



### ***Effects of Business Restructuring on Experience Rating***

Pursuant to 24-A M.R.S.A. §§ 2382-B(1) and 2382-D, all insurers and self-insurers must adhere to a uniform experience rating plan providing incentives for loss prevention and sufficient premium differentials to preserve safety. Separate and apart from this statutory mandate, experience rating is also widely used in many lines of insurance because past loss experience has been found to correlate with the risk of future losses. Furthermore, pursuant to 24-A M.R.S.A. § 2382 D(1)(D), the uniform experience rating plan must include "Provisions for reasonable and equitable limitations on the ability of policyholders to avoid the impact of past adverse claims experience through change of ownership, control, management or operation."

Therefore, Bureau of Insurance Rule 450, Article II, § 3(A) provides that except as otherwise expressly provided, "incurred experience shall be used in future experience rating modifications, regardless of any change in ownership, control, management, or operations." Similarly, the terms of the nationwide experience rating plan promulgated by NCCI provide that "The experience for any entity undergoing a change in ownership will be retained or transferred to the experience ratings of the acquiring, surviving, or new entity unless specifically excluded by this Plan." As Rule 450 takes precedence, its terms are incorporated into NCCI's Plan as a state-special exception;<sup>2</sup> however, the analysis and results under Rule 450 and under the nationwide plan are identical in this case. (It should be noted that the structure of this particular transaction as an asset sale does raise the further question of whose incurred experience should be considered. Those issues will be discussed in the next section, after addressing in this section the general principles governing the effects of changes in ownership and management on experience rating.)

A change in management is not sufficient for the new ownership and management to qualify for a clean slate for rating purposes. There must also be a "substantial change in operations," which is defined to "mean a change in operation of the insured sufficient to cause a change in risk classification assignment."<sup>3</sup> This limitation on the ability to avoid the impact of past adverse claims experience is reasonable and equitable, as contemplated by 24-A M.R.S.A. § 2382 D(1)(D). The experience rating plan would be meaningless if owners could avoid its impact merely by firing the manager and hiring someone else.

In this case, there was also a genuine arms' length sale of the business, so there is no need to worry about transactions carried out for the purpose of "mod laundering." Still, it is clear that a change of ownership, in and of itself, has no inherent effect on the safety of the business.<sup>4</sup> Although Lincoln Paper purchased the mill free and clear of the prior owner's liabilities, "An accident history is not a corporate debt, but part of the description of the operations and premises being insured." *CWCO, Inc. v. MEMIC*, No. 93-89 at 7-8 (Me. Bur. Ins., December 19, 1995), *aff'd sub nom. CWCO, Inc. v. Superintendent of*

*Insurance*, 703 A.2d 1258, 1261, 1997 ME 226, ¶ 7. “The Experience Rating Plan formerly provided that when a business was sold to new owners, the business would not be experience-rated until a three-year loss history under the new ownership was available; because of the lag time in reporting the third-year loss history, this effectively entitled the new owners to a four-year grace period with a unity mod, and provided an incentive to sell the business after four years if the loss history was poor.... For that reason, the interstate experience plan has subsequently been amended to preserve a company’s loss history if it is sold unless the change in operations is so comprehensive as to change how the business is classified.” *Id.* at 6–7 & n.13

Although Lincoln Paper cites improvements in its operating processes, it has acknowledged that the business remains a paper mill, and that none of the changes that have been made are so fundamental as to affect the governing classification of the business. Although new management and new ownership can certainly affect the safety of a business, sometimes significantly, there is no guarantee that the impact will necessarily be for the better. Thus, when there is sufficient continuity of operations between the predecessor and the successor, the Experience Rating Plan properly disregards any changes in management and ownership that might have occurred, because an adjustment to the experience modification factor would not be justified merely upon a determination that a change has occurred – it would also require an evaluation of the quality of the new management or the new ownership. That is not an appropriate role for the regulator. Such value judgments are properly made in the marketplace, by insurers and employers willing to place their own money on the line in support of those judgments. Insurers offer discounts through discretionary rating plans, and some insurers specialize in offering low rates to a selectively-underwritten clientele. Employers have the opportunity to assume a negotiated share of the benefit of favorable claims experience and the risk of adverse claims experience through deductibles and retrospective rating plans. Lincoln Paper engaged the services of a leading national insurance broker with expertise in the full range of alternatives available in the market.

