

**Initial Statement of Reasons**  
**Title 8, Chapter 8, Subchapter 2**  
**Articles 1 - 3.1**

Article 1, Section 15201

The amendments to these regulations were adopted on an emergency basis to take effect on May 30, 2003.

Specific Purpose

The proposed amendments to these regulations will add two new definitions to make clear any references made in the amendments to Article 3 and the new Article 3.1.

Article 3

The amendments to these regulations were adopted on an emergency basis to take effect on May 30, 2003

Specific Purpose

The proposed amendments to these regulations will make them consistent with the new Labor Code statutes that permit an alternative composite deposit posted by the Self Insurers' Security Fund rather than individually by each self insured employer to secure workers' compensation liabilities. In addition, due to the potential exposure of all self insurers to greater amounts of unsecured liability, new sections will establish provisions for revocation of certificates to self insure for failure to post security deposit for a specified period of time.

Necessity

Previously there was one system of posting deposit to secure workers' compensation liabilities by self-insurers. These were addressed in Article 3, Security Deposit Requirements. With the new alternative deposit statute, Labor Code Section 3701.8, the existing regulations must be amended to reflect the alternative system's existence and specific regulations must be adopted to implement the alternative system. These new regulations are in the new proposed Article 3.1.

Section 15210(b) is amended to add a reference to the requirement of Labor Code Section 3701.8 and the new Article 3.1. This amendment is consistent with the Labor Code amendments. The amendment reflects the options to the existing self-insurer and new self-insurers to post security deposit.

Section 15210(c) is amended to clarify that minimum security deposit amounts are as required by Labor Code Section 3701.

Section 15210(d) is amended to clarify that security deposits posted by new self insurers are pursuant to Labor Code Section 3701.

Section 15210(e) is amended to clarify that security deposits posted for new subsidiaries or affiliates of self insurers are pursuant to Labor Code Section 3701.

A new Section 15210(h) is added to specify that failure of a private self insured employer to post a security deposit for 60 days shall be good cause for summary revocation of a Certificate of Consent to Self Insure and to provide an appeal process for such summary revocation. This section is needed to enforce Labor Code Section 3701.8(i), which states, "At all times, a self-insured employer shall have secured its incurred workers' compensation liabilities either in the manner required by Section 3701 or through the alternative security system, and there shall not be any lapse in the security."

While existing subsection (g) of Section 15210 specifies that failure to post or maintain deposit will subject the employer to a possible civil penalty pursuant to Labor Code Section 3702.9(a) and/or revocation of the Certificate of Consent to Self Insure, the penalties are not substantial enough. The civil penalty maximum is \$5000 for each 30 days or portion thereof that the deposit is not posted or maintained. This civil penalty is a cheap alternative to posting for an employer that must post a very large deposit. Over 22 self-insurers, for example, have security deposits over \$50 million. The \$5,000 per 30 day period civil penalty is not large enough to spur compliance. The alternative of revocation of the self insurance Certificate is more effective, but under the hearing procedure in Article 11 can be drawn out for several months. In the meantime, not only are the liabilities not secured fully, but additional liabilities are being added daily. Ultimately, the other self-insurers are responsible to pay

all liabilities if the self insurer is unable to pay the workers' compensation liabilities for any reason. It is therefore in the best interests of all private self-insurers that employers that are unable or unwilling to post and maintain the required security deposit be removed from the program quickly. Given that the employer may post minimum or no deposit under the alternative deposit system proposed, it becomes ever more important to ensure that required deposit assessments be paid, since the amount of unsecured liabilities can be significantly greater for each individual self insurer than in the past when each employer posted deposit individually.

Therefore, a summary revocation process without hearing must be added to subsection 15210(g) for failure to post deposit for more than 60 days, with a 15 day notice of the cutoff date. Even with this provision, the unsecured period could be as much as 75 days. The employer could still appeal to Manager's summary revocation action but will have to show as a condition precedent to a request for hearing that the company is fully insured for workers' compensation liabilities, thus preventing a lapse in the security insofar as is possible.

The Manager under this section would be required to give a 15-day advance Notice of the Termination to the self-insurer so that the employer could obtain workers' compensation insurance coverage under a policy. This requirement is necessary because the new Alternative Deposit system is designed to replace the employer's deposit, and the amount of deposit could be in the hundreds of millions of dollars. The largest security deposit currently posted is over \$400 million by one employer. A \$5000 civil penalty per month is a small price to pay for cost of not posting a \$400 million deposit that would essentially be secured by all other self insurers through the Security Fund. Something more than a minor civil penalty is needed to ensure compliance. Summary revocation of self insurance coupled with proof of insurance coverage if the self insurer wants to appeal the Manager's action after 75 days of non-compliance (60 days failure to post and 15 days advance notice of Termination Date) would enforce Labor Code Section 3701.8(i) and move most self insurers to action. In addition, this provision would shorten the self insurance period if the self insurer does not take action much quicker than current provisions allow.

## **Section 15210.1 Adjustments to Security Deposit**

Section 15210.1 discusses adjustments in the amount of security deposit.

Section 15210.1(a) was amended to clarify that the subsection addresses the system adopted pursuant to Labor Code Section 3701. This clarification was necessary because of the advent of two security deposit systems operating simultaneously following the implementation of Labor Code 3701.8. The subsection specifies that it applies to "any" security deposit required under Labor Code Section 3701.

Subsection (b) was amended to clarify that any annual security deposit required by Labor Code Section 3701 was the subject of this subsection rather than any deposit due pursuant to the alternative deposit under Labor Code Section 3701.8. The subsection was also revised to cover any other reason that the Manager might require a deposit increase. There are a number of other reasons the Manager might require a deposit increase under these regulations, such as, after an audit that determines liabilities were understated on the Self Insurers' Annual Report, because of additions to the employer's self insurance program, or because of a change in the rate of deposit to be posted above the minimum 135% level of Labor Code 3701. Subsection (b) was further amended to specify that the deposit calculation be consistent with section 15210(c)(2) by allowing credit for specific excess insurance coverage above the self-insured retention of the special excess policy. This credit is consistent Self Insurance Plan's practices, but section 15210.1(b) did not include this step, so it was added for clarity and consistency.

Subsection (d) was amended to include a reference to new Labor Code Section 3701.8 to clarify that the Manager may require a self insurer to post and maintain additional deposit or a higher rate of deposit than the minimum set forth in Labor Code Sections 3701, 3701.7 and now, Section 3701.8. Subsection (d) is further amended to include a list of reasons (although it is not an all-encompassing list of reasons) that a self insurer may be required to post a higher deposit when it is required to post deposit in whole or part as a result of the Labor Code Section 3701.8 alternative deposit system. Non-fully participating employers and excluded employers must post some or all the deposit needed under Labor Code Section 3701. A fully

participating employer would have no individual deposit posted, but if it was downgraded subsequently to non-fully participating status by the Manager, or brought in new additions to the self insurance program, the employer would have to post separate deposit under Labor Code Section 3701. Therefore these amendments were added for clarity and consistency.

Subsection (f) is added to indicate that any increases in a self insurer's security deposit requirement made because of understated liabilities as determined through an audit (as addressed in subsection (d)) shall be reported to the Security Fund so that adjustments to the self insurer's security deposit through the alternative composite deposit may be made.

#### **Section 15210.2. Deposit Adjustments Upon Revocation of Certificate of Consent to Self-Insure**

Subsection (a) and (b) are editorially revised to reference any deposit adjustment pursuant to either of the concurrent deposit systems. The regulation currently addresses only security deposits posted pursuant to Labor Code Section 3701, so a reference to Labor Code Section 3701.8 was added in both subsections for clarity and consistency.

