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From the Chairman

by Patricia A. Hannemann, CPCU

Patricia A. Hannemann, CPCU, is the chairman for the CPCU Society's Risk Management Section. Her insurance career consists of more than 20 years' experience working in agencies and companies. Currently, she is working with The Insurance Society of Baltimore in promoting and teaching various insurance classes. Hannemann served as the CPCU Society's Maryland Chapter president and chaired both the Public Relations and Good Works Committees. The Maryland Chapter's CPCU Excellence Award was presented to her for spearheading the Good Works Committee and establishing the chapter's scholarship fund in connection with the SADD organization. Serving on the CPCU Society's Chapter Awards Task Force, she helped create and judge the current Circle of Excellence Award. Hannemann received her CPCU designation in 1987 and holds bachelor's and master's degrees in music from the Manhattan School of Music and a master's degree in business from Johns Hopkins University.

Our *RMQ* is continuing to grow with interesting articles, roving reporters, and your continued support and contributions. In this *RMQ* we are introducing a new column by **George L. Head, Ph.D, CPCU, CSP, CLU, ARM,** entitled "HEAD-Lines on Risk Management." Head retired in 2000 as director emeritus at the American Institute for CPCU and the Insurance Institute of America, where he was principally responsible for the development of the Associate in Risk Management (ARM) program and for the risk management components of the CPCU curriculum since joining the Institutes in 1967. We are thrilled to add his expertise and knowledge regarding risk management to our *RMQ*.

The other articles included in this *RMQ* cover a variety of topics such as risk management, mediation, moral leadership, workers compensation risk control, claim management, and captive investments. Authors for the articles are **Christopher J. Heffernan, Esq.; Demmie Hicks; Maureen Hunter Ph.D.; Hamid Mirsalimi, Ph.D.; Walter G. York, CPCU, AIC, CCLA; Linda L. Harding, CHSP, HEM, CHCM;** and **Andrew. J. Barile, CPCU.** Now I know everyone reads their *RMQ* from cover to cover, and these articles are certainly well worth the time.

On another note, the Risk Management Section Committee met at this year's Leadership Summit in Phoenix in April. Now don't you wish you were on the committee so you could have joined us? Phoenix was a delightful place to get warm, talk business, make decisions, plan future activities, and just plain relax. The atmosphere was perfect and those of us who attended had a wonderful and productive time. Here are some items from various meetings that were discussed:

- As with any committee, the time has come for some people to depart and others to join. If you are interested in participating and creating the future for the Risk Management Section, please let me know. Send me your name and send your application to **John Kelly, CPCU,** at the CPCU Society.
- Currently, the Risk Management Section has 654 members.
- Since last April we have issued five *RMQ*s under the guiding light of **Kathleen Murphy, CPCU,** our past editor, and **Jim Baggett, CPCU,** and **Jane Damon, CPCU,** who became the editors in December 2004.
- Our section will be sponsoring a session at the CPCU Society's Annual Meeting and Seminars in Atlanta. This is the first "solo" session for the Risk Management Section in about five years. It is scheduled for Tuesday, October 25, 2005, from 10 a.m. to noon; please plan to attend to support your section. The session is titled, "How Your Behavior and Decisions are Impacted by Leadership, Corporate Culture, and Ethical Guidelines," and will discuss corporate culture, ethics, fraud, leadership, and the Sarbanes-Oxley Law in a combination of scenarios including psychology, human studies, and behavior. The moderator is **Demmie Hicks** (president and CEO of DBH Consulting) with panelists of **Maureen Hunter, Ph.D.** (DBH Consulting), **Hamid Mirsalimi, Ph.D.** (DBH Consulting), **Marjorie Fine Knowles** (lawyer—Georgia State University College of Law), **James R. Pender, CPCU, CLU, ChFC, ARM** (chairman of Oswald Companies), and **Lori Taylor**, vice president, risk management of Coca-Cola Enterprises, Inc. This is a session **not to be missed** at the CPCU Society's Annual Meeting and Seminars in Atlanta.

As always, I look forward to hearing from any section member with comments on how to improve our *RMQ* or our section, new ideas, articles, or just to say "hi." My e-mail has changed so please make a note to e-mail me at pah@hoco150.com. ■

Risk Control and Claim Management Techniques for Workers Compensation

by Walter G. York, CPCU, AIC, CCLA, and Linda L. Harding, CHSP, HEM, CHCM

- **Walter G. York, CPCU, AIC, CCLA,** is an account executive with RCM&D and is responsible for a wide range of accounts including non-profits, public entities, healthcare, and manufacturing.

  York began his insurance career as a claims adjuster for The Hartford. He also worked as a claims supervisor for Reliance Insurance Company, and as an insurance analyst for the Baltimore Gas and Electric Company (BGE) before joining RCM&D. He obtained additional risk management experience at the Insurance Buyer's Council and at the Mass Transit Administration.

