EXPERIENCE RATING *In Rem* AND *In Personam*

BY

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Among the peculiar questions that arise as an incident to the rating of workmen's compensation risks, I can think of nothing quite so important from the viewpoint of the individual policy holder as the question whether experience incurred under workmen's compensation policies shall attach or follow the person, i. e. the employer, or the risk. In order to fully appreciate the importance of arriving at a fair decision on this question, it is well to bear in mind the fact that the status of the employer is not fixed permanently. As the owner of the enterprise, the employer frequently changes his legal form and the style of his organization. An individual employer invites new capital and admits a partner into his enterprise; members of an old firm retire and allow younger men to take their places; partnerships change into corporate form; corporations change names and transfer large or small holdings of stock to new interests. At times individuals as well as copartnerships and corporations are forced into bankruptcy because of bad management or poor economic conditions and Receivers are appointed to conduct or liquidate the business.

So far as experience rating is concerned, what shall be done in following this gamut of changes? If it is accepted that experience reflects the morale of the management and that the owner is responsible for the character of the management, should not the experience incurred under a given ownership be discarded as soon as the new owner comes into possession? In that connection, how can it be best determined that a bona fide change in ownership has actually taken place and that the results flowing from such change will bring about reduced accident frequency and severity? Or is it not more rational to require that the experience shall follow the "risk," a term that requires an exact definition.

Rule 32 of the New York Experience Rating Plan permits the exclusion of past experience incurred on a given risk if a material change has taken place in ownership and control; corresponding rules in plans adopted in other states have substantially the same

provision with some minor modifications. This rule has been accepted quite submissively for a long time and until quite recently, when the line of decisions promulgated under the rule prompted the New York Department to direct a general inquiry into the soundness of the rule and its underlying theory. As an incident to this inquiry, the assumption that experience must follow the person of the employer and not the risk has been seriously challenged. In fact, one or more members on the rating committee of the New York Board have been bold enough to advocate a new idea which for the sake of brevity and convenience I have christened as "Experience rating *in rem*" to be distinguished from our present system of "Experience rating *in personam*." Those familiar with practice in admiralty courts will recognize the analogy. The proponents of the new idea would require that experience shall attach to the risk and not to the person, just as in certain actions at admiralty it is the practice to file suit and pursue the claim against the ship and not against the owner. This proposal like all suggestions that are new and strange immediately provoked a storm of criticism, the essential points of which will be covered in this discussion. The burden of proof is, of course, on the proponents of the new rule to establish: first, that the present system is faulty, and second, that the new rule will cure such defects and inequities as may be caused under the existing practice.

The arguments for and against the proposal should be subdivided so as to give proper weight to the legal as well as to the underwriting aspects of the case. Preference should be given to the legal viewpoint as the more important of the two. If under the general principles of law or equity the new owner must not be charged with experience incurred by his predecessor, expressed in terms of premium rates, then it becomes immaterial to delve into the underwriting question. A legal inhibition of this kind precludes further discussion. To make sure of our ground we have consulted a committee of five distinguished lawyers, all familiar with the subject of casualty insurance. The opinions expressed by the individual members of the committee follow:

For the proposal:

1. To have the experience follow the risk and not the ownership is more equitable because a credit would be allowed when

due and the charge would be in the nature of a liability of the concern which the new management would assume and one that proper supervision and control would eventually be able to eliminate from their policy.

2. When an established manufacturing plant, for instance, passes from one owner to another without any change in the physical conditions, it would seem perfectly reasonable to expect that the experience, so far as accidents are concerned, would continue under the new management substantially the same as under the old management. If, therefore, the rating organization should see fit to make a rule that the rate for the new owner shall be the same as it would have been for the old owner if no change had been made, it would be a perfectly reasonable rule and hence entirely legal. It is also conceivable that the character of the business might affect the question in a given case. If it is a manufacturing establishment where the employees, machinery and material remained substantially the same, a change in ownership or control would not indicate a change in experience. If, on the other hand, the business was of a kind where the character and place of work and the workmen changed frequently, as for instance in the business of a general contractor, a change in ownership or control might result in a very decided change in the experience.

3. It seems to be in furtherance of the spirit of public policy to demand that the experience follow the risk and not the management. If the experience of a risk has been unfavorable and is so at the time of the sale and transfer of ownership and control and the rate or rates as theretofore applied to such risks did not produce an excessive or unreasonable profit, it would seem to be not only improbable but impossible that the rates applicable to such risk would produce an excessive and unreasonable profit merely by reason of the change of ownership. Unless the experience is held to follow the risk, there would be no inducement or incentive for the successor to cure, correct and remedy the equipment of a risk, the experience of which was unfavorable.

Against the proposal:

1. The experience of a plant under one ownership cannot be charged to a new and different owner; furthermore, the idea that the experience rating plan pertains primarily to the risk and not

to the management, ownership or control is erroneous; physical conditions in plants are cared for by schedule rating, and the personal factor referred to as the "moral quality of the management, ownership or control" is taken into account by experience rating. Hence, it would be unreasonable to burden a new owner of a plant subject to experience rating with the poor experience of the former owners for approximately five years without relief in rates, notwithstanding a definite marked improvement in the experience after the change of ownership. For these reasons it appears that the proposal is unreasonable and will be so held in the event of litigation and therefore not enforcible.

