of who has it, it hurts the entire industry," he said. "Blowouts give the whole industry a black eye."

Losses from blowouts can range as high as \$300 million, and wells have been known to run wild for more than a year (see related story).

The damage caused by a blowout can take many different forms, Mr. Keen suggested, citing a number of examples.

When a well on an offshore platform near Burma started blowing out gas and mud a few years ago, the gas caught fire and the entire platform burned and capsized. "They couldn't find any of this rig. It was completely buried," Mr. Keen explained.

Another rig drilling for oil in the Arctic Circle blew out water and became encased in a cone of ice.

Many blowouts occur in deep gas wells where pressures are high, but this isn't always the case. Mr. Keen said he knew of one gas well that had been drilled to a depth of only 85 feet when it blew out and destroyed the rig.

"The quantity of gas there was just enough to burn the rig down," Blowouts do have several common causes, however. One of the most frequently cited is improper control of drilling mud, Mr. Keen explained.

In the process of drilling for oil or gas, mud is injected into the well and brought back out in a continual circulation. The mud flow is designed to carry away pieces of rock and other debris loosened by the drill bit and to provide a kind of seal to prevent gas or oil from rising to the surface. The downward pressure of the mud should exceed the upward pressure of the oil or gas.

If drillers don't fill the hole with enough mud, if mud is lost in the circulation process or if the mud is not dense enough to provide adequate downward pressure, a blowout can result, Mr. Keen said.

Various forms of equipment failure can also cause blowouts, he said. Blowout preventers, devices designed to choke off a flow of oil or gas at the wellhead, may fail be-

cause they haven't been properly maintained or tested. If the wrong type of blowout preventer is installed, it may fail under pressures it isn't designed to handle. And, corrosion may weaken equipment or keep valves from closing, while valves may freeze in cold weather.

Inexperienced rig hands can contribute to a blowout by not following proper emergency procedures while the disaster can still be prevented, Mr. Keen said.

This problem became acute when the oil shortage of the late 1970s and early '80s created a demand for rig hands that couldn't be filled with experienced workers. Some feel that the current slowdown in the oil and gas markets may have the beneficial effect of shaking out inexperienced workers, contractors and operators.

Blowouts can also be caused by completely unforeseen events, Mr. Keen added, saying he knew of one blowout that occurred after a drunk driver ran his car into a wellhead.

"Unexpected things can come up; that's what I'm trying to point out here," he said.

A number of steps can be taken to reduce the chance of a blowout, Mr. Keen advises. Drillers should be more careful in observing well operations and equipment condition.

Blowout preventers, in particular, should be carefully maintained and tested to be sure that all valves open and close properly and that the device itself is adequate to hold back the pressures that might be exerted on it. In addition, drillers of deep, high-pressure wells should test their equipment more frequently.

Blowout preventers may actually be needed in only one of every 200 wells, "but when you need it, you need it badly," he said.

Rig hands should also be better-trained to handle a developing crisis, he added.

Blowouts are usually preceded by kicks, temporary flows of oil or gas that are not so powerful that they cannot be brought under control if correct procedures are followed.

A number of signs can indicate a kick in progress, Mr. Keen said. These may include:

- An increase in the rate of mud flow out of a well without any increase of pumping pressure.
- An increase in the amount of gas or water in the mud returned from the well.
- A decrease in mud circulating pressure, which may be caused by oil, gas or water mixing with the drilling mud.

If a blowout occurs even though an operator watches for warning signs and takes preventive measures, the wild well can be "killed" in several ways, Mr. Keen noted, including:

- Letting the well deplete.
- Hoping for a "bridge," or a shift in underground formations that might choke off the flow.
- Hiring a wild-well specialist to attempt to kill the blowout at the wellhead.
- Drilling a relief well, which is a well begun near the wild well on the surface and angled down to the bottom of the wild well. If mud can be pumped through the relief well to the bottom of the wild well faster than the wild well can blow it out, the blowout can be killed.

One problem with relief wells is the difficulty of finding the base of the blown-out well, Mr. Keen noted. Another problem is the enormity of such an operation.

"It takes a long time to drill those wells, and it's very expensive," he said.

'Killing' a wild well not a quick process, Minneapolis-based operator discovers

NEW ORLEANS—Minneapolis-based Apache Corp. now knows how expensive and time-consuming bringing a wild well under control can be.

Apache is the operator and part owner of a deep gas well in Wheeler County, Texas, that blew out in October 1981. Gas flowed from the well at the rate of up to 30 million cubic feet a day until the well was "killed" last February.

Although Apache managed to collect and sell much of the gas that was blown out of the well, it's estimated the company spent about \$50 million to bring the well under control.

According to an Apache spokesman, the company's well-control insurance will not cover the entire loss.

Here is what happened, according to Apache officials.

The 16,000-foot well, called Key No. 1, was completed in July 1981, at which time it was flowing at a rate of 24.5 million cubic feet of gas per day. The flow was shut off and the well was waiting for connection to a pipeline when it blew out Oct. 4, destroying the wellhead and about 85 feet of well casing.

Apache was able to bring the well under control and install a new wellhead. Key No. 1 was connected to the pipeline Oct. 30 and produced gas at a rate of about 31 million cubic feet per day—for three days.

On Nov. 3, the well blew out again, turning the area around the wellhead into a 25-foot crater. In an attempt to find out if there was any solid well casing left, the company excavated around the wellhead. After digging a hole 161 feet deep, 1,500 feet long and 1,200 feet wide—moving an estimated 2.5 million cubic yards of clay—solid casing was found.

On March 22, the company attempted to kill the gas flow by injecting a heavy mixture of mud and iron ore into the well. The attempt failed.

Earlier, in December, Apache had begun drilling a relief well, called Key No. 2, about 720 feet from the wild well. On April 7, it started a second relief well, Key No. 3, about 900 feet away. The relief wells were to be drilled down to the base of the wild well and it was hoped that drilling mud could be pumped in to cut off the gas flow.

But Apache had problems locating the base of Key

No. 1 with both relief wells.

For example, Key No. 2, which was drilled against the natural drift of the rock formation, was not penetrating to sufficient depths or at the correct drilling angle. Key No. 3 drilled a "corkscrew" around the Key No. 1 hole, and the drill had to be backed out for another try.

Metal sensing devices eventually enabled Key No. 3 to locate the bottom of the Key No. 1 hole. Mud was injected through the relief well, choking off the gas flow, and a cement plug was inserted. On Feb. 16, 1983, Apache announced that the well had finally been killed.

Drilling will continue on the Key No. 2 relief well, which may be used as a replacement well for the now-plugged Key No. 1.

In addition, Apache had managed to connect equipment to the sound Key No. 1 casing in June 1982, and it has been producing and selling gas from the blown-out well since that time.

But the company has no estimate of how much gas was lost before that connection was made, according to Gary L. Strumpfer, an Apache official. The value of any gas that was lost will not be covered by Apache's insurance, he added.

Apache operates the Key wells under a "farm-out" agreement with HNG Oil Co., which holds the lease on the tract in the Texas panhandle near the Oklahoma border, he said. Apache holds a 23% working interest in the well and the company's 1980-III Oil & Gas Program—a collection of smaller individual investors—holds a 27% interest. El Paso Exploration Co., a subsidiary of El Paso Co., holds the other 50% interest.

Under the farm-out agreement, the shares held by El Paso, Apache and the Oil & Gas Program will be reduced by half after their costs of developing the property have been recouped. That share of the well's profits will then revert to HNG, Mr. Strumpfer said.

The blowout has complicated the partnership, however. Several parties with working interests in the well have filed lawsuits in Wheeler County District Court against Apache and El Paso for damages to their property and interests.

None of the suits has yet been decided, Mr. Strumpfer said.