  York holds a bachelor of science degree in business administration from the University of Maryland and a master of administrative science degree from the Johns Hopkins University. He holds the Chartered Property Casualty Underwriter (CPCU), Associate in Claims (AIC), and Casualty Claims Law Associate (CCLA) designations.

- **Linda L. Harding, CHSP, HEM, CHCM,** is vice president and risk control manager of RCM&D, and has more than 15 years of experience in safety and health management programs, with expertise in the investigation and evaluation of employer safety and health issues. She has earned the Certified Healthcare Safety Professional; Certified Hazard Control Manager; and Healthcare Environmental Manager designations. Harding's responsibilities include managing the Risk Control Department. Her consultant services include investigating and evaluating safety and health risk issues in the industrial, commercial, and healthcare environments; and providing tools to management to encourage accountability and to embrace a safety culture. In addition, she develops and implements risk management programs to control workers compensation exposures.

  Prior to joining RCM&D, Harding worked for Royal & SunAlliance, The EBI Companies, and Maryland Occupational Safety and Health. Her affiliations include The American Society of Safety Engineers; Board of Directors for the Safety Council of Maryland; and the Maryland Occupational Safety and Health Advisory Board.

Proactive employers are committed to having a safety culture. They use proven techniques to prevent accidents and reduce the associated costs. Listed below are 16 points that will have a positive impact on your workers compensation program.

Senior Management Commitment

Obtain a commitment by senior management to address and control workers compensation costs. This commitment is accompanied by communication of management's position to supervisors with workers compensation cost control included as an element in performance evaluations.

Safety Committee

Create and operate a safety committee reporting directly to senior management. An effective safety committee, at a minimum, reviews events, accidents, and frequency trends. The committee also undertakes hazard identification inspections providing recommendations for correction.

Incident Reporting

Implement a procedure where a specific report is made of every incident. The incident report is completed by the operational supervisor in conjunction with the injured employee. Incident reports are then compiled for tracking and trending purposes. In association with the incident report, a coordinated procedure for promptly rendering the employer's first report of injury should be developed.

Accident Investigation

Implement an accident investigation procedure where supervisors investigate the causes underlying every accident with suggestions for future prevention, with reports sent to the safety committee.

Workers Compensation Program Coordinator

Appoint a workers compensation facilitator with the following responsibilities:

a. Ensure that the first report of injury is promptly sent to the carrier so the adjuster can contact the injured employee. This may help to reduce the anxiety level of the injured employee.

b. Serve as the focal point for referral of employees for follow-up medical care, i.e., industrial clinic, emergency room, orthopedic, etc.

c. Remain involved with follow-up care, i.e., discussing the status of cases with treating physicians, claims adjusters, and the injured employee.

Transitional Duty

Install and maintain a transitional duty program for all departments. Transitional duty, a proven means of reducing workers compensation claim payments, includes the following:

a. A written policy explaining the details of this program.

b. Senior management holds the manager/supervisor accountable for bringing employees back to work and supporting the policy.

c. Employees know that transitional duty is the company standard. When an employee injury occurs, the employee knows he or she will be brought back to work on transitional duty as soon as possible.

d. Healthcare providers know the company has a transitional duty policy and is committed to bringing their employees back to the workplace.

e. The treating physician should have a job description of the injured worker to assist with determining what duties the injured worker can perform.

Referral Physicians

Set up a panel of referral physicians for workers compensation injuries in states where panels are allowed. A good working relationship with a local occupational clinic is beneficial. The clinic should have knowledge of the facility, process, and company's return-to-work program. A local occupational clinic understands workers compensation cases and will possibly work with the employer in providing a discount for treatment and other services (drug testing, pre-employment physical). Additionally, the clinic can usually provide quicker treatment for the injured employee.

Pre-Placement Physical Evaluations

Conduct pre-placement physicals including "workability evaluations" for individuals in positions that involve lifting or other significant physical activity. Although the Americans With Disability Act may make this more difficult, it can be an important facet in reducing the occurrence of back injuries. Functional capacity job descriptions that carefully detail the physical requirements of all positions must exist along with everyone being tested to assess their ability to handle the position.

Periodic Claims Review

Periodically (usually quarterly), review all open claims with the carrier to discuss progress and tactics to bring each open claim to the best possible conclusion for all concerned.

Prompt Reporting

All lost-time injuries should be promptly reported to the carrier. The adjuster should contact the injured employee within 24 hours of the injury. This helps to reduce the anxiety level of the injured employee.

Claims Cost Accountability

In an effort to support direct accountability, claims activity could be a charge-back to the individual department. Claims costs should be reviewed with each department head on a periodic basis.

Communication

Open communication throughout the organization is necessary to assure a safe and healthful workplace. Employees should be encouraged to bring safety issues to management's attention. The coordinator should be in communication with the claim adjuster. The coordinator or supervisor should be in contact with the injured worker. Open communication will reduce anxiety and help facilitate early return to work.