2. Under the existing rules and practice with respect to experience rating the inability of an owner to escape the penalty of a bad experience for so long a period as five years is in itself an unreasonable requirement. Where an owner of a plant is able to demonstrate that during a reasonably long period because of the exercise of care and supervision in the enforcement of the rules and selection of competent and skilful supervisors he has been able to so improve working conditions as to effect a marked reduction in the number and character of accidents, with a corresponding reduction in the loss ratio, the courts will not be slow to afford him relief in the matter of rates for insurance, where, as in New York State, the statutes require that the schedules, rates and methods employed in computing rates charged for insurance shall be reasonable.

Whatever may be the final holding as to reasonableness in this connection, where the change in ownership is merely nominal, as where two partners turn their partnership business into corporate form and go on thereafter with the same pecuniary interests in the same organization, and where the corporate experience does not vary substantially from that under the partnership organization, it is altogether unlikely that the courts would sustain a rule which would make the bona fide purchaser of an existing plant pay a higher premium than he would be called upon to pay upon the establishment of a new plant.

When these opinions were submitted to a committee of underwriters, it was decided that the objections to experience rating *in rem* far outweigh any possible advantages that may be derived from the proposed change. The argument follows:

For the proposal:

1. The purchaser of an enterprise knows or should know its past condition and should therefore inherit the experience as one of the assets or liabilities of the risk.

2. There would be no inducement for the new owner to remedy the equipment of a newly purchased plant unless it was directly brought to his attention that he is the legitimate successor to the past experience.

3. Experience rating *in rem* would be simple in application; it would no longer be necessary to determine as a matter of fact or as a matter of law whether certain conditions constitute nominal or material changes in ownership and management, nor would the rating organization be called upon to eradicate the past experience upon evidence which does not establish any change in prospective hazard.

Against the proposal:

1. If an assured owns or acquires separate enterprises, each enterprise would have to be looked upon as a separate risk to be separately rated. In practice, it would be necessary to keep the experience segregated for each enterprise and follow it through for rating purposes over a series of years. It is doubtful if a procedure of this kind can be followed in practice.

2. If employer "A" starts his business career by the purchase of an enterprise from employer "B" and if the risk has developed a charge, such employer will be unfairly handicapped as against "C" similarly starting his business career with an enterprise that has no compensation history. Other illustrations on these lines can be given where two new employers would become subject to unfair discrimination.

3. It would be especially difficult to follow the risk in the case of contracting enterprises. In such cases there is almost a complete absence of physical characteristics that would permit the application of experience rating *in rem*. For the purposes of the rating organization the only thing of value in that case is the name of the contractor and the good will of the business.

4. If the plan is to be changed so as to allow for experience rating *in rem*, our conception of the term "Risk" will have to

undergo a material alteration. As at present defined, the term "Risk" includes all operations of any one assured within a given jurisdiction. What definition can be devised for "Risk" under a plan that directs experience to follow the risk?

A review of the arguments both from the legal and underwriting points of view leads to the conclusion that the theory for Rule 32 seems to be in accord with the general principle of the plan itself; that it is not proper either in law or insurance practice to charge a new owner with the sins of the past or to give him rewards for experience not earned under his supervision. In order that Rule 32 may be fairly applied in practice, a change becomes necessary so that the terms used may be more sharply defined. The general idea should be to prevent the obliteration of past experience on improper applications conceived in fraud or presented on frivolous grounds.

As a result of the discussion on the subject, the following amendment to the present rule is suggested:

> The past experience of a risk shall not be excluded because of nominal changes. The following conditions constitute nominal changes: Admission of new partners; retirement of old partners; changes from individual or copartnership to corporate form; changes in stock transfers and corporate shareholders; changes in executive staff; appointment of receivers in bankruptcy and other proceedings; changes in corporate names or titles under which the business is conducted. The past experience of a risk shall be excluded only if a material change has taken place comprising a complete transfer of the proprietary interest, together with corresponding changes in executive control and operative management.

This amended rule follows the present theory of experience rating *in personam*, defines just what may be construed as nominal and material changes, and permits the exclusion of past experience provided there is a complete change not only in proprietary interest but also in executive control and operative management, linking together the three conditions for the purpose of satisfying the rating authorities that exclusion of past experience is in order.

The question might be raised as to why the rule should not stop with the requirement of evidence showing a complete transfer of proprietary interest. Why inject as a condition precedent to the exclusion of experience, changes in executive control and operative management? I think the answer lies in the fact that

evidence respecting change in proprietary interest is at times cloudy. To make out a complete case the burden should be on the applicant to show that the new owner has not only come into possession, but has entered with doors wide open and has lent the force of his personality into the management of the enterprise. In other words, while the underwriting committee was influenced to a large extent by the opinion of the lawyers, it has nevertheless reserved certain rights and has incorporated its own views by insisting that the new owner shall give additional evidence of prospective changes in hazard by proof that he has assumed executive control and operative management.

It is quite true that other rating plans which have come under my observation use more elaborate definitions, reciting in greater detail the particular conditions that constitute a nominal or a material change. I have a feeling though, that these elaborate definitions lend themselves too readily to the purpose of building up a case, and that the better practice is to have sharp definitions of a general character, permitting sufficient latitude for each case to be judged on its merits.