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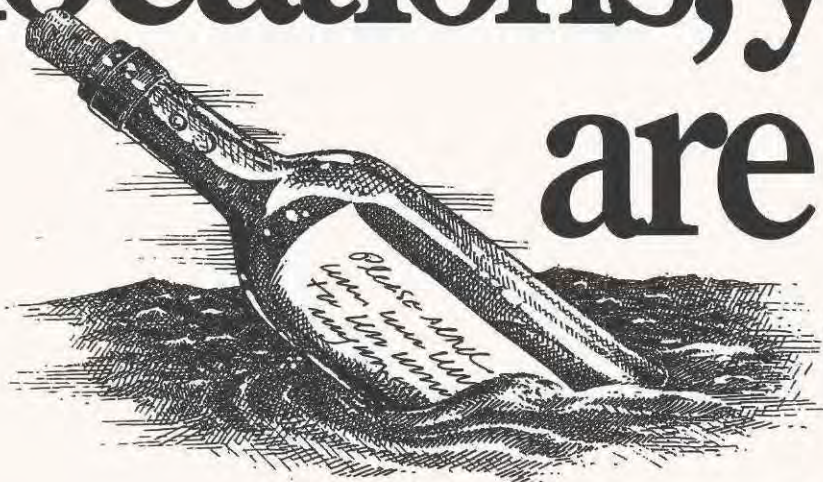


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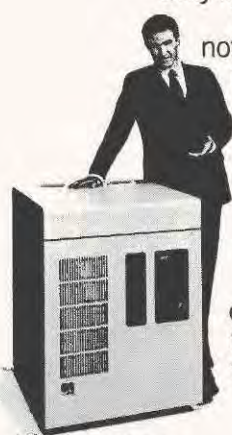


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A WORLD VIEW FROM THE TOP

By Bruce W. Schnitzer

I'M PLEASED TO be here today—invited to offer my views and speculations as to the current and prospective state of the world insurance and the broader financial services industry. With the ongoing swirl of change all of us are naturally speculating about the likely shape of our future.

To put our conjecture as to the future into context, we must appreciate just how important insurance is to the world market economy. For example, world property and liability insurance premiums are about 3% of free-world gross national product. If one looks only to U.S. insurance capital, total assets are more than \$750 billion, about 25% of the GNP, or 75% of our entire national debt.

So, an initial conclusion we can draw is that the insurance industry is plenty large enough to hold its own in any intensified competition with other financial service suppliers.

Of course, problems face our industry today, justifiable fears regarding the reinsurance pyramid and the quality of world insurance security in the face of a major catastrophe and scandals that raise questions about our ability to self-regulate our relatively lightly regulated industry. Parallels can be drawn to possible crises that might befall other branches of finance—notably the world banking system's ability to manage its way through these turbulent times.

But, there are no "central banks" in place to backstop the insurance community. We have a special obligation to conduct our affairs in a manner which, over the long haul, proves prudent and ethical and which successfully spreads the risks facing society and thereby underwrites the continued growth of the world economy.

But I feel sure that we will manage our way through today's and tomorrow's problems. And, if so, the insurance industry and the more broadly defined financial community can, in aggregate, play a central role in the emerging post-industrial future. We can, to a large extent, become the neural network of the knowledge-driven industries which will dominate the future economy of the developed world.

What will be the shape of our industry in the years to come? Opinions abound as to the relative roles various types of financial firms will play in the rapidly developing future. But, a great many observers seem to concur on one major

prediction: namely, that a trend toward rapid consolidation will continue, causing profound industry restructuring.

Almost daily, some additional capability is absorbed by a major insurance company, or is otherwise attributed to the financial services industry. And, we now begin to see the widely predicted next wave—the fusion of financial firms with major information service enterprises.

Of course, the early 1980s is not the first period of rapid consolidation. In the United States, circa 1968 for example, the "financial congener" was a popular concept. Insurance companies, credit card companies, banks, securities firms and investment banks, insurance brokers, real estate developers and REITs (real estate investment trust), financial companies, leasing companies, mutual fund companies, computer manufacturers, data-processing service firms and others were variously joined together, amid high hopes.

The arguments for cross-selling and synergy seemed persuasive enough at the time. The realization of benefits has been slow and painful in coming.

Now, like then, there is some question as to how well the integrated firm, the financial supermarket, will actually work and—an even larger question: Will it dominate? Fundamental questions face any firm attempting to perform all the functions associated with insurance or attempting to compete along the broad spectrum of financial services.

But to say the task is difficult is not to say that some may not succeed. And, these successful firms will represent strong competition for the rest of us.

Having said that, however, all of us who work in the insurance community—particularly for large, powerful firms—have found, to our frustration, that it is often remarkably difficult to add a new service or penetrate a new client market, even when we seem to have the necessary capabilities and credentials. Why?

Three lines of questioning may be illuminating:

- Who have been the firm's traditional clientele? Who are the prospective clients for proposed new services? How does one effectively market to the targeted client group?

- What have been the firm's traditional functions? Do the new services have similar characteristics? Are they processing-intensive or advice-intensive? Are the services inherently capital-intensive, or not? Do conflicts of interest exist between tradition functions and the new services?

- And, perhaps most important, what are the culture, operating mode and organizational structure of the firm?

Arthur D. Little, in "A Redirection of the Financial Services Industry," recently developed a depiction of financial services, based on a division-of-client type, between consumer/retail and wholesale/commercial and on a segregation of capital-intensive vs. non-capital-intensive activities.

First, let's deal with the huge,

A brokerage chief executive gives his ideas on the present and future shape of international insurance and financial markets

competitive and potentially very profitable consumer market. Here, I personally expect to see a continuing trend of horizontal integration in the direction of the supermarket concept. This trend will, to some extent, be an inevitable response to consumer preference. Economic instability—particularly inflation—has increased consumer expectations for convenient, cost-effective, well-packaged and marketed financial services available from a single supplier.

International competition will also fuel the trend. American banks and insurance companies were relatively early among the post-war internationalists. But, at home, America is virtually unique in the degree to which the several branches of finance have been held separate. Firms active in other countries have considerable experience with offering a full range of services and they will continue to be attracted by America's vast consumer market.

There is also the promise of new technologies. Information and communication systems now make a mass approach to the delivery of insurance and other financial products highly cost-efficient. And, new interactive capabilities can make mass marketing personal—perhaps sufficiently personal to be accepted by increasingly sophisticated consumers.

And, finally, there will be some consolidation among smaller, less-efficient competitors—simply to fund the capital requirements of technology, specialization and acceptable market security.

One-stop shopping, well-implemented, does seem to have good reasons to become of value to many consumers. First, the individual customer—except, perhaps, the most affluent—is too often not particularly well-served. Second, consumer financial services are processing-intensive, which makes the efficiency of the distribution and execution functions important.

Third, this area has been capital-intensive, both in terms of its financial facilities and as regards the distribution network required.

Returning to the matrix, commercial insurance underwriting is, of course, also a highly capital-intensive industry. So, again there are powerful forces suggesting a trend toward some horizontal integration.

First, there is the continuing internationalism of world insurance. The major world insurance markets have become—and will continue to become—increasingly interdependent. The combination of good security, competitive underwriting and innovation is, more than ever, a world product. And, while plenty of capital currently exists to underwrite traditional risks, the total world market capacity is and will continue to be tested in such areas as space, energy exploration, excess liability and political risk.

Insurance underwriting will also, almost certainly, continue to attract capital from other areas of financial service and even from industry. Why? Because insurance underwriting is, in relative terms, a very

good business.

The use of insurance correlates almost perfectly with the increasing wealth of society, but its relative importance grows as a society becomes more affluent.

Because of the high correlation between insurance premiums and GNP, the recent world recession has resulted in little or no real growth in world insurance markets since 1979. But over a longer period—in spite of the growth of various forms of self-insurance and other risk management facts of life—world insurance has been growing at a rate of 2% faster than GNP. Over the next five years, with world inflation moderated somewhat, real GNP growth again should reach 3% to 4% and insurance premium growth in double digits (nominal) might be anticipated.

Much has been said recently regarding the risks of cash-flow underwriting at an underwriting loss, and most insurance company executives publicly state that one must write for an underwriting profit.

But actual competitive behavior belies these statements and the industry has been consistently profitable. In fact, it is now, in spite of large underwriting losses, at one of its highest points of profitability.

And, return on equity of property/casualty insurance companies has increased along with inflation and long-term interest rates.

Property/casualty insurance has been a consistently profitable, if cyclical, business—the return on investment produced by successful insurers looks quite good relative to other investment opportunities.

In comparing successful insurance companies to other successful financial institutions, we can see that:

- Insurance companies have performed well and command respectable price/earnings multiples.

- While it is a simplistic and sometimes dangerous view, other types of financial institutions see underwriting losses as simply representing a cost of funds to insurance companies.

- The return on equity in insurance is quite respectable when compared to other financial service activities. The industry can thus be expected to continue to attract capital to it.

Even in 1982, while the operating income of leading property/casualty insurers declined, the industry remained quite profitable during a very difficult time for many other industries.

My comments so far suggest that the capital-intensive areas of insurance are likely to see considerable restructuring. But what about services that are advice-intensive? Can some firms reach the consumer without a massive commitment of capital? And, more basically, what about the wide range of financial services that are offered, not to the consumer, but to a corporate decision maker?

