

# How Much is that Doggy in the Window?

*When conducting a sale or acquisition, PEOs' workers' comp programs need to be scrutinized.*

"...The one with the waggly tail. How much is that doggy in the window. . . arf, arf. . . I do hope that doggy's for sale." Learned in kindergarten, the song, "Doggy in the Window" is comparable to the merger mania that is apparent in the PEO industry today. Look around and take note: Investment bankers now show up at the PEO association meetings looking for buyers and sellers alike. They advertise in PEO trade magazines. Potential acquirers and acquirees huddle together at meetings—off in corners, talking in discreet, hushed tones. These are definite signs of consolidations taking place in this new industry of ours. Everyone, enamored, is learning the dance. The buyer has just found another 2,500 employees—two steps this way, three steps that way—while the seller visualizes retirement on his yacht, sipping a cold one at sunset—three steps this way, two steps that way. . .

But wait! The next tune, played by the band at the dance after the "Doggy in the Window," is the old favorite "That Old Due Diligence has Me in its Spell..." The make-or-break stage of most deals, due diligence asks the question, "Can the proper value of the company be ascertained, in light of all the market dynamics out there?" One of the prime areas held under scrutiny is the workers' compensation program. What are some of the areas of the workers' comp program that should be analyzed for soundness and profitability? Are we looking at a pup with a pedigree or a bag full of fleas! The answer is in the tail, my friend—ah yes, remember the tail.

Anybody who's been in this business for more than five years knows from experience that the workers'

comp losses stated on the loss runs, printed on the last day of the policy, will not stay the same one, three, and five years after the expiration of the policy. A myriad of reasons exist, for the claims to escalate over time, until the final close-out of the policy year—which, actually, could be eight to nine years down the road. Incurred but not reported claims (IBNR) could be filed, sometimes three to four years after the expiration of the policy. This is especially true in occupational disease claims, such as a lung disease from foreign particles or exposure to a chemical or prolonged excessive noise.

Some claim situations have medical payments that go on ad infinitum, due to slow healing. In some cases, a low-grade infection could settle in what was considered to be a simple laceration. This type of claim could go on for a couple of years, to be finally settled at \$80,000, for what you thought would be a \$300 doctor's visit with five stitches.

The carrier is on the hook for life in cases where the treating physician has been able to trace the injury or dis-

ease back to the work site. For example some claimants may have contracted serious diseases, such as Parkinson's, due to exposure to toxins. Or others may have fallen, incurring a blow to the head that later develops into other symptoms.

Needless to say, the pinch of claims development will be experienced on a loss-sensitive workers' comp program. You'll receive a debit retrospective adjustment, lose your anticipated dividend, or pay for the deductible reimbursements during the next few years. In addition, your experience modification will climb, up to point where it will be difficult to compete, which is also true if you're on a guaranteed cost program. Interestingly, as the market hardens, you'll see carriers insist, more and more, on receiving currently valued loss runs, before they offer a quote. The insurance marketplace will tend to offer more loss-sensitive programs in lieu of guaranteed-cost-with-credits programs.

The National Council on Compensation Insurance (NCCI) provides extensive actuarials on loss development. They publish loss development factors every year, based on data provided by all carriers in 36 states. These loss development factors provide the average growth factors of claims. Obviously, they are in a position to utilize the law of large numbers. The 1998 loss development factors reflect the anticipated final ultimate loss on a given workers' comp policy. To obtain the final projected loss, simply multiply the losses shown on the last day of the policy. The following factors show the growth factors for both the claims reported paid as of the last day of the policy and the claims reported



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totally incurred (paid and reserved) as of the last day of the policy:

<u>Valuation Month</u>	<u>Paid</u>	<u>Incurred</u>
12	4.376	1.610
24	2.084	1.273
24	1.642	1.189
36	1.458	1.153
60	1.360	1.133
72	1.300	1.121
84	1.260	1.111
96	1.230	1.103

If you had \$100,000 of paid claims 48 months after the policy is over, you could reasonably expect another \$45,800 to be paid (\$100,000 x 1.458). Ever hear of the tail wagging the dog? Well, folks, it's looking at you in the face. It's real!

What can a PEO do to mitigate the effect of loss development? Certainly, anything that can be done will help with the profitability and long-term pricing structure of the workers' comp program. There is growing evidence that PEOs that closely monitor and manage claims, even years after the date of loss, will beat the numbers. The above factors contemplate all industries. In all too many situations, claims go unmanaged after the policy is over not only by insureds, but by carriers as well: "The squeaky wheel gets the oil." If your risk manager is howling at the claims adjuster—to act on a three-year-old claim—chances are that some action will be forthcoming, if only to avoid the next inevitable phone call from your insistent risk manager. Be sure to insist on monthly loss runs from every carrier that you've had coverage with for the past five years. Be on the lookout for changes in reserves and newly reported claims. Investigate the cause of any changes.

Most PEOs' workers' comp books of business follow the 80/20 rule: 80 percent of the claims come from 20 percent of the clients. Is the 20 percent really worth jeopardizing the value of your company? It would be prudent to replace them with quality business. Some carriers are now using a differ-

ent approach to quoting PEOs. Whereby an attractive quote is provided for the majority of your business, with the bad apples carved out, and perhaps a second quote -clearly expresses their desire not to write the account. There are three basic approaches for handling reserves and loss development during a merger or acquisition:

- Reserve and development liabilities are agreed to at the time of the transaction. Runoff is the responsibility of the acquiring organization. In this, the buyer should be confident that the purchase price properly reflects the costs of settling outstanding claims.
- Reserve and development liabilities remain with the seller. The seller must make sure that sufficient funds are set aside, out of the proceeds, to pay losses. The method of loss-portfolio transfer is the shifting of open claims, incurred but not reported, and future development to a third party—typically, an insurance company. This is also known as "selling off the tail." An insurance company agrees to assume all liability, from a certain date. A price is negotiated after very close scrutiny

of the open claims and the nature of the book of business. The liability is taken off your books. If the claims ultimately close out lower than the agreed upon tail price, the carrier comes out ahead. If, in fact, the claims develop out at more than the agreed upon tail price, the carrier comes out behind.

Prior to the sale or acquisition of a large PEO, that is saddled with a significant workers' comp tail, this method of risk transfer should be thoroughly explored. As has already occurred, with at least two publicly traded PEOs. It could raise its value, or, in the very least, the perception of its value.

How much is that doggy in the window, the one with the waggly tail? As a seller, you could raise your price by managing your waggling workers' comp tail. As a buyer, a better return on your investment could be achieved by holding that tail still. Either way, it's a win, win situation for all.

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