Education

Employees should be oriented to the company's safety rules, policy, and procedures. Training should be provided on hazard recognition and on topics required by OSHA and other governmental regulations.

Employee Accountability

Safety performance should be part of every employee's annual evaluation. Management and supervisors should be measured on their actions such as prompt reporting, accident investigation, safety training, etc. Other staff should be measured on following safe procedures, wearing personal protective equipment, or attendance at training sessions and safety meetings.

Review Current Reserves to Reduce Your Experience Modifier

The experience modifier is used on the Workers Compensation Policy and is a number produced by measuring the difference between an insured's actual past loss experience and the expected loss experience of its class. The modification can be either a debit or credit that can increase or decrease the standard premium.

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The National Council of Compensation Insurance (NCCI) computes experience modifiers by using past losses (compared with industry averages) to modify future premiums. For example, an experience modification of 0.88 represents a 12 percent credit that is created by a favorable loss history. By contrast, an experience modification above 1.00, such as 1.50, represents a 50 percent debit due to unfavorable past loss trends. A review of the workers compensation reserves is suggested to make sure the information reported to the NCCI is accurate. This review should be done before the insurance carrier submits the loss information to NCCI.

The experience period used to determine an insured's experience modification factor consists of three completed policy years ending one year prior to the effective date of the modification factor. For example, an insured's modification factor for the 2005 policy year is based on the insured's loss history for the years 2001, 2002, and 2003. The 2004 policy is not used since the claims for the expiring year have not developed.

The insured's experience modification factor is based on payroll and loss records, which are submitted by the insurance company to the rating bureau. These records are valued as of six months prior to the effective date of the policy, and are used to calculate the next year's experience modification factor.

Check Employee Classifications for Accuracy

Check to make sure that your employees are classified correctly on your workers compensation policy. Review your classification codes and discuss them with your agent or broker to make any adjustments.

Proactive employers are committed to having a safety culture. They use these proven techniques to prevent accidents, manage claims, and control costs, all of which results in control of the workers compensation premium. Workers compensation is a sizable expenditure for most companies, but it can be controlled. ■

HEAD-Lines on Risk Management

The Problem with "Utmost Good Faith"

by George L. Head, Ph.D., CPCU, CSP, CLU, ARM

■ **George L. Head, Ph.D., CPCU, CSP, CLU, ARM,** is director emeritus at the AICPCU, in Malvern, PA.

Working directly or through marketing intermediaries, risk managers and underwriters buy and sell—in effect, strike negotiated bargains that center on—insurance for business organizations. Risk managers typically know more than underwriters about the daily intricacies of the specific exposures against which they wish to insure; underwriters usually know more about the inner workings of the financial protection and perhaps other services that each of their companies offer to guard against policyholders' exposures.

To assure that these transactions are fairly bargained despite this systemic difference in the negotiating parties' areas of special expertise, the insurance industry has for centuries relied on the principle of "utmost good faith" between the seller and the buyer of insurance, in much of today's commercial insurance world between the underwriter and the business firm's risk manager.

The principle of utmost good faith developed at a time in world history when buyers and sellers of insurance often had little specific information about the current condition of objects or activities they insured. The principle states that the insurer and the insured are duty-bound to share all relevant information with one another, regardless of how favorable or detrimental that information may be to either the prospective insurer or the prospective insured. The principle of utmost good faith also binds both parties to share all their relevant knowledge regardless of whether the facts to be shared pertain to the condition of the insured's particular exposure (where the buyer of insurance is likely to have an information advantage) or to the exact provisions of a particular insurance contract (where the insurance seller often has the greater information).

As a classic ancient example, suppose a ship owner and an underwriter in 1692 Belgium are negotiating about whether and at what premium to insure a ship that each believes is currently sailing through the Indian Ocean. The ship owner and the underwriter then each receives separate news via their respective carrier pigeons. The ship owner learns that his ship went down five days earlier. He must tell the underwriter, for to try to insure against a loss that you know has already occurred is not an act of utmost good faith toward the insurer's underwriter. But, upon hearing this news, the underwriter would also have to confess something: The underwriter's carrier pigeon from the home office brought a note saying the policy the insurer would offer included the new "Indian Ocean exclusion"! To try to sell an insurance policy when you know an insured event can never occur also is not utmost good faith toward one's prospective policyholder.

So in principle, especially in ancient stories, utmost good faith between an insurer and an underwriter is a fine thing. In most cases, in the long run, utmost good faith helps the insurance mechanism operate as it should for specific insurers, individual insureds, and for both small and large groups of essentially similar insureds. As a principle of insurance and risk management theory, utmost good faith works: Genuine risks are shared and fair premiums are paid to honest insurers, on average in the long run, when policyholders and underwriters are true to one another.