#### **Section 15216 Administration of Insolvent Self Insurers' Claim's**

Section 15216 and subsection (c) are amended to editorially change the title of the section from "Insolvent" to "Defaulted" and in subsection (c) to delete the use of the terms "insolvent" and "bankrupt" leaving only the term "defaulting" self insurer. While the regulations permit calling of security deposits due to insolvency (lack of funds) or bankruptcy (reorganization or liquidation) it is defaulting (stoppage of payment of benefits) that triggers action by the State. While insolvency or filing of bankruptcy may result in a simultaneous or subsequent default on payment of benefits, it is the default itself not the insolvency or bankruptcy that causes the Manager to take action on the deposit.

Subsection (d). Editorial correction to cross reference Labor Code Section 3740-3747 is changed to Labor Code Section 3701.5. It is Section 3701.5 by which the Director

of Industrial Relations turns over responsibility to the Security Fund to pay benefits. The statutes that created the Fund are the sections currently referenced, Labor Code Sections 3740-3747.

A new subsection (e) is added to address the call order of security deposit. Currently there is no call order under Labor Code Section 3701 or in self insurance regulations. Call order has to do with which security deposit is called first if there is more than one. It is the practice of Self Insurance Plans to call all deposits, convert them to cash, and turn the entire cash amount over to the Security Fund. Thus, a letter of credit posted for half of the deposit required along with a surety bond for the other half are both called, converted to cash, and provided to the Security Fund. A call order would require one or the other in the example of the letter of credit or surety bond to be called first and exhausted prior to the other being called for payment.

The Department is proposing a call order for the first time, with all deposits of any type posted pursuant to Labor Code Section 3701 to be "first in line". Second in line is any cash portion of the alternative composite deposits posted by the Security Fund under Chapter 3.1 of these regulations and Labor Code Section 3701.8. The third in line would be the remainder of the alternative deposit posted by the Security Fund. This would constitute the proposed call order. In most cases, the deposit posted for any one of these deposits will be inadequate to pay all benefits once the alternative deposit program is implemented. Therefore, the language of subsection (e) also clarifies that the Director at his/her discretion may call any portion of the entire security deposit posted at his/her discretion without waiting for the exhaustion of all funds in the prior level of the call order set forth in this subsection. This later discretion is needed to prevent arguments by deposit providers at a higher call level that all the funds must be exhausted and paid out before the next level deposit may be called. The new subsection (e) sets forth a call order for clarity and permits the director to call any or all deposit as the Director determines is needed to pay benefits.

An editorial revision of subsection number is made to subsection (e) and subsection (f) of the existing Section 15216 to subsections (f) and (g) due to the addition of a new subsection (e) on call order to the text.

## Article 3.1

### Specific Purpose

The proposed new regulations in Article 3.1 will permit the Director of Industrial Relations to accept an alternative security deposit system pursuant to Labor Code Section 3701.8 whereby private self insured employers workers' compensation liabilities could collectively be secured through the Self Insurers' Security Fund. The new sections will establish the qualifications and procedures for the new alternative security deposit system.

### Necessity

Labor Code Section 3700 currently requires every employer in California, except the State itself, to carry workers' compensation by either being (1) insured against liability to pay compensation by an insurer(s) duly authorized to write compensation insurance in this state (Section 3700(a) Labor Code) or (2) securing a Certificate of Consent to Self Insure from the Director the Department of Industrial Relations (Section 3700(b) Labor Code).

Labor Code Section 3701 requires every private self insuring employer to post a security deposit to secure incurred worker's compensation liabilities and requires the security deposit to be cash, securities, surety bonds or irrevocable letters of credit, or any combination the director deems adequate security and in a form approved by the Director.

Existing Article 3 of self insurance regulations address requirements for security deposit s required under Labor Code Section 3701.

New Labor Code Section 3701.8 permits the Security Fund to post an alternative security deposit for private self insurers to replace some or all of the deposit posted by qualified self insurers to secure their aggregate incurred workers' compensation liabilities through the Self Insurers Security Fund. To the extent the Security Fund's alternative deposit would replace some or all of the security deposit required by Labor Code Section 3701, the two deposit systems run concurrently. In any year that the alternative security deposit system is proposed by the Security Fund and approved by the Director, the self insurers designated as eligible to participate by the Manager shall secure their liabilities through the

alternative security deposit system. Participation is mandatory for these employers. To the extent the alternative deposit excludes certain self insurers, the Labor Code Section 3701 requirements for individually posted security deposits remain in place. The new regulation in Article 3.1, therefore, addresses the alternative deposit to be posted by the Security Fund.

Labor Code Section 3702.10 authorizes the Director of Industrial Relations to adopt, amend and repeal regulations necessary to carry out the purposes of the Labor Code Section 3701 and 3701.8.

The amendment of these self insurance regulations and adoption of Article 3.1 are necessary to implement and make specific the provisions of Labor Code Sections 3701, 3701.8 and 3702.10. These regulations were adopted on an emergency basis to take effect on May 30, 2003

### Article 3.1

Labor Code Section 3701.8 was added by legislation, (Chapter 866, Statutes 2002), that would permit the Director to accept an alternative security deposit system whereby all private self insured employers designated for full participation could collectively secure aggregate self insured workers' compensation liabilities through the Self Insurers' Security Fund. This alternative composite deposit by the Security Fund would be in lieu of each participating private self-insured employer, to the extent of its participation, individually posting its own security deposit for its worker's compensation self insurance liabilities. A new Article 3.1 addresses the alternative deposit system.

### **Section 15220 Participation in Alternative Composite Deposits**

Labor Code Section 3701.8 permits any or all qualified self insured workers' compensation liabilities or current or former self insurers to be secured by the alternative composite deposits. The proposed section 15220 will specifically address factors that will determine eligibility for full or partial participation in the alternative composite deposit program and indicate factors that will result in exclusion from the program. Private self insurers



are divided into three categories: fully participating, non-fully participating and excluded. Each category has different eligibility for coverage under the alternative composite deposit program.

A new Section 15220(a) requires the Manager to annually determine whether each private self insurer, active or revoked, may participate in the alternative security program. The section allows participation to be either partial or full participation.

A new subsection (b) describes the criteria that will lead to the exclusion of a self insured employer from participating in the program. These are the categories of self insurers that are more at risk of defaulting on their workers' compensation liabilities than participating self insurers or are excluded for other practical reasons:

(1) Any new private self insured employer during their first 3 full years of self insurance as defined in the section.

Security deposits during the first 3 years of self insurance in Section 15210 are based on prior 3 years of incurred liability of that employer in California. The deposit amount is adjusted after 3 full years of self insurance, so that the deposit for an existing self insured employer after three years is based on estimated future liability of claims as reported on the self insurer's annual report. Estimated future liability cannot be used to determine the security deposit for new self insurers, since the new self insurer has no prior self insured claims and no Annual Report to base or calculate deposit upon. The new self insured employer may have few or many claims with varying amounts of estimated future liability, but the only information the Department knows for sure is the incurred prior losses before self insurance. At the end of years one and two, new claims would be immature ("green"), and have little basis to correctly estimate a proper security deposit. By the end of year three, the assumption is that the equivalent of one year adequately developed claims liability has been reported. The application process is financially sensitive to new employers with acceptable but poor financials and/or employers with parents that do not want to assume and guarantee their subsidiaries' workers' compensation liabilities. The deposit rate can be adjusted under Section 15210. The Department proposes to retain this initial deposit system for new self insurers. Notwithstanding the

above, an exception is proposed to this regulation to blend in past practices with the much more credit sensitive alternative deposit statute.

(2) Any former private self insured that has a revoked self insured certificate that no longer files an Annual Report because all claims are closed.

This exclusion is necessary because former self insurers are numerous and date back to 1917. As a result, many former self insurers have no remaining workers' compensation liabilities or those liabilities are currently fully secured under deposit posted that may be more or less than the current minimum deposits required. These employers no longer submit annual reports. Most have not had any claim liabilities for decades. Some employers have gone out of business or been liquidated over the years. Therefore, these past self insurers are proposed to be excluded from alternative composite deposit coverage.

