

SUBROGATION: THAR'S GOLD IN THEM THAR CLAIM FILES!

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Subrogation is often a missed opportunity in workers compensation claims files. The average amount of lost recovery dollars approximates one point on many insurers' combined ratios. For the insured, the result can be unnecessary premium increases along with a poor experience modifier. Specialized subrogation efforts can yield an attractive return on investment (ROI). I will detail the scope of the problem and provide specific steps for the insured, self-insured, or insurer to take to maximize recovery from workers compensation claims.

MAKING SUBROGATION A WIN/WIN FOR INSURED AND INSURER

For 20 years, I worked in increasingly responsible positions in the casualty claims division of one of the United States' major property and casualty insurers. In the 1990s, I jumped at an opportunity for a change of pace, accepting a position as vice president of claims for a large regional

workers compensation insurer. During my first few months, I tried to minimize “leakage” from our claims files as I helped our claims adjusters cope with an increasing caseload and a burdensome daily stream of bills. Lacking a dedicated recovery unit, the claims representatives were forced to spend precious time handling the routine subrogation matters that popped up in their files. It seemed that centralized bill payment and subrogation units would resolve many problems and let the claims adjustors focus on their area of expertise.

I discussed these ideas with several senior members of my claims team. They were unanimous in agreeing that a central bill-pay unit would work well and save time, but they were dismissive of my idea for providing them with a specialized subrogation unit. Digging deeper, I learned that these workers compensation adjusters spent little time with subrogation. True, they got a motor vehicle rear-end case from time to time, but other than that, they encountered few subrogation opportunities in their workers compensation claims handling, or so they thought. They felt they did not need a special unit to assist them.

This insurer was averaging 1.3 percent gross recovery against paid losses. The CEO had read an article in an insurance publication suggesting that a “best practice” would be to obtain 1 percent of gross claims payments as recovery. He was reluctant to fund a dedicated recovery unit, but finally gave the go-ahead. For an annual expense of roughly \$400,000, we staffed a unit with former general liability adjusters and hired one full-time staff attorney to handle litigation.

Within two years, our dedicated subrogation unit was averaging 4 percent gross recovery on a consistent basis. This 4 percent equaled \$3.8 million, or about \$2.4 million more on a net-of-cost basis than the insurer had previously been obtaining. This \$2.4 million equaled just about 1 percent of the insurer’s combined ratio. In addition, complaints from insureds reviewing loss runs and questioning missed opportunities for clear recovery ceased. It took five years for our very conservative actuarial firm to finally “change their assumptions” in our expected loss calculations. They had been using a 1 percent factor in our numbers, a national average. Their concession that we really were consistently yielding better numbers had a major impact: We did not have to raise rates that year, a significant competitive advantage.

WHAT IS SUBROGATION? HOW DOES IT WORK?

Craig Stanovich, a principal in a respected risk management firm,

defines subrogation simply as “the right to acquire someone else’s right.”¹ Common law, as followed in most states, allows an insurer to step into the shoes of its insured and pursue whatever claim the insured held against responsible parties. Workers compensation insurance policies have a section reciting this right as a term and condition of the policy. Subrogation is often defined in a policy as the acquiring of the right to proceed with a tort or a contract action on behalf of the insured that has been indemnified. Given the obvious nature of this right, why is it so often overlooked, dropped, waived, or just plain missed? What is the impact on an insured? How does this affect insurers?

I will explore the implications of subrogation on the insured’s future premium rates; I will also look at the potential that subrogation holds to subtract a point or two from insurers’ rapidly rising combined ratios. While clearly not a panacea for insureds reeling from premium shock in the wake of September 11, energized subrogation efforts can make an impact. And for most insurers today, the “found money” in those claim files can be a welcome addition to the company’s bottom line. The ROI exists, but only if handled expertly by those charged with making subrogation a profit center for the company.

ESTIMATING THE MINING POTENTIAL

As with any successful mining operation, the rewards versus the costs must be considered. For an insured, the rewards can be substantial. An employer’s premium is based on variance from expected loss rates. An experience modifier, or *E-mod*, of 1.0 means that an employer has experienced precisely the loss results expected from an operation of the same category and payroll size. Premiums move up or down based on whether an operation is performing better than or worse than this actuarial prediction.