This is all fine, but sometimes I get concerned about more modern, shorter-run situations—especially situations where risk managers and underwriters (directly or through their marketing representatives) have more parties or interests than just one another to whom they must be loyal and true. For example, in addition to being faithful in the utmost to underwriters, a risk manager (let's say for a manufacturer) has duties to the owners of the company that hires him or her to manage its risks. One of these duties is to maintain the company's profits. In the long run, in a fair world, being faithful to underwriters should, in principle, enhance the company's profits by giving it access to the best insurers by saving it money on insurance premium. But in the short run, in an imperfect world. . . ?

. . . the insurance industry has for centuries relied on the principle of "utmost good faith" between the seller and the buyer of insurance . . .

Suppose the company's main production plant has sat alone atop a large hill for 30 years, and that the company's broad named-perils property insurance covers many potential causes of and does not exclude either subsidence or landslide. When leaving this plant one day during the week that he happened to be renewing this property coverage for the fifth straight year with the same underwriter, this manufacturer's risk manager happens to notice some new cracks in the sidewalk that leads from the plant to the employee parking lot at the edge of the property, as well as more cracking in the blacktop at the far edge of the lot. Along this edge, the risk manager also finds some loose soil and small rock fragments, which she remembers her college geology text called "detritus," an indicator of likely gradual earth movement where the detritus appears.

Now the risk manager has an ethical problem. Should she ask the insurance agent or broker to tell the property underwriter about the likely earth movements around the plant? The underwriter has never asked anything during this or past renewals about changes in the condition of the grounds, and this underwriter probably would not realize the possible significance of detritus even if he saw it—after all, this underwriter was an English major. On the one hand, as an insurance principle, utmost good faith says she should tell him. But then the underwriter is likely to insist on earth movement/subsidence exclusion or on an increased premium rate. Such an exclusion or increase also would be fairer to other insureds in this manufacturer's property insurance rating class—other insureds who presumably occupy firmer terrain, and to whom this manufacturer's risk manager also presumably has some duties of fairness.

On the other hand, by not telling the underwriter about the increased subsidence threat she sees, the risk manager reduces her employer's current insurance costs and increases stockholders' profits, probably the company's stock price and the current value of its investment portfolio, as well as perhaps this year's dividend income. Furthermore, on a more personal level, this risk manager may earn a higher yearly bonus if she can keep the manufacturer's insurance costs in line. Higher costs are likely to mean a lower bonus, she fears, or none at all. Yet for her, a good bonus could help pay her son's current college tuition bill. Along with the underwriters, don't this risk manager's employer, its stockholders, and her family also deserve some utmost good faith?

In short, the problem with the principle of utmost good faith between an insured and an insurer (or between the marketing intermediaries through whom they negotiate) is that this principle can easily create conflicts with other seemingly valid loyalties that real people in real life genuinely cherish. I cannot resolve these conflicts with some absolute, universal rule of priorities—none of us should seek such a rigid rule. The risk manager in our example must herself decide what, if anything, to say to the underwriter. Utmost good faith clearly does not allow an insured to lie to an insurer—if the underwriter in the above example asks about the condition of the plant grounds, the risk manager certainly must explain what she knows or suspects. But utmost good faith also does not mean abandoning all other commitments. Some balance among commitments is needed—a thoughtful balance each of us must carefully strike, every day if necessary, for ourselves as we trust others to do likewise for themselves. ■

Lessons Learned from Mediation

by Christopher J. Heffernan, Esq.

Christopher J. Heffernan, Esq. is a partner at Niles, Barton & Wilmer, LLP in Baltimore. His practice focuses on insurance defense, real estate, construction, business litigation, and alternative dispute resolution. Heffernan has achieved an AV rating from Martindale-Hubbell, awarded by peer review, for the highest standards of professional skill and ethics. He is admitted to practice law in Maryland and Washington, DC.

Heffernan is a frequent lecturer on various legal topics, including drafting and negotiating construction contracts, defense of construction defects claims, insurance requirements for construction contracts and liability of owners, contractors and design professionals, and alternative dispute resolution. He is an instructor for Maryland Institute for Continuing Professional Education for Lawyers, the Construction Specifications Institute, and the National Business Institute.

We litigators have a variety of tools at our disposal to assist in the resolution of disputes involving our clients. These tools include negotiation, litigation, trials, arbitration, and dispute resolution boards, to name but a few. We use these tools with varying degrees of success in a wide variety of factual and legal scenarios. During the course of the last 20 to 25 years, we have also began to use mediation as an effective dispute resolution tool.

Seeing Mediation as an Opportunity

Mediation is an opportunity for litigators to serve their clients by working with a neutral third party to reach a negotiated resolution of their dispute in a confidential setting. Successful mediation depends upon a variety of factors including: risk analysis, timing, factual and legal issues, counsel, the parties, the mediator, relationships, finances, and personalities. The outcome of the mediation is largely a function of how these factors come into play through the participants' use of the mediation process. Sometimes, mediation results in a complete settlement. Other times, it narrows the issues in dispute, or opens doors to further discussions and negotiations.