(3) Any former private self insured that has a revoked self insured certificate and is required to post only a minimum deposit pursuant to Labor Code Section 3701.

Like Exception 2, this exclusion is necessary because former private self insurers go back to 1917, and all of them left self insurance with continuing security deposits amounting to at least the amount of security deposit required at that time. This category of self insurers, however have some remaining claim liabilities and are still filing Self Insurers' Annual Reports for a handful of claims - generally to report future medical benefits potentially due. Some others do not file Annual Reports but have the potential remaining claim liability, such as for asbestos claims (which are not excluded from coverage by a statute of limitations). Some of these former self insurers still exist, while others have gone out of business or have been liquidated over the years. There is a need to exclude this category of former self insurers from participation because it would be virtually impossible to collect deposit assessments from them and so that the individually posted security deposits will remain in effect.

(4) Any current or former private self insured employer who has sold all or any portion of its workers' compensation liabilities under a special excess workers' compensation insurance policy to an admitted carrier and that is required

to continue to post its security deposit to secure sold off liabilities.

Labor Code Section 3702.8 permits any self insurer to sell off any or all of its workers' compensation liabilities to an admitted carrier using a special excess workers' compensation policy, essentially transferring the legal responsibility to pay the formerly self insured liabilities from the self insured employer to the admitted carrier. However, Labor Code Section 3702.8(d)(1) also requires the employer to continue to post its security deposit for 36 months in order to secure payment of compensation by the special excess carrier - in effect, to protect the California Insurance Guarantee Association (CIGA) from carrier insolvency for the initial three year period. Acceptance by the Director of a special excess under Labor Code Section 3701.8 automatically relieves the Self Insurers' Security Fund of liability for the sold off claims. This ultimate liability therefore transfers to CIGA, the guarantor of insurance carriers. This unique requirement to individually post deposit specifically to ensure carrier performance under a special excess workers' compensation policy leads to the need to exclude this category of self insurers from participation in the alternative security deposit program - otherwise, these former self insurers would be "double deposited."

(5) Any private group self insurers.

Labor Code 3700 permits private group self insurance since 1995, but to date there are only four private groups that have applied and qualified. These groups are each less than one year in existence.

Unlike a large, financially strong employer that self insurs its own liabilities only, a private group self insurer is a group of small employers that collectively handle workers' compensation together, with joint and several liability for all losses. The first group to self insure, an auto dealer group, started with less than ten members initially and over the course of one year it now has about 50 members. The group will likely continue to grow to eventually have perhaps 300-400 members (of the some 2,000 potential members in the state). Group underwriting standards and self insurance regulations on homogeneity by Standard Industrial Classification Code will limit the size of most groups. Having little past experience to rely upon with private group self insurers, the Department is taking a cautious

approach. The nature of a group self insurer is such that the exposure and predictability of losses are much more unpredictable than with individual self insured employers. Until such time as there is an adequate measure of the liabilities of group self insurers, group self insurers should be excluded from participation in the alternative security deposit program.

(6) Any private self insured that transfers any or all of its workers' compensation liabilities to a fully insured employer as a result of a merger, reorganization, sale or spin-off of a division or subsidiary.

Generally self insurers are large businesses, and they frequently buy, sell, reorganize, spin-off, merge, reincorporate and un-incorporate parts of their business. Historically, an employer retains workers' compensation liabilities related to its shedded businesses, giving the new operation no prior workers' compensation liabilities. While this pattern is less prevalent today, it is not uncommon for an employer to transfer all prior workers' compensation liabilities along with assets of the business to the new owner, or to sell off the workers' compensation liabilities to a carrier. The new "owner" of the workers' compensation liabilities may be a self insurer or may immediately apply to become one. In other instances, the new owner may agree to take the workers' compensation liabilities but may not be self insured or plan on becoming self insured.

Without this exclusion, the alternative composite deposit system could be covering the liabilities that are transferred without the self insurer posting any security deposit (i.e., if the self insurer falls into the fully participating category). Since the new owner is not self insured, a separate deposit for the liabilities must be posted under Labor Code 3701 to secure the transferred liabilities by the new owner. Self insured employers that transfer self insured liabilities to a non-self insurer must be excluded from the alternative composite deposit because the new owners are not qualified self insurers with Certificates of Consent to Self Insure.

(7) Any current or former private self insured that has defaulted in payment of their workers' compensation liabilities and liabilities have been turned over to the Self Insurers' Security Fund, pursuant to Labor Code Section 3701.5.

When a self insured employer defaults - stops paying workers' compensation benefits on all claims - regardless of the reason, the liabilities and the existing security deposit posted under Labor Code 3701 or 3701.8 will be turned over to the Self Insurers' Security Fund by the Director pursuant to Labor Code Section 3701.5. If there is a failure to post or if there is a shortfall in the security deposit posted - as compared to the claim liabilities to be paid out - this liability would be unsecured and the Security Fund would need to assess the private self insured community to collect the remaining funds needed.

This exception is needed to make it clear that even if there was an alternative composite deposit in place when the next default would occur, any unfunded liability of a defaulting self insurer is not somehow automatically secured by the alternative composite deposit. Otherwise, the Security Fund would have no ability to recover deposit shortfalls from the estate of the self insurer or the defaulting self insurer as the Fund currently has under Labor Code Section 3701.5(e). Deposit shortfalls would result from increased deposit requirements related to understated liabilities found during an audit, new additions to self insurance, changes in credit worthiness that would require a deposit to be posted under Labor Code Section 3701, etc. In any of these situations, if the self insurers failed to post the deposit required and then defaulted on payment of its claims, the Security Fund would remain responsible to pay the shortfall but could still seek recovery for the security deposit required but not posted. For clarity and for consistency between the statutes and regulations, this exclusion is needed.

(8) Any current or former private self insured employer that has failed to post the full amount of any security deposit required by the Manager pursuant to Labor Code Section 3701 for more than 60 consecutive days.

Under the current Labor Code Section 3701, other security deposit statutes, and existing self insurance regulations, self insurers are generally required to post an adjustment to their security deposit each year in May. For many the adjustment means an increase in the deposit. Similarly, every 3 years SIP audits self insurers for estimates of future liability reported on the Annual Reports. Revocation audits are conducted when an employer leaves self insurance. Many of the audits result in self insurers being required to

post additional deposits. The addition of new subsidiaries and/or affiliates for inclusion in self insurance requires increases in deposits as well. Changes in financial standing and lack of parental guarantees, among other reasons, can result in an increase in security deposit rate from the minimum 135% to up to 200%. Regardless of the reason for the deposit increase, there are self insured employers that fail to post the security deposit. In each instance the employer is notified in writing of the need to increase the deposit and given a period of time to post the deposit increase. A reminder letter is sent out usually with a 14 day grace period to file without civil penalty. After the grace period expires, the civil penalty is invoked back to the original due date with the maximum rate permitted by Labor Code Section 3701.9(a) of \$5,000 for each 30 days or portion thereof that the employer fails to post deposit.

In the new alternative composite deposit, up to 50% of the aggregate security deposit for qualifying self insurers would be covered by the Security Fund. There will always be a few employers that refuse or otherwise fail to post the balance of security deposit required. If the employer's credit rating qualifies to be fully participating, all deposit is covered by the alternative deposit for that employer at a point in time--for example July 1, 2003. It does not cover subsequent increases in the deposit to be posted under Labor Code 3701. This factor raises a policy issue: should a non-conforming self insurer who fails to post deposit and is otherwise eligible for full or partial coverage under alternative deposits be allowed to participate in the alternative deposit program? And how long can a self insurer delay posting before the employer becomes ineligible? This exclusion addresses the problem by excluding any self insured employer that fails to post deposit for more than 60 days. Self insurance is a voluntary program and posting the required deposit is a requirement that must be met. Since cash is always an option to post as deposit, 60 consecutive days without posting a required deposit after notice from the Manager to post seems reasonable to exclude the employer from the benefit of any alternative composite deposit posted by the Security Fund.