In summary, the experience of the predecessor may not be as predictive when the business is under new ownership and management, but it is still the most predictive information available. This is not contradicted by the significant improvements in loss experience reported by Lincoln Paper during its first year of operation,<sup>5</sup> since this is a matter of hindsight. Lincoln Paper does not contend that it was denied the opportunity to purchase a retrospectively rated policy, under which it would have been entitled to a refund – as its actual experience turned out – in return for the risk that had things gone differently, it might have had to pay even more than it now must pay. These decisions must be made at the beginning, before we know how things actually turn out: “the nature of insurance dictates that the premium rate ... must be based on the insurer’s reasoned evaluation of the risk at the beginning of the policy period.” *Support*

*Solutions, Inc. v. MEMIC*, No. INS-04-104 at 3 (Me. Bur. Ins., September 2, 2004)

To the extent that they are actuarially significant,<sup>6</sup> these improvements in Lincoln Paper's loss history will soon find their way into its experience modification factor. Furthermore, to the extent that Lincoln Paper can persuade an insurer that the new information provides meaningful evidence that the current experience modification factor exaggerates the actual risk, a premium credit might even be available on the current policy. However, that is a matter of the insurer's reasoned discretion, and not relief that it would be appropriate for the Superintendent to order in this proceeding. See *Support Solutions, supra*, at 2-3.

### ***Significance of the Asset Sale***

As discussed earlier, the foregoing analysis presumes that from the perspective of the experience rating plan, the business of Lincoln Pulp was sold to new owners rather than simply being extinguished and a brand new business started on the same premises. For essentially the same reasons already discussed in the previous section, a provision requiring the experience of the seller to be considered when rating the purchaser would be meaningless if it only applied when the corporate entity is sold and not when the sale is structured in the form of an asset purchase, and there would be no reasonable limitation, as required by 24-A M.R.S.A. § 2382 D(1)(D), on the ability of the purchaser to avoid the impact of adverse claims experience. Accordingly, Rule 450, Article II, § 3(B) provides as follows:

*B. Disposition of physical assets.* If an entity disposes of most, or all, of its physical assets by sale or lease and then

1. Becomes entirely inactive with no employees, or
2. Retains a few employees for the purpose of closing out its affairs prior to dissolution as a legal entity, or
3. Retains a few clerical employees for the purpose of carrying on operations in connection with investment of its financial assets,

its incurred experience shall be assigned to that entity, if any, that has taken over its previous operations and employees, provided that there was no substantial change of such operations at the time of the takeover.

This provides, in essence, that if the old corporation disappears or is reduced to a shell, then the purchaser of the assets is treated exactly as if it had purchased the corporation for experience rating purposes. Lincoln Paper, however, argues that it qualifies for a clean slate under this provision because it has not "taken over the previous operations and employees" of Lincoln Pulp. This argument fails for both legal and factual reasons.

First, as a matter of law, the cited language does not mandate the absurd result that an asset purchaser could avoid the application of the experience rating plan by laying off its entire workforce and starting fresh with people who have no experience working together, and conceivably who even have no experience at all in the business. That would hardly be expected to improve safety. The cited language merely establishes that when the operations and employees are transferred, it is crystal clear which entity is the predecessor and which is the successor. In situations not explicitly addressed by the plain language of the rule, as when an asset sale is accompanied by a mass layoff, a case-by-case determination may be necessary in order to effectuate the intent of the rule.

Second, I find as a factual matter that Lincoln Paper did take over the previous operations and employees of Lincoln Pulp. It is operating the same mill in largely the same manner, it negotiated a new collective bargaining agreement with the same union that previously represented Lincoln Pulp's workers, and Lincoln Paper re-employed more than 60% of Lincoln Pulp's union workforce, despite a substantial downsizing, and more than 70% of Lincoln Paper's salaried employees. The continuity is even clearer if we look at the "after picture" – more than 80% of Lincoln Paper's employees had worked for Lincoln Pulp, and this statistic disregards employees who were only hired by Lincoln Pulp in the months immediately preceding the asset sale. Since this exception, if it had been one, would have been the only exception that might apply here to the general rule that the experience of the seller transfers to the purchaser, as set forth in Rule 450, Article II, § 3(A), Lincoln Paper's challenge to its experience rating is denied.

### ***Assignment to the High-Risk Program***

Finally, somewhat different considerations are raised by MEMIC's assignment of Lincoln Paper to the high-risk program established pursuant to 24-A M.R.S.A. § 3714(7). This is an experience rating program of sorts, in the sense that it uses prior adverse loss history as a predictor of future losses and as a safety incentive. However, it is not part of the uniform experience rating plan, and is governed by different statutory provisions. The statutory criteria are:

**7. High-risk program.** The company [MEMIC] shall maintain a high-risk program subject to the following provisions.

A. An employer must be placed in the high-risk program if the employer has at least 2 lost-time claims, each greater than \$10,000 of incurred loss, and a loss ratio greater than 1.0 during the previous 3-year experience rating period. Notwithstanding paragraph C, an employer may also be placed in the high-risk program during the term of a policy for noncompliance with reasonable safety standards.