Stated simply, is vertical integration also an inevitable trend? A key to this question may lie in what academics call organizational theory. Perhaps the operating mode of a given firm is

Continued on next page



Bruce W. Schnitzer is president and chief operating officer of Marsh & McLennan Inc. He delivered this speech March 3 at the Changing World Insurance Markets Conference in London. This is Mr. Schnitzer's first major statement of views since he became president of M&M Inc. on Jan. 1.

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Employee attitude surveys

By James B. Weitzul

A FREQUENTLY HEARD criticism of attitude surveys from personnel directors, employee benefit managers and individual employees is that they lack scientific credibility. Many people (consultants and corporate personnel alike) see employee benefit surveys as simplistic exercises that anyone can design, administer and interpret.

Individuals with this misconception generally speak from ignorance rather than malice. All the same, they frequently mispend thousands of dollars collecting erroneous data and end up reporting fallacious results. The additional money they spend to change employee benefit programs, as a result of these surveys, is often counterproductive to the employees' real wishes and the organization's goals.

Numerous articles in professional journals deal with the steps in designing and administering attitude surveys. These "cookbook" approaches are useful in



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Taking the time to get correct results will save more than money in the end

laying out the necessary steps to complete an attitude survey.

However, they generally gloss over the two most important aspects of the process: establishing the reliability of the survey instrument and establishing the validity of the survey instrument in a controlled environment. These two critical concepts and the necessary steps to build attitude surveys are explained here.

Maximizing the degree of reliability and validity actually obtained in an attitude survey is largely a matter of control—controlling outside factors that interfere with the survey.

Just as a physician uses certain instruments to conduct a medical diagnosis, the researcher must use standard procedures to measure employee attitudes. For a researcher to do otherwise allows for a large amount of what statisticians call error variance to be included in the measurement process. This error variance distorts the meaning and limits the utility of the survey results.

In general, those procedures that seek information in the simplest, most structured and non-overlapping fashion

provide the most reliable and valid results. Using a one-variable-at-a-time method, the researcher focuses each respondent's attention on one survey component—for example, the medical plan—and gains information about the respondent's attitudes toward that variable.

The researcher then repeats this process several times for each variable in the benefit program, like the pension plan, disability plan and life insurance. The entire process is repeated for all employees being surveyed.

It can be compared with a physician piecing together a variety of X-rays to get a meaningful picture of a person's body. In the same way, the researcher pieces together each bit of information to see a reliable and valid picture of the employee's attitudes.

Reliability and validity, two frequently misunderstood terms, represent the scientific base of the entire survey process. The potential value of a survey instrument can only be determined when one understands what those words mean. Survey instrument reliability is a measure of the consistency of scores obtained by

the same people when resurveyed with the same instrument on different occasions. An example can help in understanding this definition.

Let's assume an employee attitude survey is administered and scored. At a later date, the same employees complete the identical survey, which is also scored. The reliability of the survey instrument is determined by statistically correlating the two sets of scores. The greater the correlation, the higher the reliability.

The correlation obtained is generally expressed in terms of a correlation coefficient ranging from zero to one. Coefficients below 0.85 are considered low and above 0.85 are acceptable.

High statistical reliability, by itself, is not sufficient to guarantee the scientific credibility of a survey. Just because an instrument demonstrates consistent results does not necessarily mean that the results are true. This truth measurement is the domain of validity.

The validity of a survey instrument concerns what the survey measures and how well it does so. Survey instrument validity is a measure of the consistency of scores obtained by the same people when resurveyed with a different instrument on different occasions. The procedure for establishing the validity of a survey

Continued on facing page

A look at worldwide insurance and financial markets

Continued from previous page
fundamental to understanding its role.

To simplify, let me characterize the relatively large financial service participants as dividing into two basic types. First, the great financial institution—insurance companies, the big banks and others; and second, the fine professional firm—insurance brokers, merchant banks, accounting firms and the like. While the financial institutions are highly professional, and some professional firms have become institutions, profound differences of culture and operating style do, I think, exist.

These caricatures do not promote, or denigrate, either type of firm. Each is more or less successful, depending upon the nature of the service and the clientele served.

In a financial institution, much of the task is inherently processing-intensive. As such, efficiencies have been obtained by subdividing tasks into basic elements. And, these institutions have become well-organized, with a strong middle management overseeing the specialized work of various operating divisions.

On the other hand, in a professional firm skills tend to be standardized, rather than tasks. To a large extent, professionals design and maintain their own standards. And professionals tend to work rather independently, so the middle-management group is relatively small. In general, professional firms have tended to succeed—and are likely to continue to do well—in the provision of services which are advice-intensive and relatively non-capital-intensive.

What might be the implications of these caricatures? In the consumer market, the now-fashionable buzzword networking would seem to have major application.

There are currently successful examples of the consumer market for financial services being approached as a two-tier sale. At the first level, highly specialized manufacturers and wholesalers are interacting with an institutional clientele—say, a professional association or a corporate employer. Working together, the wholesale supplier and the non-controlled distribution channel are competing with the integrated financial institution.

Some of these distribution channels can be very efficient—corporate payroll deduction is an important example. Cable TV and the frontier technologies which are its cousins, offer an opportunity of unknown dimension. But, one does not have to look to the future to understand the power of networking, specialty manufacturing, wholesaling and the use of non-controlled distribution channels in the world of insurance. Lloyd's underwriters are the world's most venerable examples of efficient, professional wholesalers competing successfully with even the largest financial institutions.

The dichotomy of roles played well by different types of financial firms is nowhere more obvious than it is in the broad range of services offered to the large, complex corporate or institutional client.

Decision makers in large corporations live in a world unrelated to that of other insurance buyers and financial service users. In this market, the basic service is advice. Complex corporations have enormous internal resources, they use suppliers on a specialized basis. The various services they may purchase from a given firm tend to be distinct and unbundled.

A brokerage firm, for example, does need to be large, as professional firms go, to operate globally and be deep in specialty resources. But specialist suppliers can be small, sometimes very small, often providing just one very specific service. And, as is the case here in London, truly talented specialist firms, even the very small ones, can become the principal adviser of the corporate decision maker. The financial institution or the large professional firm can find itself a de facto subcontractor.

So, when purveying professional services to corporate clients, size is a mixed blessing. Capital may not help much. Processing efficiencies, while necessary, are not really a key to success.

The real job—the management task—is to organize professionals well, a task performed best through entrepreneurial initiative and a spirit of partnership. The challenge to the management of any large professional firm is to maintain an environment that is the best of both worlds; a combination of institutional resources and dedicated individuals providing a consistent and superior result.

I think the future will see various types of professional firms continuing to edge into one another's primary fields of advice. Financial markets and insurance markets are, after all, alternative sources of funding. The line between risk decisions and financial decisions will continue to blur. The area of financial guarantees, under whatever name, represents a rapidly emerging example. So, as is likely among capital-intensive financial institutions, a horizontal integration of the services provided by large, professional firms should be expected.

But what about the integration of capital-intensive activities with advice, in insurance terms, the merging of the underwriting and the broking functions? This is a hot topic today. At Lloyd's, the functions will now, again, be separated. In our firm, we plan to divest ourselves of all non-Lloyd's underwriting as well. But, just in the past few months, others have entered into business combinations of brokers with underwriting companies.

To me, vertical integration in insurance—and other financial service activities—run counter to another concept, client service. The professional firm acts for its corporate clients, advising as to appropriate programs—risk management financing, diversification or whatever—then representing the client in the negotiations with appropriate financial markets. The large financial institutions—insurance companies, banks and the like—sit on the other side of the negotiating table. The conflict inherent in integration seems obvious.

In the world of retailing, the complete range of enterprises—from the hyper marche to the couturiers—prosper and coexists by responding to different client needs. And that is what seems likely to me in our financial world. Giant financial institutions, relatively large professional firms and small specialists—all play a part in those areas that benefit from their particular strengths. The interplay of competition, high technology, secure markets and international cross-fertilization offers great prospects for society—and substantial rewards for successful suppliers.

Whatever type of firm best suits each of us, as an employer and as a place to shop, I think we can look to the future with confidence and enthusiasm.

Continued from facing page
instrument is the same as that for establishing the reliability of a survey instrument, except that a different instrument is used.

The second survey instrument in a validity study should be more simple, direct and controlled than the first. If the first instrument was a written questionnaire, then the second should be a one-on-one interview between each surveyed employee and the researcher.