(9) Any former (revoked) self insurer whose liabilities are secured by a surety bond that has no provisions for release of the surety.

Until 1989, surety bonds had no provisions that would allow for their release or reduction after a self insured employer ceased to be self insured. Former self insured employers whose Certificates to Self Insure were revoked and whose liabilities continued to be secured by these "old form" surety bonds are not charged for these surety bonds after the certificates are revoked. The full amount of the surety remains in place while the liabilities decrease over time. It would be inequitable to require these revoked self insurers to pay deposit assessments when their current deposits are substantially over secured with bonds that cannot be released.

(10) Any private self insured employer that does not meet the minimum credit rating criteria as indicated in subsection (d) (3).

The alternative composite deposit regulations are much more credit sensitive than current regulations. Credit sensitivity is necessary because the composite deposit cost structure is based upon the credit worthiness of the entire group of private self insurers. Subsections (d) and (e) of this section sets forth credit worthiness requirements to be fully participating or non-fully. Since this subsection (b) lists specific exclusions, a reference to the credit worthiness requirements in subsection (d) and (e) are needed.

(11) Any current or former private legally self insured employer that is a member of a public sector healthcare joint powers authority.

One public sector joint powers authority (JPA) has extended membership to three private sector employers without obtaining Certificates of Consent to Self Insure pursuant to Labor Code Section 3700. The JPA claims that there is authority under Government Code Section 6527 for its actions. The matter was in dispute before the Director of Industrial Relations. In the initial decision of the Director, it was determined that statutory clarification was needed to allow the private sector employers to participate as self insurers in the jpa. Legislation (Chapter 750 § 2002) was subsequently passed on behalf of the JPA that specified only that public sector healthcare JPAs could now accept private healthcare members and that the Security Fund was not responsible for their workers' compensation liabilities. The Director has now determined that these private, non-profit members of public health care JPAs are not required to post security deposits. Since they are not

required to post security deposits, they will be excluded from participation.

(12) Any self insured employer that has been specifically excluded from participation by written request of the Security Fund.

A new subsection (c) requires all private self insurers determined by the Manager to be eligible to participate as either fully or partially participating, as determined by the Manager.

A new subsection (d) will establish the requirements for fully participating employers. In order to be eligible for fully participating status in any alternative composite deposit, each private self insured employer shall possess an acceptable credit rating on the date of the Board of Trustees alternative deposit written proposal to the Manager. An acceptable credit rating of any "A" or any "B" as determined in either Moody's Global Ratings Guide or Standard and Poor's Credit Market Service. This subsection is necessary to establish the requirements for full participation in the alternative composite deposit program. Full participation effectively means the employer will pay the deposit assessment and not be required on the basis of its credit rating to post individual security deposit. Their workers' compensation liabilities will be secured under the alternative composite deposit up to the amount of security deposit they are required to post.

Neither the Department nor the Security Fund are in the employer credit rating business. It is necessary, therefore, to utilize the credit rating services of specialists in this field. These specialists are Moody's Investor Service and Standard and Poor's Company. Each has a business rating service sold on a subscription basis that rates credit risks of businesses.

There are instances when credit rating companies do not necessarily agree on the same credit rating for an individual company at a given date. Therefore, in case of "split" ratings from the two rating agencies, the lowest rating will be used.

A new subsection (e) lists criteria that may lead to partial participation, including the addition of subsidiaries and/or affiliates after the written proposal for the alternative deposit program has been submitted and/or because of action by the manager for cause.

A new subsection (f) specifies that self insurers that are excluded must continue to post security deposits pursuant to Article 3 and must pay assessments as required by Article 4.



A new subsection (g) specifies that partially participating self insurers must post the portion of their security deposits not covered in the alternative program.

A new subsection (h) specifies various failures on the part of self insurers that may affect their eligibility for full or partial participation.

### **Section 15220.1 Financial Summary**

Each year every private self insurer provides its annual financial report to the Manager pursuant to Section 15203.2. Most annual financial reports are available within 4 months after the close of the company's business year. Some business years correspond to the calendar year but many do not. Thus financial reports are received by the Manager at various times during the year. Financial reviews conducted by Self Insurance Plans are focused on net worth and net income, as required by Section 15203.2.

Alternative composite deposits in this new Article 3.1 are credit-sensitive, much like the charges of banks and surety companies for providing letters of credit and surety bonds. In order for the Security Fund to have credit-worthiness information on most employers, it must obtain the information from business credit rating agencies such as Dunn & Bradstreet, Moody's, or Standard & Poor's. Publicly traded companies have public financial reports and published credit ratings that can be obtained from these agencies.

In the private self insured community, there are a number of large, privately held companies (closely held companies, such as by family members) that do not have published credit ratings. Some of these self insurers are of significant size and have self insurer's workers' compensation liabilities that require a security deposit in excess of \$2 million. Some of these entities are also very sensitive about access to their company's financial information.

In order for a financial rating to be performed by a credit rating agency, certain standard items contained in Balance Sheet and Income Statements are needed. There is a need, therefore, to obtain the necessary credit rating information in order for the Security Fund to adjust composite deposit amounts by credit sensitive factors under the alternative

deposit statutes. To address this problem, Section 15220.1 is proposed.

Section 15220.1 (a) permits the Manager to require any private self insurer that does not have a public financial statement or which has no published credit rating to prepare and provide the Manager with a summary of designated general and key financial information from the employer's current financial statement. To further limit the number of self insurers that might have to provide this financial information, subsection (a) further defines the employer to have a required security deposit equal to or greater than \$2 million or from any private self insured employer that does not need the financial standards in Section 15203.2 applicable to that employer.

It is estimated that there currently may be less than 30 private self insurers that would be required to provide the financial summary. Because each of these employers are large enough that that they would constitute a large portion of the pool, a credit rating agency issuing a credit determination (on commercial paper, for example, to be used by the Security Fund as an alternative deposit instrument) would require a credit rating determination for each of them.

The availability of the Financial Summary information would permit the Security Fund to determine an equivalent credit rating determination for the employer that does not have one.

A new subsection (b) lists the general information and key financial items that would be required and incorporates them by reference into a Financial Summary Form. General information items are the name of the master certificate holder and the date of the last annual financial statement. The name of the master certificate holder is necessary to identify the self insurer whose financial information has been summarized. While the parent company is often the master certificate holder, there are numerous master certificate holders that are subsidiaries of another company that does not have employees self insured in California. The date of the last annual financial report is necessary as the most current report may be from the previous year, depending upon each company's business year.

Key financial information includes the usual asset and liability figures contained in audited financial statement,

all of which are necessary to produce an equivalent credit rating.

A new subsection (c) provides that any self insurer that fails to submit a form A4-7 will not be eligible for full participation, and also allows the Manager to disallow partial participation if the self insurer fails to submit the Form A4-7. The section will also permit the Manager to assign a credit worthiness rating to help determine assessment amounts. This section is necessary in order to determine equitable assessment amounts that reflect the risk for self insurers whose financial stability cannot be measured. Depending upon the non-invested grade assigned, it could also mean the deposit assessment charge to this employer would be higher than it might have been if the credit rating determination was able to be made.