My initial experience with mediation was almost 20 years ago in one of the first formal mediations of a significant design and construction dispute in the Baltimore region. The dispute arose several months after completion of a multi-million dollar building addition project. The project experienced back-ups from its sanitary pipelines into the building. The pipelines extended beyond the perimeter of the building and were located approximately 23 feet underground. Through the operation of a robotic camera through the pipe, the owner discovered significant cracks in the pipelines. It was also apparent that the pipe sections were not "belled" at one end as required. It was determined that the cracks and blockages had been caused by the heavy construction equipment traffic over the pipelines during construction of the project.

After preliminary discussions of the problems with the design professional and the contractor failed to generate a resolution, the owner instituted suit against them both. This prompted cross claims and third-party claims against excavation and grading subcontractors, the pipe supply and installation subcontractor, the on-site inspector, the pipe manufacturer, the geotechnical engineer, and the civil engineering sub-consultant. In short order, more counterclaims and cross claims were filed among and between the parties, creating a tangled web of pleadings.

Before substantial discovery got underway, one party and its insurance carrier suggested that the parties attempt to reach a resolution through confidential mediation. The carrier offered to pay the mediator's fee. Most, if not all, counsel were not familiar with mediation. Some counsel were hesitant due to the lack of discovery regarding the details of the case. The owner agreed to provide the participants with its expert reports. Faced with potential exposure to significant liability and the likelihood of expensive and time-consuming litigation, the parties, their insurance carriers, and their counsel eventually agreed to try mediation.

The mediation was led by an experienced and strong mediator. The parties submitted confidential mediation statements before the first session. At the plenary session, the mediator laid out the ground rules of confidentiality, good-faith participation by parties and counsel, and civility in all discussions. We spent most of the first day in public session, where the parties discussed the project, the discovery and nature of the problems, the roles of each party on the project, potential repair schemes, and the potential liability of each party. The

second day was spent primarily in private and semi-private caucuses with the mediator. After five full days of mediation over the course of the next four months, the participants' and mediator's hard work was rewarded with a complete settlement of the dispute including the design and implementation of a repair program.

Many factors played important roles in the success of the mediation. For purposes of discussion in this article, I have selected six factors that played significant roles in the success of the mediation.

Risk of Loss

From the outset of the first mediation session, it was clear that each party was exposed to a significant risk of loss. There were liability issues based on the design and manufacturing of the pipe sections, as well as the design and installation of the pipeline in terms of the location, placement, and configuration of the pipe, the underlayment, and the backfill. There were also issues concerning the field inspection, geotechnical investigation, and the mechanical and civil design of the project. In addition, each party faced the risk of exposure to significant litigation expenses and lost time. The risk of loss was crucial to bringing everyone to the table and to creating incentive to work toward a resolution.

Willingness to Negotiate

Experienced counsel agreed to try to negotiate early. All counsel participated in good faith and contributed thoughtful and creative ideas while zealously representing their clients in a civil manner. Initially, some counsel "took control" and "ran interference" on the mediator's efforts to draw the parties into the process as active participants. However, once the parties began to invest their time and effort in the mediation, most counsel adjusted their approach to be more in the nature of negotiators rather than litigators. This transformation by counsel and the parties allowed them to work together to resolve the problem.

Skilled Mediator

Our mediator was tireless in her efforts to encourage the parties and counsel to evaluate and discuss the nature of the problem, the repair alternatives, the parties' exposure to risk, and their investment in a mediated resolution. She led the plenary sessions, private caucuses, and a number of different semi-private caucuses throughout the process. She pushed the process forward and kept the participants focused on the issues and working to find common ground. In talking to other counsel since the mediation, I have learned that on many occasions, our mediator encouraged all of the participants to consider the best alternative to a negotiated agreement, or "BATNA." This repeated analysis by the parties and their counsel helped them realize, in terms of time, effort, and direct and indirect cost, the net cost of proceeding with litigation instead of mediation.

Participation by Clients

The active participation by the parties themselves was critical. It took time for the parties to feel comfortable in participating directly, instead of through counsel. This was due in part to the novelty of the process and concern about letting down their guard. The parties' participation increased proportionately with the time they invested in the process. The confidential nature of the meetings was essential to increasing the parties' comfort level. Lastly, once the first party "broke the ice" and became directly involved, others followed suit. Eventually, the parties were involved in discussions of the nature of the problem and how to repair it. These discussions prompted work by the parties and their counsel between mediation days. Interestingly, however, there was less direct discussion among the parties concerning relative liability. This topic was addressed mostly by counsel.

Timing of Mediation

The timing of the mediation was also very important, but different than in most mediations in which I have participated. Many litigators understandably believe that mediation can be productive only after a certain amount of discovery has been conducted, so that the parties and counsel have enough information to evaluate the risks involved in the case. This makes good sense, especially in most large and complex cases. However, the pipe case demonstrated that in some cases, even complex ones, extensive discovery is not always needed in order to engage in a successful mediation. Because the parties and their counsel recognized exposure to risk before having spent thousands of dollars in litigation fees and the parties' own time, and because they developed a rapport through good-faith discussions of the problem, its resolution, and the question of liability in a confidential arena, they seized the mediation as an opportunity to craft a resolution to the problem.