During the interview process the researcher verifies the employee's understanding of each question and then records the scores a second time on the survey instrument. Again, the greater the statistical correlation between the two sets of scores, the higher the validity.

Survey instrument validity also is generally expressed in terms of a correlation coefficient ranging from 0 to 1. Correlations below 0.7 are considered low and those above 0.7 are acceptable.

In the validation process, individual interviews are strongly preferred over group interviews. Research studies show

that despite the fact that all group members are ostensibly equal, group settings retard individual candor. In group meetings with as few as six people, individuals will not admit to misunderstanding a question in order to avoid group sarcasm, rejection or anticipated pressure to conform.

Individuals with "perceived" high status often influence group members' indications of high or low understanding levels. Some individuals with "aggressive" temperaments tend to disagree with the group "just to be different," despite their real understanding. For these and other reasons, group sessions are notoriously inadequate and uncontrolled settings for establishing a survey instrument's validity.

Therefore, achieving a high degree of reliability and validity requires expertise and is time-consuming. It is, however, the only way to establish the scientific credibility of survey instruments.

Two questions frequently arise:

- Why should a corporation bother to validate a survey when a simple

"quick-and-dirty" questionnaire may do about as well?

- If a corporation should decide to validate a survey instrument, isn't it cost-prohibitive?

For the first question, a simple survey will definitely not suffice. Investing thousands or millions of dollars in a new benefit program without a scientific survey is like consulting a Ouija board to make major financial decisions. It's a poor investment.

The additional time and expense necessary to complete a valid survey is small compared with the return from a properly planned benefit program. The alternative quick-and-dirty method is just that and, usually, the benefit program designed from it will be a short-term solution that creates long-term problems.

As for the second question, a corporation's cost to build a reliable and valid survey for its own use can be high. The key to overcoming this dilemma is sampling theory.

Using sampling theory and other sophisticated statistical methodologies,

reliable and valid survey instruments can be utilized for moderate cost.

Once a basic survey instrument is constructed and found to give reliable and valid results, based on data from a sample of "test" companies, it becomes a standard instrument.

At this point, it may be safely used with a wide variety of new companies. Survey data from the new companies are then analyzed. Statistical comparisons are made between the new and old companies and any anomalies investigated.

Finally, reliability and validity procedures can be followed with each new company survey but at a reduced level and lower expense.

Scientifically designed and constructed benefit attitude surveys can be highly worthwhile. Surveys that lack those ingredients can provide misleading and erroneous information. Reliability and validity are essential ingredients of any survey process. The better one understands these concepts, the better prepared one is to implement a benefit survey.

Never say always when talking about reinsurance

By Jonathan F. Bank

IREMEMBER my instructor for the California Bar Review course giving the class a helpful hint: Any true/false question containing the word always should be answered false, for there are often exceptions.

I can only blame my subsequent loss of memory on the intervening years. I have been advising participants in The College of Insurance reinsurance seminar that, "in the event of a ceding company insolvency, reinsurance proceeds, absent cut-through endorsements or other similar devices are always payable to the insolvent company's liquidator, and not to other claimants who are often vying for the funds."

I felt safe in making that statement. The U.S. Supreme Court decision in *Fidelity & Deposit Co. vs. Pink*, 302 U.S. 224 (1937), prodded New York Superintendent of Insurance Louis H. Pink to legislate the insolvency clause into virtually all reinsurance agreements. Since then, U.S. courts, with few exceptions, have been funneling reinsurance proceeds to the insolvent ceding company's liquidator. This procedure worked quite well, and met with little opposition until the mid-'70s, when guaranty associations began to emerge.

Created by statute in almost all the states from the late 1960s through the 1970s, these associations or funds provide what is often referred to as insolvency insurance, paying "covered" claims to the policyholders of insolvent insurers.

Reinsurance proceeds are often the only major asset of an insolvent insurer. So these associations started relying on language in the NAIC Post-Assessment Property & Liability Insurance Guaranty Assn. model act, adopted by the National Assn. of Insurance Commissioners in 1970, and incorporated into most state statutes.

The associations began claiming that they, not the liquidators, were entitled to the reinsurance proceeds generated from the payment of covered claims. Predictably, neither the liquidators, reinsurers nor other claimants agreed with this statutory construction

and the battle lines were drawn.

The courts responded by repeatedly holding that the overall statutory scheme of a liquidation is best served by funneling all assets to one company, the liquidator, thus preserving them as a general asset for the benefit of all claimants.

The courts noted that guaranty associations have no greater right to receive direct payment of reinsurance proceeds than did the original assured; since the original assured had no such right (subject to certain specific exceptions), neither did the guaranty associations.

The foregoing cases seemed to resolve the question of a guaranty association's entitlement to reinsurance proceeds, thus leading to my remark in class. However, the Massachusetts Insurers Insolvency Fund remained unconvinced by the previous decisions. In reliance upon a recent and easily distinguishable case, the fund attempted to collect directly from General Reinsurance Corp. the reinsurance proceeds owing to an insolvent insurer, Rockland Mutual Insurance Co.

The receiver of Rockland, the Massachusetts Insurance commissioner, disagreed with the fund contending that he was entitled to such proceeds. The Massachusetts Superior Court, in *Massachusetts Insurers Insolvency Fund vs. General Reinsurance Corp. & another*, Civil No. 8057 (Superior Court, Commonwealth of Massachusetts, filed Sept. 7, 1982), recently granted a partial summary judgment in favor of the fund, making it the direct beneficiary of reinsurance proceeds.

More specifically, General Re had four reinsurance treaties in force with Rockland until Rockland's insolvency in 1974. The insolvency clauses in three of those treaties were identical and, in related parts, stated that reinsurance proceeds are payable without diminution because of insolvency, "... directly to the company or its liquidator, receiver, or statutory successor, except as otherwise specified in the statutes of any state having jurisdiction of the insolvency proceedings." The insolvency clause of the fourth treaty did not contain the language commencing with the words "except as otherwise specified. . ." That language, it should be noted, is atypical and not generally found in insolvency cases.

The fund claimed entitlement to the reinsurance proceeds that Rockland, had it not been insolvent, would have received and that were attributable to "covered" claims paid by the fund. Rockland's receiver asserted a like claim to the reinsurance proceeds and

General Re, in disagreement as to the amount of proceeds owed, asserted a right to set off from payment of such proceeds monies due it from Rockland.

The court, in finding for the fund, relied upon an earlier Massachusetts decision involving the Massachusetts Motor Vehicle Reinsurance Facility, an entity created by the legislature to assume a portion of the substandard or high-risk auto exposure in a kind of reinsurance transaction.

In that earlier decision, *Massachusetts Motor Vehicle Reinsurance Facility vs. Commissioner of Insurance*, 379 Mass. 527 (1980), the court, in granting proceeds to the fund, drew a clear distinction between the fund's rights to reinsurance proceeds from the facility, a "state-created reinsurance facility," on one hand and from private reinsurance companies on the other hand.

The Massachusetts Court, in the Rockland case, went a substantial step further, concluding that the fund was entitled to reinsurance proceeds from not only public or state-created reinsurers, but from private reinsurance companies as well.

In so doing, the court relied, in part, on the language "except as otherwise specified. . ." contained in the insolvency clauses in three of the treaties. It would be comforting to suggest that this result might be avoided in the future by omitting that language from insolvency clauses. The court, however, so fleet of foot, reached the same result with respect to the fourth treaty, which did not contain such wording.

The court then addressed itself to General Re's set-off claim. In what appears to be "bootstrap logic," the court denied a setoff because:

- The reinsurance proceeds were owed to the fund, not to the receiver of Rockland.
- The fund was not liable for pre-insolvency debts of Rockland.
- The setoff allowed obligated the fund for such pre-insolvency debts; therefore, General Re was not entitled to a right of setoff, but "... must stand in line with the other of Rockland's creditors. . ."

Hopefully, this case should have minimal impact, as it may be confined to its own facts. Further, it is likely that the parties will settle and thus, from a procedural standpoint, as it is only a trial court opinion, it should have little precedential value.

Nevertheless, it did serve to refresh my memory, and so, with apologies to those who have previously taken the reinsurance seminar, I will in the future state with respect to the guaranty associations' right to reinsurance proceeds, "that the better rule, with one exception, is. . ."

Jonathan F. Bank is a partner in the law firm of Buchalter, Nemer, Fields, Chrystie & Younger in Los Angeles.