### **Section 15220.2 Listing of Security Deposit Amount Required**

Each private self insured employer annually prepares a Self Insurer's Annual Report that provides an estimate of future liability of each self insurer's workers' compensation claims. This report is provided to the Director of Industrial Relations through the Office of Self Insurance Plans. If the Security Fund is to post an alternative composite deposit, it will need information on each employer's liabilities and the deposit amount required. New Section 15220.2 will require the Manager of Self Insurance Plans to provide the deposit required for each individual self insurer to the Security Fund in order for the Fund to provide an alternative composite deposit if the Fund chooses to do so.

A new subsection (a) is added which requires the Manager to annually prepare a listing of the security deposit amounts required by Labor Code 3701 for each private self insured employer. The listing will contain the total amount of security deposit required based on the year end Self Insurer's Annual Report as well as any deposit adjustments made by the Manager due to audits, additions of new subsidiaries or affiliates, deposit rate adjustments, or any other adjustments necessary. The listing is confidential under Section 15405.

This section is necessary because calculations based only on estimated future liability as reported on the Self Insurer's Annual Report do not always reflect other adjustments in

security deposit. When new subsidiaries or affiliates are added, a deposit adjustment, for example, is required in most instances under Section 15210(d). The Annual Report does not reflect these adjustments. The same is true for understated liabilities found in audits. The figures provided on the List of Open Indemnity Cases is audited against the figure. When the liability is understated, the audit report will note the indemnity or medical liability that was found to be unrecognized. Calculation errors are also frequently made on the Annual Report - even when the liabilities are correctly stated. Each year the Manager processes the Annual Reports and prepares a demand letter that is issued to each employer indicating the deposit increase due or decrease in security deposit authorized. The information specified in this section, therefore, is available and needs to only be converted into a listing to be provided to the Security Fund.

A new subsection (b) addresses the problem of how to handle the self insured employer that is late filing its Annual Report. Each year there are approximately 50 employers that are late in filing the report by more than 30 days. If the listing to the Security Fund is to be complete, some deposit amount must be utilized for each employer. The Manager will not have a current figure from those employers that fail for whatever reason to file a complete and timely Annual Report. Subsection (b) will specify that any private self insurer that fails to file its Annual Report by April 1 - 30 days after its March 1 due date pursuant to Labor Code Section 3701.9 and 3701 - shall be deemed to have twice the liabilities indicated in the prior year's Annual Report for purposes of preparing the listing of required security deposits. Each such self insurer will be flagged in the listing that has an entry based on this section to permit easy correction when the late Annual Report is subsequently received.

A new subsection (c) requires the Manager to provide the listing to the Security Fund Board of Trustees, and also permits the Manager to provide the listing of required security deposits to the Security Fund in a series of partially completed lists as the Annual Reports are processed. The latter is necessary to provide information on the required amount of deposits as quickly as possible, rather than waiting until all reports are fully processed. For example, Self Insurance Plans could process the first 100 largest self insurers and provide this partial listing, followed by a second listing of the next 100 largest self

insurers, and so on, until the list is completed. At some point in the listing, the remaining self insurers that have not been processed will have a negligible impact on the total amount of deposit to be posted. Currently, approximately \$4.5 billion is posted individually. The 300 largest self insurers make up probably 90% of the total, while the remaining approximately 400 self insurers represent about 10% of the total deposit (the latter group is made up of self insurers with smaller deposits).

### **Section 15220.3 Alternative Composite Deposits**

Labor Code Section 3701.8 does not specify in detail the process by which the Security Fund may propose to cover all or part of the self insurers' security deposits, nor does it specify a process or a timeline for the Department to review and approve or reject the Security Fund's proposal. Section 15220.2 is proposed to establish the process.

A new subsection (a) restates the function of the alternative composite deposit program under the new Labor Code Section 3701.8 with reference to the forms of deposit allowed by Labor Code Section 3701 for clarity. The Security Fund may propose to the Manager to post aggregate security deposit as required, in whole or part, for all participating private self insurers utilizing any one or combination of security instruments listed in those two Labor Code sections.

A new subsection (b) describes in detail what security instruments may be used in securing their aggregate security deposit.

Subsection (c) requires the Security Fund to submit a written proposal to the Director each year the Fund proposes to replace individual security deposits with an aggregate composite deposit.

Subsection (d) sets forth the minimum contents of each Security Fund's formal proposal to the Manager, specifying the following:

- (1) A complete description of the proposed composite deposits includes what portions are cash and non-cash; any retention, deductibles, or co-payments contemplated by each layer if any; and any insurance or reinsurance being utilized.
- (2) A list of all proposed self insured employers to be covered, their percentage of coverage; their applicable

credit rating or equivalent credit rating; and the credit rating agency used to determine the credit rating.

- (3) Specification of a call order, if any, of the instruments proposed as alternative deposit.
- (4) A proposed effective date of the proposed alternative deposit that is at least 30 days after the date of the written proposal to the Manager.

It is necessary that the Security Fund describes exactly what it is posting, how the pieces fit together, who is proposed to be covered, a call order if any deposit must be utilized before the next one can be utilized, and an effective date. Labor Code Section 3701.8 provides few limitations on what may be utilized, so the proposed alternative could be relatively simple or complex. Since the Fund is making the proposal, it must provide the Manager enough information to evaluate the proposal.

A new subsection (e) is added to require the Manager to advise the Director of all written proposals from the Fund and the details of any proposal.

A new subsection (f) requires the Manager to approve or reject the proposal in whole or in part and advise the Security Fund within 30 days. Once accepted, the Security Fund has 30 days to post the alternative deposit with the Director or within some time period that was specified in the proposal. The subsection is needed to establish a procedure for the process of the alternative composite deposit.

A new subsection (g) addresses the release of any existing security deposit posted individually by self insurers pursuant to Labor Code Section 3701. The Manager must hold the existing individual deposits until the alternative deposit is posted before releasing any individual deposits. This requirement is necessary to prevent the release of a deposit before its replacement is received. Some self insurers will receive their entire security deposits back, some others will receive them back in part, and some (those excluded from participation) will not receive any.

A new subsection (h) addresses handling of additions, extensions, replacements, substitutions or other changes in an existing or proposed alternative deposit. It requires the change to be handled in the same manner as the original proposal as set forth in this section. This subsection is

necessary to address changes as a result of a rejection of all or part of the proposed alternative composite deposit by the Manager, or other changes or substitutions, as for example of a like bond, for example, because the originally proposed bond was no longer available. In addition, there may be changes to the proposal because of the cancellation of bonds proposed, the expiration of letters of credit, unexpected redemption of bonds posted, and so on. A means to change proposals or existing alternative deposits are likely to occur from time to time.

A new subsection (i) permits the Security Fund to offer its own financial guarantee in various forms, provided that the guarantee is backed by segregated cash or securities posted with the Director. It is anticipated that the Security Fund will over time build up a considerable amount of excess cash that would permit such a guarantee to be offered. Subsection (i) merely clarifies that such a guarantee may be offered and accepted.

**Section 15220.4**  
**Deposit Assessments by the Security Fund for**  
**Participants of the Alternative Composite Deposit**

Subsection (a) divides the deposit assessment into three component parts - each individually determined and itemized but initially collected with one notice of assessment broken into parts. Each part addresses a different cost portion of the whole assessment. The parts are:

1. Default Loss Fund Fee.
2. Excess Liability Protection Fee.
3. Pre-Existing Deposit Shortfall Fee.

Proposed subsection 15220.4 addresses the first 3 fees of the assessment, and proposed Section 15220.6 addresses a fourth part, a surcharge for new self insurers not previously covered in the alternative composite deposit. In order to understand the assessment in total, it is necessary to break it down into component parts:

(1) Default Loss Fund Fee. This is the portion of the deposit assessment that builds a cash fund (net worth) of the Security Fund to pay defaults on covered workers' compensation liabilities of eligible self insured employers. This fund is necessary because the Security Fund, as it is currently operating, has a negative net worth. The negative net worth of the Security Fund is somewhat by statutory design - the Fund acquires the workers' compensation liabilities of defaulting self insurers that have posted individual security deposits that at the moment of default

may or may not adequately cover all workers' compensation liabilities. The Security Fund has 50+ "estates" (insolvent private self insured employers) and incurred liabilities exceeding current assets of approximately \$50 million.