Patience, Perseverance, and Civility

Lastly, all of the participants demonstrated patience, perseverance, and civility throughout the mediation. The mediator patiently and persistently kept the parties and counsel focused on the pipe problem, repair options, risk, and BATNA. This took exceptional effort considering the number of parties and their divergent views of the case. Likewise, counsel was patient with the mediation process, giving it time to work once they adjusted their approach. In all cases, counsel's discussions were civil and directed at the issues, not other counsel or other parties. Counsel also worked hard in private caucuses with their clients, in semi-private caucuses, and in public sessions with other participants. Most important was the parties' patience with a new process and their persistence once they became involved. Once the participants felt that they, as a group, were in good faith addressing the problem, options for repair, and liability, they perceived the opportunity to resolve the dispute and the litigation.

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Lessons Learned from Mediation

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Preparing for Mediation

My experience with the pipeline mediation and with many mediations since then has led me to the following observations:

Prepare the Client

Counsel must prepare their clients for mediation, not litigation. This means they must make the client understand that the process is designed to encourage the disputants to formulate a resolution together. Clients should be instructed to actively participate in the discussion and the resolution. However, this does not mean that they should try to convince the mediator that they are correct. Rather, they should be encouraged to provide the mediator information to help the mediator to persuade the other side of the benefits of reaching a resolution, rather than leaving the resolution up to a judge, jury, or arbitrator. In addition, the client must understand that effective mediation takes time and cannot be rushed.

Adjust Tactics

Successful mediation tactics differ dramatically from litigation tactics. Mediation is not the place for aggressive behavior, table pounding, personal attacks, or insulting the opposition. Rather, it is an opportunity for civil discussions of the issues, alternatives to resolve the dispute, and the relative strengths and weaknesses of each party's case. Such good-faith communications are often the most persuasive tactics used to reach a mediated resolution. Participants should also bear in mind that mediation is often the first and only chance for the parties to talk directly to one another about the dispute without filtering of information by counsel. The parties and counsel should take full advantage of this opportunity to communicate their best case directly to the other side and to convince them of the reasonableness of their proposed resolution.

Pre-Mediation Statements

Pre-mediation statements provide a framework of preparation for the parties and counsel. Drafting the statements

forces the participants to spell out the particulars of their case, assess the strengths and weaknesses, and evaluate the true value of the case. The exchange of non-confidential statements provides the parties an opportunity to communicate before the first mediation session. A good-faith statement of the nature of the dispute, the damages sought, and any legal issues existing between the parties is an effective way to begin to persuade the opposition to resolve the dispute. Finally, confidential statements to the mediator are crucial. The participants provide the mediator with additional information to reach a negotiated resolution. They also help the mediator to assess the potential for resolution and to determine what mediation tools might be most effective.

Mental Preparation

The parties and counsel must be mentally prepared to negotiate. They must come to the mediation with a plan to "get" what they need in order to resolve the matter. However, equally important is their mental preparation to understand their opponent's viewpoint and to expect to "give" in order to reach a resolution. The "get and give" process takes time. Counsel must prepare their clients to allow the process to evolve to the point where meaningful negotiations can take place. Business clients, used to making prompt and efficient business decisions, must be prepared to invest time in the mediation process. The exchange of information requires time to develop into a resolution and must be viewed with an eye toward the end. Lastly, all proposals, offers, and demands should be accompanied by rational explanations. This promotes reasoned and good-faith discussions about the problem and its resolution, as opposed to mere posturing and speculation.

Conclusion

Looking back on that initial mediation, it seems that it was, in many ways, a watershed event. Though the dispute was technical and complex in nature, involved several parties and very high stakes, and though little formal discovery was conducted beforehand, the mediation achieved the highest level of success. Certainly, many factors came into play, only some of which have been discussed in this article. In any event, however, this mediation aptly demonstrated the vast potential for this form of dispute resolution. While mediation is not the "cure all" for every dispute, and while there will always be stubborn and unreasonable parties, litigators who cannot, or will not, change their tactics, and mediators who lack patience and persistence, or who inappropriately take sides, mediation is a dispute resolution tool with great potential. For this reason, a growing number of parties and counsel have embraced mediation with optimism and with the understanding that it can be an effective tool for resolving disputes. ■

Investment of Captive Insurance Company Funds

by Andrew J. Barile, CPCU

Andrew J. Barile, CPCU, is an internationally recognized expert on captive insurance companies, with more than 30 years of experience. He currently is retained by law firms with respect to captive disputes, sits as an independent director on the Board of Captives, Domestic and Offshore, finds fronts for captives, negotiates reinsurance for captives, and provides the feasibility study for new captive owners. His book, *The Captive Insurance Company, An Emerging Profit Center* was written 25 years ago, and is still relevant today.