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Industry changes most evident in U.S., observers maintain

By STACY SHAPIRO

LONDON—The insurance industry in 1995 will be far different from today's, industry experts and observers predict.

For example:
• Many insurance companies and brokerages will have merged with other financial services interests to provide one-stop shopping for buyers.

• However, small specialty insurers and brokers will remain, offering superior expertise in their particular fields

• Buyers will be able to communicate with markets via computer, both in the office and in the home.

• Some offshore captives will have grown into large onshore insurers and compete with the established U.S. and London underwriters.

There are just some of the predictions given by participants at the Third Annual Changing World Insurance Markets Conference held earlier this month in London. The conference, sponsored by City Financial Services Ltd., examined what effect current developments will have on the future of the insurance services industry.

Participants largely agreed that changes in the insurance marketplace are now most noticeable in the U.S. property/casualty industry, where both insurers and brokers are merging with conglomerates to form financial services giants.

"The outlook...in the United States is for more freedom—not less—to offer new financial services through new distribution methods as well as traditional ones," said Lee Barnes, a former vp at Continental Corp., who is now an industry consultant.

But in some cases, insurers and brokers have not merged because they wanted to, Mr. Barnes said, adding that lack of growth, the high costs of distribution and administration and the entry of new players into the insurance industry have created huge problems.

For example, the growth of self-insurance and of captive insurers has eroded some insurers' premium base. Also, Mr. Barnes pointed out, expenses now consume about one-third of the insurers' premium volume.

To reduce expenses and to gain new business, many insurers and brokers are finding it attractive to combine with other large purveyors of financial services and gain economy of scale, Mr. Barnes said. This type of integration will spell the end of the traditional broker and insurer, he predicted.

But, "There will at least be market niches left by the giants to be filled by specialists that provide an outstanding service in their chosen field," Mr. Barnes explained.

Others at the conference, however, said that huge financial services companies could have rough going if they stray too far from their areas of expertise and forget to keep the buyers' interests in mind.

"Everyone is now in everyone else's territory and in everyone else's business—underwriting, reinsuring, broking, risk management, cash management, consultancy," said C.F.M. Rawlinson, joint deputy chairman for Morgan Grenfell & Co. Ltd., a London merchant bank.

"But every business must know its own boundaries and limitations...The great empires of the world have usually fallen because they did not know this."

"In Britain, where 60 million people live in a very small space, we already have a complete national network of financial services provided separately by banks, building societies, insurance brokers, insurance companies and many others," Mr. Rawlinson said, adding that clients are citing a need for further expansion of financial services.

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Also, Mr. Rawlinson added, many underwriters and brokers have been historically linked through British banks or the large Lloyd's of London brokers.

In fact, British insurers and brokers are entering a period of divestment, not integration, he said.

The Lloyd's Act of 1982, for instance, clearly states that brokers must divest their Lloyd's underwriting agencies within five years.

Some of those attending the conference said that the brokers probably will not make large profits when they sell the underwriting agencies, most likely to the agencies' principals.

The divestiture provision in the Lloyd's Act also might further convince the British Department of Trade that insurers and brokers should be separated because of potential conflicts of interest, they added, noting Marsh & McLennan's decision to sell its British underwriting interests (BI, Feb. 21).

However, David Rowland, chairman of Stewart Wrightson Holdings P.L.C., said the trend toward divestment would not last long in Britain.

Events in the United States have "powerful" influence over what happens in the British insurance industry, he said, adding that he expects British brokers and underwriters to start to combine someday.

"Some conflicts of interests are superficial and unimportant and in 15 years' time they will be meaningless," he said.

"Our perception of what insurance is will change," said Mr. Rowland. "I do not believe that major brokers will be the kind of brokers that Marsh & McLennan perceives today."

In fact, Mr. Rowland is surprised that Marsh & McLennan is trying to sell its British underwriting subsidiaries, since their sale was not required in the Lloyd's Act.

"Before the latest M&M pronouncement, I was wondering why they did not go the other way," he said. "They should not have divested, but moved the other way as they were beginning, at least here, to control the underwriting as well as the broking."

Others at the conference also believe that the age of integration will hit Britain, and it will be U.S. suitors that will want to acquire the large British insurance companies.

"Now is the time for overseas companies to think about the acquisition of British insurance companies that have interests throughout the world," said Roger Harvey, a partner at stockbrokers W. Greenwall & Co.

The major British insurers, like Commercial Union Assurance P.L.C. and Royal Insurance Co., have suffered recent losses and could be prime targets for takeover, he added.

Although many of the conference participants agree the industry will be greatly changed by 1995, the same questions that face the industry today will probably still be around then: When will the market turn? Will deductibles increase or decrease? Are losses too large?

How much things remain the same was illustrated by a letter read to the conference by David King, chairman of D.G. King & Others, a Lloyd's underwriting agency:

"Underwriting has been a discouraging business of late but, I hope, may show signs of pulling around soon. The worst is that current business is done at such absurd rates as to be no longer worth taking."

The letter, which echoes the sentiments of many of today's underwriters in all parts of the world, was written by a Lloyd's underwriter in 1893.

Scrutinize foreign markets: Accountant

LONDON—Before you place your risk in a foreign insurance market, learn as much as you can about the nation's insurers, says an accountant who has liquidated several insolvent underwriters.

Otherwise, claims may go unpaid and years may be spent in court trying to obtain the money, says A.W. Dyer, senior partner at Ernst & Whinney in London.

"I cannot stress too much to those who are about to enter a marketplace which is foreign to them—wherever that marketplace is situated in the world—the need for caution and control right from the beginning of negotiations through to the day-to-day reporting required," he advised at the Third Annual Changing World Insurance Markets Conference earlier this month.

Buyers, especially those dealing with the London market for the first time, should watch out for underwriting agents that front for insurers, Mr. Dyer said. Too often, such agents pay but little attention to the quality of the risk or the security of the reinsurers. And many times, the insurer that eventually will pay the claim does not know what kind of business the agent is underwriting.

"I notice that for some reason there often appear to be a great deal less inquiry made and a great

deal less information given when a company enters into an arrangement with an underwriting agency than when a company sets up its own underwriting department or its own national company," he said.

The tenuous relationships can spell trouble.

"I know of an offshore company which was set up some years ago. The company is now in liquidation resulting in a considerable amount of time and money being spent by the liquidator in retrieving assets from reinsurers and others in various countries.

"Now, some five or six years later, the person who is mainly responsible for setting up that company appears to be involved in a similar arrangement all over again."

Beware, too, of "contact" offices, Mr. Dyer suggested. London contact offices for offshore insurers are not registered with the British Department of Trade to underwrite business and do not have to follow normal British underwriting and security requirements.

"In these situations, the Department of Trade has no control whatsoever over the business and, all too often, the (buyer) is not even aware that the risks being accepted are being dealt with outside the United Kingdom," said Mr. Dyer.

"All semblance of trading in

London and the offshore offices may well only be one room with a convenient telex."

Buyers, regulators and even insurers and brokers can avoid these problems by making sure they ask the right questions before a policy is signed. They should include:

- What kind of liability reserves are available to pay future claims?

- What kind of accounting methods does the underwriter use? Are they sound?

- If dealing with an underwriting agent, who will ultimately accept the risk and issue the coverage? Why is that underwriter being fronted? And, who are the other intermediaries?

For their part, underwriters should demand that the buyer pay the premium immediately and make sure their reinsurance is secure to cut down on abuses, Mr. Dyer said.

"I have always been surprised that a payment date is not automatically demanded by the underwriter as a condition of accepting a risk," he said. "I sense, perhaps unfairly, that the underwriter himself is not aware—or is not always made aware—of the difficulties that can arise in the collection of premiums or of reinsurance recoveries."

Regulators around the world could also help wipe out under-

writing fraud by creating standard regulations for financial reporting, Mr. Dyer said.

"There is a considerable need for worldwide standardization of information disclosed," including universal classifications of risks, ways of expressing technical reserves and reporting reinsurance contracts.

Also, companies should disclose the level of gross and net premiums "to show the reliance it is placing on reinsurers to bring about underwriting results," Mr. Dyer said. Insurers also need to carefully document assets and liabilities to show the potential risk of non-recovery of losses.

U.S. state insurance departments, Lloyd's and the European Economic Community are making strides in adopting tighter accounting regulations, but even these efforts may not go far enough to protect the buyers from unsecured or insolvent insurers, he said.

Buyers, brokers and insurers should aid these efforts by exchanging information they have collected regarding the security of insurers, he added.