In the alternative composite deposit design of the new Labor Code Section 3701.8, the Fund will build net worth over a period of years by collecting the fees or costs that participating self insured employers would have paid out for individual security deposits to be posted with the Director, in the form of. The aggregate assessments collected by the Fund will total considerably more than the current and expected annual payout to pay the liabilities of defaulted self insured employers, so each year approximately \$35 - 50 million in net worth will accrue. In ten years the sum could grow to a massive fund of \$500 million or more to pay workers' compensation claims of defaulting self insurers. In other words, the collective body of private self insurers are self insuring their risk of defaulting self insurers among themselves. The Default Loss Fund is the vehicle for the payment of these future losses and the Default Loss Fund fee is the annual contribution from each participating Self Insurers' Security Fund member to build this Default Fund.

(2) The second portion of the Deposit Assessment funds the costs of a different form of protection for the private self insured employers - aggregate loss protection against multiple, large defaults by self insurers during the years when the Default Loss Fund is relatively small. The aggregate loss protection is necessary because the alternative composite deposit eliminates most of the individual security deposits posted for participating private self insurers.

Before the alternative security deposit system was established under Labor Code Section 3701.8, individual security deposits were the only means of securing liabilities. When a self insurer with a security deposit \$45 million (based on estimated future liabilities reported in its Self Insurers Annual Report) defaults on its workers' compensation claims and actual liabilities actually end up costing \$50 million, the Security Fund would assess its members for the \$5 million shortfall. Under the new alternative composite deposit system, the Self Insurers' Security Fund would pay out the entire \$50 million if the employer was fully participating over a period of years. In a "worst case scenario", instead of one self insurer with \$50 million in liabilities defaulting, there could be five defaults with \$100 million liability each, or one default that with \$350 million in liabilities. To protect against these types of occurrences, the Security Fund will protect its members by arranging for a layer of catastrophic protection, such as for any loss or series of losses exceeding \$300 million. Thus the Security Fund would only



pay up to its "self insured retention" - in the last example \$300 million. This layer (or layers) of aggregate protection would be purchased in a number of ways. The cost of this level of protection - whatever it may be - would be spread among the private self insurers through a pro-rata fee to each participating self insurer. The cost to secure aggregate protection is the basis of the Excess Liability Protection Fee portion of the deposit assessment.

(3) The third portion of the deposit assessment will fund the existing deficit of the Security Fund, which is approximately \$50 million. This fee is necessary because the current Security Fund Insolvency Assessment is capped at a maximum rate of 2% of paid benefits during the previous calendar year under the individual deposit system if no alternative security deposit is established. Currently 2% of paid costs assessments raise approximately \$4.5 million per year. With a current liability shortfall of over \$50 million, it would take over ten years to raise the amount needed to retire the liability - and if there were more defaults, the deficit would grow. Since 1984, there has been an average of two or three defaults per year, so it is unlikely that defaults will cease altogether for the next ten years. The cash flow generated by the existing Labor Code Section 3745 Insolvency Assessment has proved to be inadequate, but the proposed composite deposit assessment will retire this pre-existing liability through funds collected with the third portion of the new assessment, the Pre-Existing Deposit Shortfall Fee. When the pre-existing \$50 million plus shortfall has been eliminated, the Pre-Existing Deposit Shortfall Fee will also be eliminated. In addition, there will no longer be a need for the Labor Code Section 3745 Insolvency Assessment.

An exception to the requirement for payment of this portion of the total assessment is indicated in this subsection as any self insured employer whose certificate to self insure was revoked before the enactment of Labor Code Section 3701.8.

(4) A fourth portion of the deposit assessment is the New Self Insurers Fair Share Contribution Surcharge Fee. This fee is covered by Section 15220.6 of the proposed regulations.

One of the reasons for breaking down the deposit assessments into four parts - including the New Self Insurer Fair Share Contribution Surcharge - is to allow the Manager to determine the portion of the deposit assessment that the excluded self insurer must pay. The excluded employers post their own security deposits individually, so these employers receive only some indirect, practical benefit from the Default Loss Fund and Excess Liability Protection portions of the deposit assessment - namely that future losses undoubtedly will be more adequately covered by these two

fees than in the past. Therefore, excluded employers' contributions to these fees should be minimal.

The pre-existing deposit shortfall fee can be applied to any self insurer that has not been revoked for at least 36 months because pursuant to existing Labor Code Section 3745, the Insolvency Assessment is not applied 36 months after the employer leaves self insurance. Many excluded self insurers fall into this category - revoked for over 36 months. Once the Labor Code 3745 Insolvency Assessment becomes entirely non-operative, all remaining self insurers and all future self insurers are "fair game" for the New Pre-Existing Default Shortfall Fee. An argument could be advanced that former self insurers whose Certificate of Consent to Self Insure has been revoked prior to January 1, 2003 should also be considered as eligible to be charged for existing insolvencies for 36 months after their self insurance has been revoked. While Labor Code Section 3701.8 makes no such distinction, it is expected that the Director may receive appeals in all such instances. Accordingly, as a practical matter the Manager intends to apply the New Pre-Existing Shortfall Fee portion of the deposit assessment on all revoked self insurers that have not gone beyond 36 months from their revocation date.

This portion of the assessment will not be assessed against those former self insurers whose self insurance has been revoked more than 36 months, nor will it be assessed after 36 months against any self insurer whose self insurance was revoked prior to January 1, 2003. For all those current self insurers who might leave self insurance in the future, it is the Manager's intention that this portion of the deposit assessment be assessed as long as the revoked self insurer has open claim liabilities, so that these former self insurers will be charged on some basis, as is any current self insurer. The method used to assess the Pre-Existing Deposit Shortfall Fee for revoked self insurers may change from cycle to cycle of the Alternative Security Deposit system, depending upon how the Board of Trustees applies this portion of the assessment to the rest of the self insured community. Ideally, the Board of Trustees will settle on a particular methodology, such as a percentage of paid losses or some other calculation that could then be added to the regulations if necessary.

Subsection (b) requires each participating self insurer to annually pay the Security Fund deposit assessment.

Subsection (c) requires the Security Fund to determine and collect the deposit assessment owed by each fully participating and non-fully participating private self insured employer.

Since the deposit assessment is the funding mechanism for the alternative composite deposit, it is reasonable that the

Security Fund - the party proposing the alternative composite deposits - be the party to collect the assessment.

Subsections (c)(1) through (c)(8) then specify the factors used to determine pro-rata assessment amounts:

Section 15220.4 (c)(1) references the three statutory considerations.

Subsection (c)(2) addresses cost considerations of security instruments permitted, including the cash holdings that will make up the Default Loss Fund and/or the level of aggregate excess liability protection provided in the proposed alternative composite deposit.

Subsection (c)(3) addresses the amount of security deposit required by the Director for each self insurer to secure its liabilities. This requirement is necessary because of the statutory requirement to consider incurred or paid liabilities as reported in the Self Insurer's Annual Report (Labor Code Section 3701.8 (b)(2)). The amounts of security deposits afford a means of pro-rata sharing of the costs that include other factors not reflected in liabilities reported, such as recent additions to the program, lack of parental guarantee, poor credit worthiness, failure to post deposit, audit results, and so on.

Subsection (c)(4) clarifies how credit worthiness will be considered under the regulation as set forth in the reference to Section 15220.1 or Section 15220.3 of these regulations. Financial strength and credit worthiness is included in Labor Code Section 3701.8 (b)(3) as one of the items to be considered by the Board of Trustees. Since these regulations address this consideration in greater detail, a reference to them is necessary.