Now, consider the case of a typical insured with a growing business that pays just \$25,000 per year in workers compensation premium. An average lost-time claim currently exceeds \$20,000, and with expense costs including premium taxes, various governmental assessments, and agent commissions accounting for perhaps \$5,000 or more, this means that even one lost-time claim can result in an E-mod greater than 1.0. Translation: Even one claim can result in a premium increase.

In fact, in today’s safety-conscious environment, many Fortune 500 firms will not contract with vendors or subcontractors who have E-mods greater than 1.0. This is increasingly common. I once sat through a painful meeting with a customer who had a growing business dependent on one large

railroad contract. He had been informed that with an E-mod of 1.3, his safety record was such that his contract would not be renewed in the coming year, effectively shutting his business down. Why? In separate incidents, two of his employees had been injured when struck by uninsured motorists. The resulting payments shot his E-mod up. While these random accidents said nothing about the relative safety of his operations, the E-mod was the barometer used by this and a growing number of general contractors. He offered to reimburse the insurer the amounts paid out on those claims. "Not allowed," I had to tell him. Ratemaking authorities, concerned about any potential falsifications or manipulations that might affect the integrity of the measure, do not allow such a practice. This example illustrates the seriousness of loss experience while underlining that even with strong subrogation efforts, positive results may not always follow.

My experience encompasses subrogation recoveries for self-insureds and insurers. These clients fall into two categories: those that have dedicated subrogation departments and those that do not. With a professionally directed subrogation effort, gross recoveries equal to 3 and even 4 percent of total paid claim dollars can be attained on an annual basis. Tim Jackman is claims director for the Missouri Employers Mutual Insurance Company, a major insurer of workers compensation in Missouri. In 2001, Jackman's operation aimed for a subrogation goal of 3.0 percent and finished the year at 4.2 percent. Similar results are seen around the country and within my own firm. The secret is in employing casualty-trained recovery specialists, and motivating them with attainable goals that push them to find recovery potential instead of reasons to close files without recovery.

Richard Carris of Ernst and Young calls subrogation "the Rip van Winkle of the insurance industry that has now awakened."² Jeffrey Baill of the Minneapolis law firm Yost and Baill has observed that just a decade ago, insurers were placing underachieving employees in the claims department to work on subrogation.³ I once pointed out to an insurer's CEO, dubious over the value of yet another specialization, that we could also train adjusters to set the broken legs, but that that might not be cost-effective in the long run. Certainly, not all specialized subrogation efforts are examples of professional and aggressive pursuit of recovery dollars. However, *odds improve* with this approach.

An approach that I favor in the identification process is a "recovery by default" rule: All client files where subrogation has not been effectively *ruled out* in the claim file are taken as potential subrogation cases. This equates to roughly 15 percent of reviewed files. Many files are the result of

no real accident other than “employee lifted box and felt sharp pain in shoulder.” These need no further handling. Others lack accident details and must be investigated: “Employee fell from ladder while servicing air conditioner.” What caused the fall? Did the ladder break, slump inward, slide off the building, etc.? Perhaps 50 percent or more of the identified files will result in a finding of “no recovery potential.” Within that remaining 50 percent lies the gold we are mining. As with all mining operations, we are not counting on hitting the mother lode. “Dog bit service man while at customer’s residence,” read one description recently. A phone call later, a check was on the way for \$275 reimbursing the insurer for the emergency room and physician charges. Most claims are relatively small. These, too, must be mined. Together, such efforts can add up to an additional 1 percent of total premiums collected. That 100 percent loss ratio just became 99 percent!

LARGE UNTAPPED NATIONAL POTENTIAL

The national workers compensation market is estimated at \$60 billion annually. This is a conservative figure, estimated before the recent round of 25 percent premium hikes. Based on an assumption of a pure loss ratio of 50 percent, that would result in \$30 billion in claim payments yearly. This suggests a potential for recovery of between \$900 million per year based on a 3 percent number and \$1.2 billion at the high-achieving 4 percent figure. Based on my experience, I estimate actual recoveries are averaging only \$450 million, or 1.5 percent of actual paid amounts. The industry’s untapped recovery potential could be up to \$750 million, perhaps even more. Of course, to the individual insured, the problem is better defined — it is that one case missed that leads to a higher premium and a worsening loss history. These missed opportunities are easily the number-one complaint that insureds have with a workers compensation claim center. By the time the complaint is heard, it is usually too late to correct the oversight. For insurers, subrogation will reduce complaints and increase client retention rates.