"There is a great need...to share information, not just in London but in New York and elsewhere," said Mr. Dyer. "Otherwise, events like the liquidation of the Kenilworth Insurance Co. will continue" (BI, Dec. 6, 1982).

Industry faces conflict, broker says

LONDON—The insurance industry is faced with a basic but major conflict of interest, says David Rowland, chairman of Stewart Wrightson Holdings P.L.C.

How, he asks, can the industry satisfy the needs of the insurance buyer and still achieve the best performance possible for its shareholders?

"I suggest that there is the possibility of a conflict between the best management in its conduct of a professional business and the short-term treadmill of financial performance required—or thought to be required—by the financial market," Mr. Rowland said at the Third Annual Changing World Insurance Markets Conference in London earlier this month.

"The very pressure for change and development upon which this conference is reflecting arises at least as much from the need to satisfy shareholders as it does from the need to satisfy clients," Mr. Rowland said.

In the past, brokers have dealt with their clients professionally, using the utmost care, Mr. Rowland said, adding that their remuneration usually paid for the value of service rendered.

But, that's "not so in some international business," Mr. Rowland said. "There, the broker reverted to his role as entrepreneur, red in tooth and claw."

Some of these London-based international brokers, in an attempt to earn as much commission as possible, have passed risks through many intermediaries and agencies, Mr. Rowland said, not caring how much of the premium finally was received by the underwriter bearing the risk.

"The fertility of insurance imaginations devoted to squeezing the premium earnings out of each international pound of premium gave rise to many innovations in the market," he explained. "Their profits owed much to their skills, something to the wellness of the pound and occasionally, and now frequently, to the naivete of their auditors," he said.

As an example, Mr. Rowland produced a chart filled with lines to various insurers, reinsurers and in-

termediaries who, at some time in the mid-1970s, participated in the coverage for a low-quality Greek hull.

"The premium was never paid (by the policyholder) to anyone at any time," he explained. But that didn't matter to the underwriters, which kept passing the risk down the line to offset any claims.

As claims after a few years exceeded premiums by 300% to 400%, one British insurer—whose marine department was built on similar ventures—refused to pay claims.

"Refused is perhaps too strong a word. Inertia was a better answer."

Then all the intermediaries had to "finance years and years of subsequent work to unscramble the chain of appalling complexity, the labor costing many times the gross value of the brokerage—which, of course, actually never had existed," he said.

Mr. Rowland commented that such schemes are not common now as reforms have taken place in the

London market, but the possibility for such abuse remains.

Brokers can serve both their clients and their shareholders, he said, not through such arrangements, but by reducing expenses. He said that Lloyd's underwriting agencies give a good example of how this can be done.

"There is less duplication of activity there, much less than in any other part of the insurance chain," he said. "Almost everywhere else insurers and brokers, insurers and agents, insurers and risk managers duplicate almost all the functions of the market, inevitably leading to costs higher than might otherwise be the case," he said.

A restructuring of the industry will also improve efficiency, he said, pointing to the United States where large financial services firms are buying smaller brokers that are hard-pressed to keep up with the industry leaders. Those mergers are good for both the client and the shareholder, he said.

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Few Japanese firms have full quake cover

Continued from page 3

tional Paper Co., can obtain full earthquake coverage on its \$4 million in property value from the British Insurance Group in Japan. I.P.I. is able to purchase full earthquake coverage because its manufacturing plant is located in a low-accumulation zone in southern Japan.

"We didn't build down there with insurance in mind, but it did work out for us, didn't it?" says D.J. Bava, director of finance and administration for I.P.I.

Both buyers and brokers in Japan agree that earthquake rates are high, even for those like I.P.I. that can obtain full coverage.

For its \$4 million limit, for example, I.P.I. Corp. has an annual premium of about \$10,000, according to Mr. Bava. Polaroid pays about \$6,000 for its \$700,000 in earthquake coverage from AIU, says Mr. Ishidi.

"Relative to other perils," says Mr. Smith of A&A, "you're paying out the nose for earthquake. But again, there's the question, what's fair is fair. What should earthquake rates be? Nobody really knows. Think of the possibilities."

Although rates are high and it's sometimes impossible to purchase full coverage, foreign companies are in much better shape than their Japanese counterparts. According to present insurance laws, only companies that are completely foreign-owned can tap the higher levels of coverage offered by foreign insurance markets. If there is

even 1% of Japanese capital involved, the company is considered a joint venture and ineligible.

"What are the Japanese doing to cover themselves?" asks Matthew Jackson, manager of the Japanese office of The Hartford Insurance Group. "That's a good question, because the 15% they're getting is not enough to put anyone back in business after a major loss."

According to Mr. Jackson, a few Japanese companies are beginning to petition the nation's Ministry of Finance to gain permission to reinsure their self-funded retentions with London reinsurers or to be able to purchase higher limits of coverage with foreign underwriters.

The ministry routinely grants such requests, Mr. Jackson adds, although he stresses that few Japanese companies are taking advantage of this option.

In the event of a major earthquake, there is some speculation as to what would actually happen to the industry here. The Japanese admit that the insurance market would temporarily be thrown into chaos, with banks closing and the government possibly freezing claims payments. The insurers, however, would survive, says Mr. Kumakiri of the Fire & Marine Insurance Assn.

Some foreign insurers are not so certain.

"If the big one hit," Mr. Jackson says, "I believe a lot of insurers and reinsurers would fold. They are in over their heads. (The foreign in-

surers') 3% of the market is astronomical. Their (the Japanese insurers') 97% is unbelievable."

Even though Japanese insurers reinsure almost 90% of their earthquake business overseas, Mr. Jackson explains, they really aren't riding themselves of the risk because these same insurers accept treaties from the same London reinsurers they cede the risk to in the first place.

They are, in effect, partially serving as their own reinsurers, he explains.

"Of everything they give to London in reinsurance," says Mr. Jackson, "a portion of it comes back to Japan because of their treaties in the United Kingdom. They are backing themselves up."

The Japanese, however, do not seem to be overly concerned. Although the government is not directly involved in commercial earthquake insurance (as it is in some personal lines), some foreign insurance sources believe the Japanese public and private sectors would work together to bail out the insurers following a serious quake.

In addition, Japanese businesses are also protected by their business groupings (BI, Dec. 27, 1982), which often include a bank and an insurance company. In the worst scenario, the two would work with the government to rebuild the company.

"Japan has put itself back together three times in the last century," Mr. Jackson says. "They are very good at it."

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MAY 16. An Analytical Approach to Risk Management seminar in New York, sponsored by Business Insurance; \$355; 10% discount for additional registrants from the same company. Also May 18 in Dallas and May 23 in Los Angeles. Ann Vazquez, Business Insurance, Communications Services Department, 220 E. 42nd St., New York, N.Y. 10017; 212-210-0137.

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MAY 18-20. National Safety Management Society annual conference in Arlington, Texas; \$230 for members; \$275 for non-members; \$20 additional for registration after April 1. David M. Wasum, NSMS, P.O. Box 170174, Arlington, Texas 76003; 214-631-6070.

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MAY 24-27. Ergonomics seminar in San Jose, Calif., sponsored by the International Safety Academy; \$375. ISA, 10575 Katy Freeway, Box 19600, Houston, Texas 77224; 713-932-9400.

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MAY 26-28. Litigation in Aviation and Space Law second national institute in Washington, sponsored by the American Bar Assn.; \$393 for members; \$418 for non-members; \$368 for tort and insurance practice lawyers; \$343 for young lawyers and government employees; \$75 for law students. ABA, Division of Professional Education, 10 W. 35th St., Chicago, Ill. 60616; 312-567-4675.

JUNE 1-3. Fundamentals of Insurance conference in Chicago, sponsored by the Risk & Insurance Management Society; \$345 for members; \$445 for non-members. Editorial Dept., RIMS, 205 E. 42nd St., New York, N.Y. 10017; 212-286-9292.

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Commercial Consumers Sub-total	22,954
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Reinsurance renewals point to higher rates

Continued from page 1

to a lot of the treaties, so they were not completely placed this year," said Michael Howard, managing director of Sedgwick Payne Reinsurance Ltd.

"I think this is true everywhere," said Mr. Howard. "In Spain, I am told, a number (of treaties) are still not placed fully."

Reinsurers are declining proportional reinsurance business because often the premium is retained by the ceding company as loss reserves, with only minimal credit given to the reinsurer for the investment income earned on the retained premium.