B. The [MEMIC] board, with the approval of the superintendent, may modify the eligibility standards for the high-risk program if those standards limit those in the program to employers who have measurably adverse loss experience, have a relatively high claim frequency record or have demonstrated an attitude or practice of noncompliance with reasonable safety requirements or claims management standards.

The question in this case is whether Lincoln Paper and Lincoln Pulp were properly treated as the same “employer” for purposes of this statute, because MEMIC assigned Lincoln Paper to the high-risk program based on Lincoln Pulp’s loss ratio and claims experience. Although they are properly considered the same employer for purposes of the experience rating plan, this is not necessarily dispositive, because the Law Court held in *National Industrial Constructors, Inc. v. Superintendent of Insurance*, 655 A.2d 342 (Me. 1995) that legal entities that are combinable for purposes of the experience rating plan are not necessarily combinable for purposes of other statutory rating provisions.

*National Industrial Constructors* arose under former 24-A M.R.S.A. § 2366, subsequently recodified at 24-A M.R.S.A. § 2386, which established the residual market that served as the carrier of last resort before MEMIC was formed. That market was divided into a “safety pool,” for employers “with good safety records,” 24-A M.R.S.A. § 2386(4)(A), that were unable to obtain voluntary coverage but had acceptable safety records, and an “accident prevention account,” for high-risk employers. Pursuant to 24-A M.R.S.A. § 2386(3)(B)(1), an employer insured in the residual market was assigned to the accident prevention account if “The employer has at least 2 lost-time claims over \$10,000 and a loss ratio greater than 1.0 over the last 3 years for which data is available” – essentially the identical standard as now provided in the first sentence of 24-A M.R.S.A. § 3714(7)(A), *supra*.<sup>7</sup>

National Industrial Constructors and Rust Engineering were sister corporations under common ownership, but had historically operated under separate management with separate equipment and personnel, and obtained separate policies. At the time, NCCI administered both the experience rating plan and the residual market mechanism. When it adopted the “combination of entities” rule, it applied that rule to both the experience rating plan and the loss ratio calculation used to decide which account a residual market employer would be assigned to. National Industrial Constructors would have qualified for assignment to the safety pool and for a significantly lower experience rating if its experience had not been combined with Rust Engineering’s. The Superintendent found NCCI’s combination-of-entities rules reasonable and supported by the statute, for reasons similar to those discussed above, and rejected National Industrial Constructors’ challenge.

National Industrial Constructors appealed that portion of the Superintendent’s decision that upheld its assignment to the accident prevention account, and the Law Court sustained the appeal on the ground that the residual market statute referred specifically to the experience of “the employer.” Rule 450, by contrast, makes express provision for combination of affiliated entities and implements a statute which, unlike the residual market statute, is not stated in employer-specific terms, but to the contrary, expressly provides for “limitations on the ability of policyholders to avoid the impact of past adverse claims experience.” The Law Court held that the residual market statute was “free-standing and

autonomous,” and did not incorporate the terms of the experience rating plan by reference. Because the term “employer” is not ambiguous, it could not be used to mean a group of affiliated employers, and “loss ratio for purposes of safety pool eligibility is calculated from the incurred losses and earned premium of the individual employer who applies for workers’ compensation insurance coverage.” *National Industrial Constructors*, 655 A.2d at 345.

Because the MEMIC high-risk statute is derived from the former accident prevention account standard and is based in the identical manner on “the employer’s” loss ratio and claims history, *National Industrial Constructors* remains controlling. See *CWCO, supra*, at 9. The question presented here is whether the Legislature, in making its presumed choice to base high-risk surcharges on a different legal standard from experience rating, intended to establish a bright-line “separate legal entity” standard, or whether there are some situations in which MEMIC is permitted to consider the combined experience of related or successor entities. I conclude that neither the Legislature nor the Law Court intended the experience of a predecessor employer to be disregarded in determining whether the successor should be classified as high-risk.