WHY IS THE POTENTIAL NOT BEING REALIZED?

Adjusters handling general liability claims are kept abreast of statutory and case law changes. Legal training probably comprises a good 40 percent of their annual training time. Their offices subscribe to quarterly legal updates. They see the results of liability claims pressed against their insureds. They understand basic tort law theory. In contrast, workers

compensation adjusters spend the vast majority of their training time focusing on medically related issues. They subscribe to various medical publications.

While all adjusters look at the key components of a solid claim file, those components may differ. For the liability adjuster, they include coverage determination, investigation, litigation management, negotiation, and case settlement. For the workers compensation adjuster, the key components are compensability under statute, investigation to determine compensability issues, medical case management, closure, and subrogation. Claim audit forms that my firm issued to workers compensation insurers revealed that subrogation was listed last! On a weighted average scoring plan, subrogation had a 5 percent weight. Was it then a priority to a busy adjuster lacking a background in tort law? Hardly, since every issue can't be a priority issue. But with a focused and dedicated recovery effort, it is *the only issue*.

REASONS FOR "NO RECOVERY" CLOUD THE WAYS TO FIND RECOVERY

Subrogation can be a complicated and expensive management process. Liability issues often hinge on theories of negligence, and negligence is always a jury issue. You win some cases, and you lose some cases. Litigation can be expensive. While the gross recovery potential looks attractive, some insurers have found that their net recovery percentages after subtracting their related costs were not so great. Like all organizational endeavors, even dedicated subrogation units tend to take on a life of their own. First, special information technology system modifications are needed. Next, more clerical staff and in-house attorneys are required. Continuing education and professional certification follow. Budgets grow.

In addition, there are any number of reasons why subrogation may not be successful. Following is a list of obstacles that may thwart complete recovery:

- responsible party does not have insurance;
- low limits of insurance by the responsible party;
- responsible party cannot be located;
- responsible party is in bankruptcy;
- key witness cannot be located;
- injured employee cannot be located or is not cooperative;
- insured does not want subrogation pursued against one of his primary customers;

- statute of limitations has run due to late notice of compensation claim;
- attorney fees will exceed lien amount;
- injured employee or employer shoulders some comparative negligence; and
- insured has hold-harmless agreement in favor of responsible party.

No wonder subrogation ranks so low on the priority list. Recovery efforts might appear to add to an already burdened claim expense factor. In a recent study, the Workers Compensation Research Institute reported that benefit delivery expenses, consisting of cost containment, litigation, adjusting, defense attorney fees, medical-legal reports, and other litigation and adjusting expenses, ranged from \$2,603 to \$5,497 per claim.⁴ These expenses ranged from 6 percent in some states to 12 percent in California. Finding a way to excite insurance professionals about increasing their delivery costs can be difficult. Proving that such expenditures are actually investments that will yield a sure and profitable return can turn this exercise around.

MAXIMIZING THE PROCESS

To maximize recovery, both the employer and the claims adjusters must be active participants and should be educated about the opportunities that exist. Recovery must be a top priority. A disciplined process should be in place with each participant informed and aware of the steps to take to further the process. Below is a list of guidelines for employers and insurers to help ensure success.

What the Insured or Self-Insured Can Do

There are a number of steps that an insured or self-insured can take to assist in the subrogation process:

- Conduct internal investigations for all job-related accidents. Not only is this a prerequisite for any safety program, it just makes financial sense.
- Treat loss dollars as though they were your dollars. In reality, they are. Over a five-year period, an insurer expects to take in enough premium to pay an insured's losses plus an amount to cover the aggregate loss fund of all insureds, along with expenses and profit. Keeping your losses at a minimum is the only control you have.