There are a number of constraints that come into play when creating the investment philosophy of a captive insurance company. **Among these are:** who owns the captive, and what is his or her philosophy toward investment risk. This philosophy is seen when faced with severe insurance risk, such as the potential for claims as in healthcare captive insurance companies, and various forms of professional liability insurance captives.

Most of the Fortune 500 captive insurance companies integrate their investment plans for the captive, with the investment department of the parent corporation. That is why the chief financial officer and the treasurer are on the board of the captive insurance companies. Some of the captives use their investment funds to purchase domestic U.S. insurance companies, to eliminate the ultimate cost of using "fronting" carriers. This procedure has become a creative use for investment funds.

Managing the cash flow in a captive insurance company to determine the available cash to invest also requires paying attention to restrictions from the "fronts" and the regulatory authority in the various domiciles both onshore and offshore. On the basis of substantial insurance risk being absorbed by the captive, the regulatory constraints on investments of the incorporation domicile, and the "front" insurance company requirements, captives have had a conservative approach. Management decisions such as no loss of capital, fixed income securities, etc. are commonly used.

This is, however, not true for agent-owned captive insurance companies that have been able to take a more creative approach to investing available cash in non-traditional investment instruments. Some of these captives invest in hedge funds, where the anticipated return is greater. The owners are looking for higher yields on their investments, and the available float of premiums can produce ultimately higher investment income for the captive insurance company. Many of the owners of hedge funds are looking at the captive insurance company as a source of capital. Many offshore hedge funds have also set up captive insurance companies to write their directors and officers liability insurance.

The dividend payable by the captive to its parent has always been marked with internal corporation policies. Some of the early captives actually funded corporation's overseas expansions. However, reinsurers of captive insurance companies are always concerned when the captive insurance company has an aggressive investment philosophy. Reinsurers want to see the captive retain its investment funds, and not pay the funds out to the parent company.

Captive insurance company managers have attempted to provide investment advice to captive owners, and play a role of trying to get their managed captives higher yields to offset their captive management fees. Many have learned that to manage cash flow in a captive insurance company writing professional liability (long tail), medical malpractice, or earthquake insurance is no easy task.

Finally, captive insurance companies need a planned investment strategy and guidelines. Authoritative sources want to look at a complete overview of your captive's investment portfolio. Details include a breakout by sector, rating, maturity, yield information, and above all, asset liability matching. Industry breakdowns of your corporate bond and convertible bond portfolios are reviewed. Captive owners need to monitor their investments, and delineate any single large investment guidelines. You need to focus on investment risk when investing captive insurance company funds. Captive owners need to be prepared to discuss their strategy of investing in fixed income or equity securities or mutual fund holdings. Rating organizations are asking many questions about a captive insurance company's investments. They, obviously, are looking for a conservative investment philosophy if the captive wants a good financial rating.

Captive insurance company owners have both inside and outside investment management. They should continually explore the use of outsourced investment management by evaluating the role of outside investment management, their expertise, and investment performance. Captive insurance companies have two sources of income—underwriting profits and investment income. By looking to increase both of these areas, assurance of an adequate rate of return on their captive investment is obtained. ■

Moral Leadership: Using Your Inner Moral Compass

by Demmie Hicks, Maureen H. Hunter, Ph.D., and Hamid Mirsalimi, Ph.D.

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Wounded egos and bank accounts recover, but trust takes a very long time to heal—if it heals at all. "Corporate scandal" has become a household phrase, partly because it is a juicy topic for the news media, partly because it has involved such corporate giants as Enron and WorldCom, partly because of the tragedy of many who lost their life savings, and partly because it has worried the average investor who does not know who and what to believe anymore. But in all likelihood, there is another, deeper, reason why "corporate scandals" have created such an uneasy buzz: It has shaken our belief in the people and systems we have trusted for so long.

Psychologists often argue that what is truly damaging about abuse is not necessarily the actual abuse, but the resulting emotional hurt. The hurt stemming from the realization that a trusted person ended up taking advantage of that trust. Likewise, the damage many people have suffered as a result of corporate scandals is likely to have shaken the fundamental belief that CEOs and company presidents would exercise good judgment and integrity regarding employees and stockholders' well being, rather than their own personal financial gain.

So, when Kenneth Lay of Enron is indicted for fraud charges, it does more harm to our psyche than the mere realization that a corporate CEO might have engaged in some wrongdoings; it is likely to make us upset, even enraged, that the person and the system we trusted should not have been trusted. Unfortunately, Enron and Kenneth Lay were not the only people accused of corporate fraud. Recently we learned that Bernie Ebbers of WorldCom received a prison sentence for his role in the company's corporate scandals. And there are others.

In our own backyard, we have the unfortunate situation at Marsh. We recently learned that Robert Stearns, a senior vice president who had been a Marsh employee for 20 years, entered a plea to first-degree scheme to defraud by instructing insurance companies to submit noncompetitive bids to gain business contracts.