Combination of entities for surcharge purposes raises policy concerns that combination of entities for experience rating purposes does not raise. When two entities are combined for experience rating purposes, it increases one’s experience modification factor but decreases the other’s, and if the entities are under common ownership, the same parent is ultimately paying the bills. Thus, it is not as important to distinguish between situations where there is high risk of the parent shifting exposure between subsidiaries and situations where there is little to no risk. High-risk surcharges, on the other hand, do not average out. If one entity would be assigned to the accident prevention account or MEMIC high-risk program on a stand-alone basis, while the other would not, then combining their experience and assessing the surcharge on an “all or nothing” basis would result in either a significant net loss or net gain from the parent, depending on whether the combined loss ratio averaged out to more than 1.0 or less than 1.0. Thus, persuasive arguments can be made that it is unfair to combine sister corporations with a history of independent operations for surcharge purposes.<sup>8</sup>

The predecessor/successor relationship, on the other hand, raises entirely different issues. *National Industrial Constructors* dealt with two entities which continued to operate as going concerns and to develop their own loss experience independently. Furthermore, they were under separate management and not in a position for their common parent to simply redesignate a Rust Engineering project as a National Industrial Constructors project in order to take advantage of the favorable insurance rate. Here, on the other hand, the successor entity has taken on the facilities and most of the workforce of its predecessor, so the predecessor’s experience remains directly relevant to the risk profile of the successor. See *CWCO, supra*, at 9. It would be irrational to

treat predecessors and successors as separate “employers” for purposes of the high-risk program whenever they are separate legal entities, because to do so would render the high-risk program a nullity – any employer could simply sell its assets to a new corporation whenever it would otherwise be assigned to the high-risk program.

Again, however, this does not mean Lincoln Paper is without recourse in the marketplace if it can persuade its insurer that its operations have sufficiently improved that it should no longer be treated as a “high-risk” employer on the basis of Lincoln Pulp’s record. The statutory high-risk surcharge does not apply at all unless the insurer is MEMIC, and MEMIC has represented that it may waive the high-risk surcharge in extraordinary circumstances. MEMIC should evaluate whether this is appropriate for the prior policy year, and/or for the current policy year if applicable, but as before, this is a matter of MEMIC’s reasoned discretion and not a decision it would be appropriate for me to make on this record.

### ***Order and Notice of Appeal Rights***

It is therefore *ORDERED* that the Petition is hereby *DENIED*. NCCI may combine the experience of Lincoln Paper & Tissue, LLC with the experience of Lincoln Pulp and Paper Co., Inc., and MEMIC may charge and collect premium based upon that combined experience.

This Decision and Order is a final agency action of the Superintendent of Insurance within the meaning of the Maine Administrative Procedure Act. It is appealable to the Superior Court in the manner provided in 24-A M.R.S.A. § 236 (2000) and M.R. Civ. P. 80C. Any party to the hearing may initiate an appeal within thirty days after receiving this notice. Any aggrieved non-party whose interests are substantially and directly affected by this Decision and Order may initiate an appeal on or before November 23, 2005. There is no automatic stay pending appeal; application for stay may be made in the manner provided in 5 M.R.S.A. § 11004.

<sup>1</sup> Pursuant to 24-A M.R.S.A. § 210, the Superintendent has appointed Bureau of Insurance Attorney Robert Alan Wake to serve as hearing officer, with full decisionmaking authority.

<sup>2</sup> The nationwide plan provides for fewer exceptions to the general principle that experience of the predecessor employer is attributed to the successor employer for rating purposes.

<sup>3</sup> Rule 450, Article I, § 3(A). Similar language is found in the *NCCI Experience Rating Plan Manual* at § 3(E)(2)(b).

<sup>4</sup> Although it is not directly on point, it is instructive that Rule 450, Article II, § 3(D) expressly provides that the debtor’s experience continues to be used for rating purposes after a receiver or trustee has taken control of the business.



<sup>5</sup> Furthermore, it is to be expected that a period of poorer-than-average loss experience will often be followed by improvement, and not surprising to observe significant improvement. There are several reasons for this, including the “regression to the mean” effect and the likelihood that even without a change in ownership or management, adverse loss experience will trigger a heightened attention to safety, as contemplated by 24-A M.R.S.A. § 2382 D(1)(B) & (C). The experience rating formula includes provisions designed to address this issue.

<sup>6</sup> The Experience Rating Plan does not look merely at the aggregate volume of losses, but rather makes a number of adjustments to avoid, for example, giving disproportionate weight to a single large claim.

<sup>7</sup> Likewise, MEMIC’s approved surcharge methodology is derived from and substantially identical to the former statutory surcharge formula set forth in 24-A M.R.S.A. § 2386(5)(C).

<sup>8</sup> Arguments could also be made in favor of combination even in those circumstances, but the arguments on both sides are public policy arguments for the Legislature to weigh, since the meaning of the existing statute is settled as applied to that fact pattern.

**PER ORDER OF THE SUPERINTENDENT OF INSURANCE**

**OCTOBER 14, 2005**

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**ROBERT ALAN WAKE**  
**DESIGNATED HEARING OFFICER**