Ceding companies that were successful in buying proportional reinsurance had to accept new and more expensive terms, sources agree. Some ceding companies had to agree to eliminate holding premium and loss reserves for treaty reinsurers unless they are based in a country that requires these retentions, like France.

And, reinsurers often forced ceding companies that retained premiums to increase the interest rate used to credit investment income, in some cases from the previous 2% to 3% to as high as 5%.

Most reinsurers, however, demanded that premiums be paid to them by ceding companies on a quarterly basis, a custom that already exists in the aviation insurance market.

Also, reinsurers are restricting premium rate discounts and reducing profit commissions.

"The additional cost of this will have to be absorbed by the ceding company or the policyholder," said Mr. Howard. "It has to affect somebody."

If primary insurers are not placing as much proportional reinsurance as in past years, they will either have to retain more of the risk, buy excess-of-loss reinsurance at perhaps higher premium rates or reduce the amount of direct business they underwrite, sources say.

Excess-of-loss reinsurance, also known as non-proportional reinsurance, indemnifies the ceding company against all or a proportion of a loss in excess of a specified retention. Reinsurers usually receive premiums for excess-of-loss reinsurance more quickly than for proportional reinsurance.

Many factors caused this year's proportional reinsurance renewals in London to be so exhaustive and frustrating for underwriters, brokers and insureds alike.

For instance, marine underwriters are still paying for two \$400 million losses. Underwriters

must meet the claims for the three unusable liquid natural gas tankers built by Britain's Avondale shipyards that were declared total losses (BI, Aug. 11, 1980) and for the 72 vessels stranded in the Shatt al Arab waterway separating Iran and Iraq by the fighting between those two nations.

Poor loss records have also forced some insurers and Lloyd's syndicates to fold or to cease writing certain classes of business, Mr. King, the Lloyd's underwriter, said.

Also, reinsurers were reluctant to write proportional treaties because of the deteriorating loss experience in world reinsurance markets.

But the loss of several top Lloyd's underwriters, forced by the recent scandals at Alexander Howden Group P.L.C. and Minet Holdings

P.L.C., may have been the most powerful reason for the turmoil during the January renewals. Their absence decreased Lloyd's capacity for certain classes of business and forced other underwriters to lead coverages that they do not normally write, Mr. King said.

Perhaps the biggest blow was the suspension of Lloyd's most successful underwriter, Ian R. Posgate, former chairman of Alexander Howden (Underwriting) Ltd. Mr. Posgate alone wrote more than \$300 million in premiums in many classes of businesses through his large marine and smaller non-marine syndicates.

Mr. Posgate's absence sent tremors through most of the Lloyd's market as syndicates took over some of his business while search-

ing to replace their own reinsurance agreements they had formerly placed with the Posgate syndicates.

"Posgate had a big percentage of the market," said Mr. Howard. "There was a big vacuum when he left, but the market took up the vacuum quickly. It is amazing, really."

But some insurers say they have felt his loss.

One non-Lloyd's aviation underwriter says he had to reduce his capacity from \$1 million to \$650,000 for aviation hull war risk insurance because of Mr. Posgate's absence.

"Posgate dominated the aviation hull war risk market for years," said the insurer. "Posgate at the time of his suspension had 50% of the aviation hull war premiums. His rationale was that if he could dominate a market and force down

rates, he had the business. And this risk makes a lovely profit now that there are not as many hijackings as there used to be.

"We came to renew our hull war risk treaty this year, of which Posgate had 50%. But he had disappeared. Our loss record was less than 1%, but the hole he left was so large that I could not renew for the same terms as last year."

In addition, two underwriters, David Hill and Adrian Hardman who were dismissed from their posts at P.C.W. Underwriting Agencies Ltd. after reinsurance problems at Minet's underwriting agencies surfaced last year, were lead underwriters on the Lloyd's master oil rig slip.

Their absence could have an effect when policyholders on the slip renew their coverage in June.

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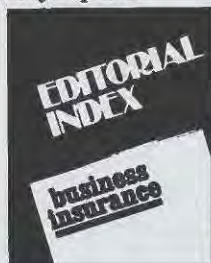
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WEEK OF FEBRUARY 1, 1982

Hyatt class action allows settlements, but will they go on?

WEEK OF MAY 3, 1982

Settlement talks rumored in Hyatt class action

JANUARY 17, 1983

Skywalk liability set at \$100 million

OSHA approves fumigant standard

WASHINGTON—The Occupational Safety and Health Administration approved a California standard limiting worker exposure to an anti-fruit fly fumigant called ethylene dibromide.

The state's standard for EDB is stricter than the federal standard, but OSHA chief Thorne G. Auchter said that "compelling local conditions exist" for the stricter California rule.

More than 12,000 workers in the state are exposed to EDB. And, according to the U.S. Department of Agriculture, there is no alternative fumigant that meets quarantine requirements.

The California standard first became effective in March 1982 during the Mediterranean fruit fly infestation. The state's standard sets the maximum exposure level to the EDB at 0.130 parts per million parts of air averaged over eight hours, while the federal level is 20 parts per million.

Business Insurance Editorial Index

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MGM sues Hall, insurers over coverage

Continued from page 1

of MGM's net liability is known.

Union International is believed to have entirely reinsured its \$35 million exposure with General Reinsurance Corp. The terms of that reinsurance, however, are believed to include a payout schedule that limits General Re's payments to Union International to specified amounts as the reinsurance premiums earn investment income.

No one at Union International or Gen Re would confirm this arrangement, which has been widely discussed in reinsurance circles since the back-dated insurance was issued in February 1981.

It also has been rumored that MGM agreed to a payout schedule with Union International, but MGM denies that it ever agreed to accept any agreements assuring its insurers that the retroactive insurance coverage would be paid over several years.

Mr. Segelin said no such agreement existed.

When U.S. District Court Judge Louis C. Bechtel surprised all parties to the litigation by setting a January trial date, MGM had to decide whether to go to trial and risk having to pay millions of dollars in punitive damages that were excluded from the back-dated policies or to settle quickly and risk a fight with its back-dated liability insurers, said another attorney.

MGM elected to risk a fight with the insurers, the attorney said.

No schedule of payments from Union International to MGM is included with copies of the back-dated liability policies filed with the MGM lawsuit.

Whether or not any payment schedules exist, it was clear in 1981 that the insurers expected the settlements to be delayed long enough to earn enough investment income on the \$25 million premium to cover the \$35 million exposure (BI, Feb. 9, 1981).

Nevertheless, MGM says, Hall and the insurers in 1981 promised to promptly pay any settlements, judgments and litigation expenses.

Now, MGM charges, "Said defendants did not intend to comply with the aforesaid promises and representations. In fact, plaintiffs are informed and believe and thereupon allege that said defendants had no intention of paying out any significant sums for settlement of plaintiffs' liability arising from the fire until several years from now, if at all."

The complaint also charges Union International and Hall with "failing to reserve adequate funds in order to effect a prompt, policy limits settlement of all claims."

Hall and the insurers of the first and second back-dated layers also are charged by MGM with "de-

manding that plaintiffs (MGM Grand) agree to contribute millions of dollars of their own funds in order to effect a settlement within policy limits."

"They want to hold onto the funds as long as they can," said Allan Goldman, an attorney with Wyman, Bautzer, Rothman, Kuchel & Silbert in Los Angeles, who represented MGM Grand in its liability litigation.

"The insurers don't want to settle at all," said a source in the industry connected with the litigation. "They wanted to keep the money and invest it."

"They didn't want to settle because they wanted to invest the money. Period."

Union International didn't even receive all the \$25 million premium in 1981 to invest.

Instead, the premium was paid to Union International in installments of \$9 million on Feb. 1, 1981; \$7.7 million on Nov. 1, 1981; and \$8.3 million on Nov. 1, 1982.

Many of the other insurers on the back-dated policies accepted premium payments in installments over one to two years.

Officials at Frank B. Hall refused to comment on the terms and conditions of Union International's policy with MGM or its reinsurance of the \$35 million policy. Hall has not responded to the suit.

Hall officials contend in telephone interviews that disputes over the back-dated liability insurance involve the issue of punitive damages and MGM's net liability and that Union International is not wrongfully withholding funds from MGM.

According to Hall General Counsel Thomas G. O'Brien III, MGM's proposed settlement with fire victims was so high that, in Hall's and the insurers' views, the amounts must have included punitive damages "at least in part."

In addition, Mr. O'Brien said, there are other defendants in the fire lawsuits besides MGM and, until it is determined what will be paid by them, it is uncertain what MGM's "ultimate net loss" will be for which insurers must pay.