- Select insurers with dedicated internal recovery units or with specialized recovery contractors. Without this single-minded and professional approach to subrogation, results may be disappointing.
- Watch loss runs for signs of recovery. Does the loss run have a subrogation indicator shown, either “Yes” or “No”? If not, make a phone call to your insurer to inquire about ongoing recovery efforts on any claim you believe to have been the fault of some other party. Watch to ensure that cases identified early as having subrogation potential do not fall by the wayside as claims age, since this can be the tendency. Make a note to follow up at regular intervals until the recovery is in hand.
- Help the insurer with the necessary investigation. This starts with a good description of the accident on your first report. Many employers are too brief in this all-important statement. Use additional paper if the form is too limited. Make your employees available. If a defective product caused the injury, attach purchase records to the loss notice. Show you are interested and available to help.
- Avoid hold-harmless and indemnification agreements whenever you can. If you must incorporate such an agreement into a contract, have your attorney look it over first. Agreements that make you responsible for injuries to your employees by other parties can be particularly damaging to an otherwise solid subrogation claim, *unless such injury is the result of the sole negligence of the other party*. Example: You are re-roofing an operations building for a client. The client engages its overhead crane while your employee is attached to a girder, resulting in serious injury to your employee’s leg. Can you show that this was the result of the *sole negligence* of the client? Probably not. Worded in the contract making each party responsible for its own negligent acts is solid and will not later constitute a total bar to recovery.
- Watch case reserves. Until the claim is closed, the amounts paid *plus remaining case reserves* are called your “incurred losses” and are used in premium calculations. If recovery is certain, many insurers will manually reduce the size of a loss for premium calculation purposes. If your insurer will not, you may find it necessary to move a case to actual settlement and collection.

- Pass on any new information. If your employee has retained an attorney to handle a tort claim, pass this information along to the insurer.
- Educate yourself about subrogation. Keep it on your business radar screen. If you are a large employer, request and review regular reports about subrogation efforts.
- Praise your insurer for a job well done. Nothing multiplies success like praised success. Avoid being apathetic.

What the Insurer Can Do

The insurer can also take a number of steps to further the subrogation process:

- Measure your recovery efforts annually and set annual goals. What percent of paid losses did you recover in your last calendar year? If the number is less than 3 percent, there is work to be done.
- If you have not already moved to a specialized subrogation process, do so now. You have two choices: Create an in-house, dedicated recovery department, or contract with a specialized recovery vendor. Pushing your workers compensation adjusters to handle subrogation will not get the job done.
- Consider utilizing a professionally managed subrogation specialty firm. Such firms can often increase your net recovery while reducing your cash outlays chargeable to "claim expense." Your recovery is the dollars net of fees and expenses. It goes straight to your bottom line. Most firms operate on a contingency fee basis. They have to be successful to stay in business. *However, you should check a firm's track record before using its services.*
- Set realistic annual recovery goals. Track both gross recovery and net recovery. How is ROI holding up?
- Consider employing "plaintiff" counsel as your recovery litigators rather than sending referrals to your tried and trusted defense counsel. Good defense attorneys have a different mindset than aggressive "plaintiff" attorneys.

- Conduct occasional recovery audits. A quick test of 150 claim files can help you determine if you are maximizing your recovery potential from every file.
- Motivate your recovery specialists to avoid marking files “OK to close without recovery.” Eventually, all claims close. It is easier to see reasons to drop recovery efforts than to see real reasons to press ahead. It is amazing how properly designed incentives, monetary or otherwise, make hopeless cases look promising.
- Negotiate special rates to reduce your costs of recovery. Directing all your recoveries to one or two firms can lower total costs by leveraging your purchasing power. Emphasize that they get the good cases as well as the not so good ones. Contract on a contingency basis, covering only court and handling costs up front.
- Use specially designed management information systems reports to ensure that cases are not allowed to run past applicable statutes of limitations. Allow at least 60 days to get a case ready for litigation.
- Incorporate subrogation into all of your catastrophic injury cases from the very start. Assign a senior claim representative or attorney to every catastrophic injury case just to examine recovery potential.
- Avoid relying on outside entities for your investigation. The National Transportation Safety Board does a great job investigating plane crashes, but do you want your subrogation on a major case to rest on anyone else’s investigation? The same holds true with police investigations or any other investigation performed by others.
- Provide insureds with regular subrogation status reports. Besides being an excellent retention tool, these reports keep the insured vigilant for information you might need to know.
- Treat your subrogation unit as a true profit center. Provide reports to the board of directors at regular intervals to let them know how you are doing. Make copies of such reports available to your reinsurers. They will value your efforts.