Subsection (c)(5) permits the Security Fund to consider an amount, if needed, for pro-rata share of incurred but not reported liabilities aggregated across all private self insurers. This inclusion is necessary to permit the Board of Trustees a full range of analytical tools commonly used to estimate incurred liability. The inclusion of "incurred but not reported" liabilities to actuarially estimate costs is commonly used, and the Board of Trustees is expected to exercise its business judgement in determining the deposit assessment.

Subsection (c)(6) permits the Fund to consider an amount to be collected to pay off the pre-existing, unfunded liabilities of the Security Fund from previously defaulted estates. This provision is necessary because the existing Labor Code Section 3745 Insolvency Assessment will be replaced by the Pre-Existing Deposit Shortfall Fee, a portion of the deposit assessment. The current approximately \$5 million plus shortfall does not have to be

immediately funded in total, but the shortfall should be retired through cash flow.

Subsection (c)(7) allows the Fund to consider other relevant factors.

Subsection (c)(8) allows the Fund to consider amounts that are posted separately pursuant to Labor Code Section 3701.

Subsection (d) requires the Board to also collect assessments due from excluded employers and also indicates that the amount of these assessments will be determined by the Manager, who will advise the Board of the amounts to be collected from excluded employers.

**Section 15220.5 Deposit Assessments; Failure to Pay; Assessment Liability**

A new Section 15220.5 will require each private self insurer who participates in the alternative composite deposit to pay a deposit assessment and establishes civil penalties for the private self insured employer who fails to post the deposit assessment in the time allotted by the Self Insurers' Security Fund.

A new subsection (a) will establish that if the Security Fund proposes an alternative composite deposit, it will be binding for all private self insured employers eligible for fully participating status or non-fully participating status.

This subsection is necessary since it is optional for the Security Fund to propose the alternative composite deposit, but, if offered, it is binding upon the private individual self insured employer pursuant to Labor Code Section 3701.8. The individual employer may not "opt out" (decide not participate). Just as each private self insured employer is required to be a member of the Self Insurers' Security Fund, when the Fund offers the alternative deposit all fully qualified and non-fully qualified members are required to participate and are covered to the extent of alternative coverage offered (Labor Code Section 3701.8). Mandatory participation of eligible self insurers also permits spreading costs equitably among the participating self insurers.

A new subsection (b) will establish the responsibility of determination of the amount of deposit assessments, billing and collections for private self insured employers to be the responsibility of the Self Insurers' Security Fund. This requirement is necessary so it will be clear who has authority to issue and collect the assessment to the individual self insurer. The funds obtained from the assessments are then used to provide the deposit instruments to serve workers' compensation liabilities of the

understated self insured employers, as determined by the Department.

A new subsection (c) specifies that, pursuant to Labor Code Section 3701.8(d), a civil penalty of not less than 10% of the amount of the deposit assessment will be assessed against a private self insured employer who fails to pay the deposit assessment in the time allotted by the Security Fund Board of Trustees.

Existing civil penalties in Labor Code Section 3702.9(a) for failure to post deposit as required under Labor Code 3701 are assessed at a maximum of \$5,000 for every 30 days or portion thereof. Self Insurance Plan's experience shows this civil penalty is often more attractive than posting the security deposit because it is less expensive than the cost to the self insurer to post the deposit increase, particularly if it is a large amount. Similarly, the Labor Code Section 3702.9 civil penalty for failure to pay an assessment (user funding assessment, fraud investigation assessment or the Security Fund insolvency assessment) - is assessed at a maximum of \$2500 for every 30 days or portion thereof. This assessment penalty is also inadequate in most instances to obtain compliance - that is, assessment payment. Labor Code Section 3701.8(d) sets a much higher penalty assessment for failure to pay the Security Fund deposit assessment in the time frame provided (not less than 10% of the deposit assessment itself), and also requires the self insurer to post the security deposit separately under Labor Code Section 3701.

The penalty is added to the Security Fund's deposit held by the Director. Thus, an employer required to pay a \$3 million deposit assessment that fails to do so in the time frame require, could pay a penalty of at least \$300,000 and would be required post a separate individual deposit with the Director. The \$300,000 would be much greater incentive than any existing Labor Code Section 3701.9 civil penalty, plus the Security Fund would receive the penalty instead of the Department. With this severe penalty, non-payment of the deposit assessments should be practically non-existent.

The severity of the penalty is appropriate, however, since the Security Fund covers half or more of the total amount of security required for all self insured employers, while those self insured employers are required otherwise to pay only their pro-rata shares of the deposit assessment. The amount of the penalty and the requirement to post a separate security deposit are mandated by Labor Code Section 3701.8(d).

Subsection (c) provides that in addition to being assessed a civil penalty, the private self insured employer who fails to pay the deposit assessment in the time allotted must post

a separate security deposit pursuant to Labor Code Section 3701, within 30 days of the notice by the Manager.

A penalty for failure to pay the assessment, or late payment of the assessment, is necessary because such a failure means no deposit would be posted by that employer to secure its workers' compensation liabilities under the alternative composite deposit for the period that payment is late. Labor Code Section 3701.8 requires such employer to post its own deposit under Labor Code 3701 to secure its liabilities. While initially, every private self insurer would have to be notified of its failure to perform, assessed the civil penalty, and advised by the Manager to post an individual security deposit pursuant to Labor Code Section 3701 in the amount required. A period of time would be needed in order to comply with posting a separate deposit. The proposed regulation provides all of this and grants the employer 30 days to post after notice by the Manager to secure its workers' compensation liabilities.

A new subsection (d) will provide for failure to pay by the self insurer of the deposit assessments in the time specified by the Security Fund Board of Trustees and/or failure to post and maintain the full amount of required individual security deposit for more than 60 days or both, shall be good cause for the Manager to summarily revoke the private self insured employer's Certificate of Consent to Self Insure without a hearing. This regulation is necessary to cut off the self insurance period. Presumably the self insured employer has made a decision not to pay the deposit assessment securing its workers' compensation liabilities and also has failed to individually secure the liabilities as required with a separate deposit under Labor Code Section 3701 for at least 60 days. Securing workers' compensation liabilities is a fundamental requirement to be self insured. Normal revocation proceedings could delay the period of self insurance for several months - at the same time adding more unsecured liabilities to the employer's period of self insurance. Summary revocation without a hearing by the Manager will cut off the period at about 75 days since 15 days notice of the summary revocation date is needed. This period is adequate time for an employer who wishes to remain self insured to comply with deposit requirements. The employer may still appeal the Manager's Summary Revocation action but must as a condition precedent to such an appeal first show that all new liabilities are secured by a workers' compensation insurance policy. Labor Code Section 3701.8(i) specifies that there be no lapse in security posted. The summary revocation of self insurance and requirement to obtain insurance may be the only means to prevent such a lapse.

Subsection (e) clarifies that the self insured employer may post a separate individual security deposit but that action does not negate any deposit assessment civil penalty

assessed (of at least 10% of the deposit due, for failure to pay the assessment) nor does posting of a separate individual deposit release the self insurer of any portion of the deposit assessment otherwise due. The only means by which these obligations can be released in whole or in part is by successful appeal under Section 15220.6.

**Section 15220.6 New Self Insurer Fair Share Contribution Surcharge**

Subsection (a) requires the Self Insurers' Security Fund Board of Trustees to track and develop a historical, annual schedule of cash contributions for the first 10 years to build net worth in the Default Loss Fund. Each new self insured employer under this regulation is then surcharged a "fair share" contribution for any years of the initial ten years that the new self insured employer did not contribute to the Default Loss Fund. This 10 year contribution to net worth is called the New Self Insurers Fair Share Contribution Surcharge Fee and shall be assessed in addition to any other payment required of the new self insurer to the Default Loss Fund.