Anatomy of a Moral Judgment

In the midst of all this, we cannot help but ask ourselves: What went wrong? How could people as smart as Kenneth Lay, Jeffrey Skilling, Andrew Faston, Bernie Ebbers, and even Martha Stewart, make the judgment mistakes that they made? Was it all greed? Was it the desire for fame and power? Whatever it was, how could it happen, and how can we prevent it from happening in the future?

To answer these questions, one has to look to a minimum of two places: The way individuals make moral judgments, and systemic issues that may lead to poor decision making in an organization. We'll focus on individuals' approach to decision making in this article, while our next article will discuss organizational issues.

Some years ago, psychologist Lawrence Kohlberg became interested in whether we go through stages of moral reasoning throughout our development. He read stories to children, adolescents, and adults in which the central character had to make a choice about an issue that was morally complex. For example, if one's wife is terminally ill and there is a pharmacy with the medicine that will cure her, but the pharmacist is asking for a lot of money, so much that the husband cannot afford it, and the pharmacist is not accepting a payment plan, would it be morally wrong for the husband to steal the medicine to save his dying wife?

Kohlberg was not interested in which choice the participants in his study made; instead, he was interested in the type of reasoning they engaged in to reach their decision.

Based on the results of his research, he concluded that there are three levels of moral reasoning:

1. The first level of moral reasoning, often seen in the way children make moral decisions, involves either fear of punishment or the desire for reward. Children often argue that the husband in the story should not steal because if he does, he will go to jail. Or that the husband should steal because he would not want to lose his wife, and his wife will be pleased with him for doing so.
2. The second level of moral reasoning, often seen in adolescents, involves a desire not to be outcast by their peers. Adolescents may say that he should steal because if he doesn't, everybody will think that he was a coward who did not save his wife; or alternatively, he should not steal because if he does, everybody will shun him and look at him as a thief.
3. Kohlberg argued that some people, not everybody, will reach a third level of moral reasoning. These adults make decisions either because they recognize that in civilized societies there are social contracts that everybody has agreed to abide by, or they have reached a stage of morality where their morality is based on self-chosen ethical principles that usually value justice, dignity, and equality. Such people may argue that the man in the story should not steal

because stealing is against societal rules; or they may argue that the man should steal the medicine because the pharmacist was being unreasonable, and preservation of an innocent life overrides the problem of stealing. Once people have reached the third stage of moral reasoning, they may fall back to the first or second stage reasoning depending on the issue at hand.

So, what does Kohlberg have to do with Enrons and WorldComs? On an individual level, it appears that leaders in these corporations engaged in level-one or level-two moral reasoning. Their guiding moral principle seems to have been the avoidance of getting caught, the rewards of getting rich, the avoidance of being shunned by others in their organizations or by the stockholders, and being admired by those who looked up to them. When leaders do not think in terms of level-three moral reasoning, they risk falling into the trap of unethical conduct. Leaders need to recognize, and be taught, that considering the welfare of their constituents and depending on self-chosen, and societal, ethical principles of justice and dignity, should be the way to make ethical and moral decisions.

As you look at your own leadership practice, consider the ethical decisions you have had to make in the past—and also those you may have to make in the future. Where might you be at risk for slipping into level one or two? And how can you use your influential leadership skills to set a level-three standard for the rest of your organization? It is very enlightening and useful to use our self-awareness to better read our internal moral compass, as well as to improve the impact we have on others.

There are also tremendously powerful organizational factors that impact the entire system, and prevent accurate scrutiny of individual actions and behaviors. In our next article, we will examine the role organizational dynamics play in causing leaders to make poor judgments. ■

A Special Remembrance

The Richard A. Gerrond Memorial Award

All sections and the CPCU Society have one thing in common—the members make the organization. Some members are just a little more active than others and their contributions become invaluable. The Agent & Broker Section recently lost one of its important members who was killed in a skydiving accident. His name is **Richard A. Gerrond, CPCU, CIC**, a member of the Agent & Broker Section, membership on the Boards of Governors, Committee/ Task Force, and an instructor at the CPCU Society's National Leadership Institute (NLI). He was a member of the Central Oklahoma Chapter and had recently moved to Dallas, Texas. He was always contributing to show that placing the letters CPCU after your name is only the first step in opening new horizons. To honor his numerous contributions, an award is being established to be given annually to an individual connected to the NLI, who embodies the commitment, dedication, desire, enthusiasm, skill, and character displayed by Gerrond. The Executive Committee of the CPCU-Loman Education Foundation has agreed to support The Richard A. Gerrond Memorial Award in his memory. However, to make this a perpetual award, funding is needed. If you knew Gerrond or would simply like to honor one of our own, please forward donations to the CPCU-Loman Education Foundation, c/o Pamela Barnes, 720 Providence Road, Malvern, PA 19355. Thank you for honoring someone who gave so much to all of us. ■

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