- Even with dedicated units or vendors, continue to train your primary claim handlers in the ability to detect *potential recovery*. Early detection starts with the assigned claim representative.
- Know the law in all of your jurisdictions. Many states have odd nuances that must be observed. Washington state, for instance, allows the claimant to pursue the recovery during the first 60 days after injury.⁵ If that option is not exercised, the insurer may have the right to initiate the action *as though it were the injured employee*. Excess funds over its costs and claim payments are transferred to the injured employee, but with a credit against future workers compensation costs on the file. Other states have similar laws. Some states have victim compensation funds that can become a factor in subrogation.
- Be careful about abandoning recovery to just any attorney retained by the injured employee. Intervene in the case if you think you need to be able to exercise control at some point. It may be money well spent.
- Place responsible parties on notice as early as possible. In some states, injured workers can settle directly with the responsible party unless that party has been placed on notice. If you wait until you think you know the amount of your final claim, you might find settlements already consummated without your knowledge.
- Preserve evidence early. Provide for an “evidence room” and keep that broken chair, blown-out tire, or any other related material. Make sure critical evidence in motor vehicle cases is preserved. This might mean storing valuable salvage as evidence.
- Integrate your recovery actions with your fraud activities. Fraudulent claims with payments made might be open to administrative as well as civil opportunities for recovery. Ask prosecutors early on to request restitution as a part of any sentencing.
- Consider lump sum payments at discounted rates if it means getting actual recoveries quickly. Adverse parties might be able to use a credit card to quickly pay off responsibilities.

SUMMARIZING THE MINING PROCESS: INPC

The mining process can be summed up by the acronym INPC:

I	Identification
N	Notice
P	Pursuit
C	Closure

Successful recovery efforts should move forward in an assembly line fashion. A poorly managed recovery operation can be identified by the percentage of cases older than one year but not in litigation. This number will vary depending on the statutes of limitations in your principal jurisdiction. Find the number that seems right for your company, and monitor it quarterly. This number should be small. Cases should move towards a decision point rapidly. Either the case is going to settle, it is not going to settle and should be closed without litigation, or it should be referred for litigation. Controlling the decision point and reaching it early in the case minimizes total costs. Without this approach, subrogation representatives will rapidly become overwhelmed by burgeoning caseloads.

Not every case is worthy of litigation. Litigation is a costly process. Some firms have found their successful recovery operations dragged under by exploding internal costs. Cases turn on facts and recoverable assets. Without both of these critical factors present, subrogation cannot succeed and should not proceed. With concentrated management attention, your subrogation efforts should quickly show major improvements at the beginning and incremental improvement thereafter.

A CHECKLIST — GAUGE YOUR RECOVERY EFFORTS

Recovery efforts should be monitored closely to ensure success. The following questions should be addressed regularly:

- Are you getting 4 percent back in third-party recovery for every dollar spent?
- Is recovery a consistent priority that commands top-level attention?
- Do your claims adjusters and risk management staff regard recovery as one of their most important functions?

- Do you get regular management reports that measure in clearly defined terms the recoveries that are “in the pipeline” and the actual dollars that have been realized to date?
- Can you state that you have never lost a strong case due to time constraints, inattentiveness, or lack of aggressive pursuit?
- Have your claims adjusters and risk management staff had formal training in subrogation law? Are they sophisticated in identifying potential opportunities?
- Have you ever waived subrogation amounts in return for settlements because it was easier? Or without closely examining the financial trade-offs inherent in such negotiations?
- Do you wonder if you are controlling the cost of the recoveries you do make? Are your subrogation efforts cost-efficient?
- Have you ever abandoned a case because it involves another state jurisdiction in which your claims adjusters or risk management staff have no experience?
- Have you ever wondered why some claim representatives seem to get many cases with potential recovery and others never get any?
- Do you know how thoroughly you are squeezing every recovery dollar out of your claim payments?

If the answers to these questions demonstrate that your recovery process is not in full control and you are leaving money on the table, it is time to take a second look. It will be money and time well spent!

ENDNOTES

- 1 Stanovich, Craig F., “A User’s Guide to Subrogation – A Short Trip Through the Legal Jungle,” <http://www.austinstanovich.com/subarticle.html>.
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- 3 Insurance Recovery Group, “Subrogation Outsourcing Checklist,” <http://irgfocus.com/>.

- 4 Victor, Richard A. and Carol A. Telles, "Where the Workers Compensation Dollar Goes," <http://www.wcrinet.org/>.
- 5 Washington State Legislature, "Required Election-Procedures-Right of Subrogation, 2002." <http://www.leg.wa.gov/RCW/>.

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