"Until we can determine MGM's portion and the other defendant's portion, we can't determine MGM's ultimate net loss," Mr. O'Brien said.

He also noted that Union International views payments to MGM to date as advances.

John F. McCaffrey, Hall's executive vp who had a key role in orchestrating the placement of the back-dated insurance for MGM Grand, said, "I don't feel anything has been done wrong here. There's confusion here and I think it's honest confusion."

"We're all addressing retroactive coverage for the first time. As the

years go by, there will be a more standardized way of settling. What we are going through now is the learning curve."

MGM vigorously denies that there are any punitive damages included in the \$75 million settlement with fire victims.

"There aren't any punitive damages involved here," Mr. Goldman said. "The settlement states that it paid for compensatory damage claims and is very clear."

"The entire settlement was for compensatory damages," adds Mr. Segelin of MGM. "The judge found the settlements were fair and reasonable and, as far as we were concerned, they were for compensatory damages."

Judge Bechtel's order approving the \$75 million settlement as fair, just and reasonable says, "The strength of the claimants' cases on the merits for compensatory damages against the parties to be released pursuant to the settlement stipulation (are) balanced against the amount offered in the settlement stipulation in exchange for such release."

There is different wording used to exclude punitive damages in the back-dated liability policies.

The Union International policy for the first \$35 million of back-dated coverage, and several other policies, state that ultimate net loss does not include "Awards, Judgments and or Settlements rendered against the insured for punitive or exemplary damages."

Other back-dated policies use the standard wording for the exclusion, which states that the coverage does not include "fines, penalties or punitive exemplary damages." There is no mention of settlements.

A lawsuit over the back-dated liability insurance was expected by those close to the case. When the \$75 million settlement was announced in January, they said MGM and the insurers had disagreements over the terms and conditions of the back-dated insurance (BI, Jan. 10).

In its 36-page complaint, MGM is asking the court to determine the extent of its back-dated liability coverage. It also charges Frank B. Hall with breach of fiduciary duties and professional negligence; Hall and Union International with breach of contract; and Hall and all the insurers on the first and second layers of the back-dated insurance with breach of the covenant of good faith and fair dealing, fraud and deceit, conspiracy and breach of statutory duties under Nevada law.

Central to the complaint is the contention that Union International stopped paying litigation fees and expenses and has not indicated that it will pay its share of the \$75 million claim under the policy.

In all, it is estimated that Union paid \$8 million to \$10 million for claims and settlement expenses prior to the January \$75 million settlement.

"From in or about April 1982 to in or about January 1983, Union reimbursed plaintiffs for all costs and expenses incurred in connec-

tion with litigation and investigation related to the fire," the complaint alleges. "Union similarly reimbursed plaintiffs for settlement of certain claims."

"However, plaintiffs have incurred and paid litigation, investigation and settlement costs and expenses which defendant Union unreasonably and without excuse has failed and refused to pay as required by the terms of its policy."

"Defendant Union has breached the terms of its policy by failing to reimburse plaintiffs promptly for their costs and expenses incurred due to litigation, investigation and settlements, upon submission of such costs and expenses to its representative by plaintiffs."

The complaint seeks a declaratory judgment that the insurers on all of the retroactive policies are obligated to satisfy each payment that comes due under the January settlement.

According to the suit, the brokers and insurers were informed of the settlement proceedings, the nature of settlement negotiations and were given copies of the settlement and proposed settlement agreements.

The defendants also were invited to become involved in settlement negotiations with those suing MGM Grand and "numerous demands" were made upon the insurers "to propose, agree to and effectuate a settlement of plaintiffs' liability arising out of the fire," the complaint says.

"Defendant insurers did not join in plaintiff's settlement negotiations with the PLC (plaintiffs litigating committee) and did not propose, approve or effectuate any settlement proposal."

"They didn't respond," said Mr. Segelin. "We were unable to receive any assurance from the insurance companies," adding that the companies never informed MGM of why they were not satisfying payments.

MGM alleges in the suit that Union and Frank B. Hall recommended to MGM that it go bankrupt rather than settle claims.

It alleges that Union International and co-defendants Frank B. Hall & Co. of Southern Nevada and The Central National Insurance Co. of Omaha, another Hall insurance subsidiary that participates in the second layer of back-dated insurance, are managed and controlled by New York-based Frank B. Hall & Co., a fact MGM said was not disclosed when the insurance was purchased.

"Defendants have breached their fiduciary duty to plaintiffs (MGM Grand) by failing to inform plaintiffs that they had placed the entire first layer of retroactive insurance, constituting of \$35 million of retroactive excess liability coverage, and \$8.8 million of the second layer of retroactive excess liability insurance with companies owned and/or controlled by defendant New York Hall (Union and Central National), and by failing to inform plaintiffs that such companies were grossly undercapitalized by defendant New York Hall."

It contends that Hall utilized the

assets of those companies for its own gain and has commingled the assets with its own.

The suit further alleges that both Union and Central National are "grossly undercapitalized and that litigation and expense payments made to plaintiffs by Union, as hereinafter described, were advanced to Union by New York Hall," the complaint says.

Using these companies as separate and distinct companies from Frank B. Hall & Co. "would permit an abuse of the corporate privilege and sanction a fraud" against creditors of Nevada Hall, Union and Central National that include MGM, it adds.

"If we are correct that they don't have assets or have insufficient assets," Mr. Goldman said, "we can go to Frank B. Hall's assets."

Other insurers named in the suit above Union International's first retroactive excess layer of \$35 million, and the portion of coverage they wrote, include, on the second layer: American Home Assurance Co., \$10.5 million; Union International again for \$3.5 million; Central National, \$7.8 million; Federal Insurance Co., \$2 million; underwriters at Lloyd's of London, \$1.75 million, through Lloyd's Syndicate 799, which is managed by Leslie & Godwin North American (Non-Marine) Ltd., an affiliate of Frank B. Hall & Co.; Les Reassurances Corefi, Groupe Josi Compagnie D'Assurances, Compagnie D'Assurances Maritimes Aeriennes & Terrestres Societe Anonyme, Compagnie Financiere Et De Reassurance Du Groupe A.G., \$6.8 million; International Surplus Lines Insurance Co., \$1.1 million; Industrial Insurance Company of Hawaii Ltd., \$500,000.

(These limits stated on the policies filed only equal \$34 million. However, the lawsuit says the limits of the second layer are \$35 million and in one section states Central National had \$8.8 million. An amendment to the U.S. Fire Insurance Co. policy for \$1 million in the third layer notes that Fremont Indemnity Co. underwrote \$1 million of the second layer. Fremont is not named in MGM's lawsuit.)

MGM Grand paid \$7 million for the second layer of back-dated insurance of \$35 million, all of which would be consumed by the \$75 million settlement.

The third layer of retroactive insurance (\$25 million excess of \$100 million) include National Union Fire Insurance Co., \$10.35 million; Insurance Corp. of Ireland Ltd., \$5 million; St. Paul Surplus Lines Insurance Co., \$3.2 million; Northbrook Excess & Surplus Insurance Co., \$2.5 million; The Travelers' Indemnity Co., \$1 million; United States Fire Insurance Co., \$1 million; The Home Insurance Co., \$1 million; Northumberland General Insurance Co., \$750,000; and Guardian Insurance Co. of Canada, \$200,000.

MGM paid about \$2.5 million for the third layer of \$25 million of back-dated insurance, about \$15 million of which would be used to cover the \$75 million settlement. ■

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Malpractice pool issues refunds

TALLAHASSEE, Fla.—The Florida Medical Malpractice Joint Underwriting Assn. is issuing refunds of more than \$2.1 million to doctors, hospitals and other members, State Insurance Commissioner Bill Gunter announced recently.

The checks will go to nearly 4,650 policyholders who were in the fund during 1975-76 and 1976-77. Policyholders for 1975-76 previously received a refund in June

1982.

Policyholders in the fund during 1975-76 will receive refunds totaling almost \$1.05 million this time. The total amount of refunds for the 1975-76 period are expected to hit \$6.2 million.

The 2,100 insureds in the fund from 1976-77 will now receive refunds amounting to more than \$1.09 million. Total refunds for 1976-77 are expected to reach

nearly \$11 million.

The size of the refund a policyholder receives depends on premiums paid; hospital members pay the highest premiums.

The FMMJUA is an insurance pool through which individual policyholders can obtain primary medical malpractice insurance coverage of up to \$750,000.

Hospitals and health care facilities can get coverage up to \$2.5 million annually. ■

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