This requirement is necessary since the existing employers that are self insured will build hundreds of millions of dollars of net worth into the Default Loss Fund over the first 10 years of its existence. New self insurers that enter self insurance in future years will directly benefit from these contributions, but will have made little contribution to this net worth. For example, a new self insurer in year 3 would not have contributed anything for years 1 or 2. A new self insurer entering into year 6 would have paid nothing for years 1-5. A new self insurer entering in year 11 would pay nothing to the net worth guaranteeing payment of their liabilities. To achieve equitability, a surcharge on the new self insurer will provide whatever years of contribution are missing to be paid off in essentially an equal number of years that were missed. This surcharge "balances the books", so that all self insurers will have paid an equal pro-rata share toward the net worth of the Security Fund. This provision has the added benefit of building a greater net worth, as well as reducing future assessments for all self insurers over time.

It is likely at some point - absent significant large defaults - that the default loss fund could reach a range of between \$500 million - \$1 billion. At that time, it is conceivable that assessments to build net worth could be greatly reduced for all self insurers, since the Security Fund could offer its own guarantee backed by this Default Loss Fund and its ability to assess for additional funds to cover any defaults that might occur. This strength could attract more companies to self insurance and those self insurers would conceivably post no separate deposit and not be required to contribute to the net worth of the Default

Loss Fund if some type of "fair share" contribution to the net worth of the Security Fund were not required.

A new subsection (b) indicates that funds collected from the fair share contribution surcharge fee shall be subject to Section 15220.8, which details the requirements for use and investment of cash generated from deposit assessments.

**Section 15220.7 Appeals on Deposit Assessments and Appeals of Deposit Assessment Penalties**

The Director is required by Labor Code Section 3701.8 to consider appeals on deposit assessments and appeals on deposit assessment penalties. The Director's regulations on Hearing and Appeal Procedures are contained in Article 11 of the Director's self insurance regulations. For clarity and consistency, Section 15220.6 cross references the reader to Article 11 for appeals on both these subjects.

A new subsection (a) specifies that any a self insurer may appeal a deposit assessment but that it must first pay the assessment in full. This requirement is necessary to ensure that pursuant to Labor Code Section 3701.8(i), no lapse in security deposit will ensue.

A new subsection (b) specifies that any penalties assessed for non-payment of an assessment may also be appealed pursuant to Article 11.

**Section 15220.8 Requirements for Use and Investment of Cash generated from Deposit Assessments**

A new subsection (a) requires the Board of Trustees of the Self Insurers' Security Fund to make a detailed accounting of the monies collected from each deposit assessment to the Director within 90 days of the payment due date of the assessment.

This subsection is necessary since the Self Insurers' Security Fund will be collecting from \$50 to \$100 million in each composite deposit assessment initially for every alternative composite deposit. Each self insurer is separately invoiced by the Security Fund so it should be a simple matter to account for its assessment collection within 90 days of the payment due date to the Director. There would be no way to know if it had all been posted without an accounting of the collection itself.

Subsection (b) requires the accounting to include a summary of all funds collected in a deposit assessment, the costs of each instrument posted as alternative composite deposit, all commissions and costs due or paid related to the alternative deposit system for that deposit cycle, and any remaining excess funds.



This accounting is necessary to delineate the net excess cash collected in each deposit assessment. All other portions of the deposit assessment are collected for specific purposes - for example, to pay off existing self insured defaults - and will be separately accounted for. The largest amount of the deposit assessment will be collected for two purposes: cash to build net worth in the default fund in order to pay future self insured employer defaults; and to purchase financial instruments to protect the Self Insurers' Security Fund (and indirectly all private self insurers) against a string of catastrophic defaults by more than one larger self insurer. As the default fund grows (by \$30-45 million per year) over the years, the cost and amount of catastrophic protection that is needed will decrease, permitting reduced deposit assessments. Since the deposit assessment will bring in tens of millions of dollars and all excess cash must be posted with the Director, an account of all direct and related costs must be made to determine excess cash available.

Subsection (c), for clarity and consistency, reiterates the requirement of Labor Code Section 3701.8(f) that the Self Insurers' Security Fund post the cash portion of the composite deposit from deposit assessments with the Director.

Subsection (d), for clarity and consistency, reiterates the requirement of Labor Code Section 3701.8(f) that any surplus funds collected from the deposit assessment be posted with the Director.

Subsection (e) requires the Director to hold any cash deposits from the Security Fund in the name of the Director of Industrial Relations in Trust for Self Insurers' Security Fund. This provision is necessary to assure that the Security Fund's cash funds are segregated from any other cash deposits held by the Director. This provision is consistent with existing cash security deposits requirements for Labor Code 3701 and existing cash in trust regulations contained in Section 15214 of these self insurance regulations. The Director holds all cash security deposits in the same manner - as "The Director of Industrial Relations in Trust For" the individual self insurers' legal name of each account.

Subsection (f) specifies how the Director will invest the Self Insurers' Security Fund cash if the Director decides to hold and invest the cash. Subsection (f) also specifies as an alternative that the Director may permit the Self Insurers' Security Fund to manage and invest the deposited cash outside of the State Treasury subject to specific conditions. This provision is necessary since Labor Code Section 3701.8(f) permits either approach. If the Director holds and invests the cash it will be deposited in the

Surplus Money Investment Fund pursuant to existing authorization contained in Labor Code Section 3701.8 for surplus cash or the cash portion of any alternative deposit.

The Security Fund currently manages and invests its own cash from the security deposits of estates of self insured employers that have defaulted on payment of their workers' compensation self insured claims liabilities. Section 15220.8(f) would also permit the Self Insurers' Security Fund to hire its own funds Manager and invest the deposited cash on its own behalf outside the State Treasury, provided the following conditions are met:

1. The Self Insurers' Security Fund Board of Trustees has adopted a cash investment policy outlining the types of investments that can be made to preserve and protect the principal.
2. The Self Insurers' Security Fund makes quarterly reports to be sent to the Manger by the Fund's Manager on all the Director's cash deposits managed by the Self Insurers' Security Fund; and
3. None of the Directors trust funds may be co-mingled with Self Insurers' Security Fund cash, nor within any single investment instrument.
4. Regardless of who manages the cash, the Director's funds must always remain in the Director's name until such time as the Director may order the release of the funds to the Self Insurers' Security Fund or back to the self insurers.

These specifications are necessary since the Director does not typically manage investments of this potential size. Existing statutes permit depositing cash of the Security Fund into the Surplus Money Investment Fund through which the funds are managed. If the Security Fund manages the Director's funds on its own behalf, it will need an Investment Manager and an investment policy to preserve and protect it its principal. Quarterly reports to the Director on the investments by the Funds Manager are a reasonable requirement to track and document the funds under management and to show that the investment policy is being followed. Separation of the Self Insurers' Security Fund funds from the Director's funds is necessary since each must be kept subject to a different party's control. The Self Insurers' Security Fund already manages extensive funds of its own, has its own investment policies and investment Manager. Funds are managed collectively but accounted for estate by estate by the Self Insurers' Security Fund. Co-mingling of funds in the same account or in the same instrument - government bond, for example - could permit funds to be withdrawn out of the Director's name. Therefore, all accounts and instruments must be separated between the Director and the Self Insurers' Security Fund if the Self Insurers' Security Fund manages the funds for the Director. This separation is not a difficult thing to accomplish, since the Security Fund already accounts separately for more than 50 estates separately. However, specifying these

requirements by regulation will clarify the minimum expectations of the Director for the Self Insurers' Security Fund's management of these funds.

Subsection (g) specifies that when the Director initially turns over compensation liabilities to the Self Insurers' Security Fund that were covered by the alternative composite deposit, the Director will also release enough cash to fund expected workers' compensation benefits for the remainder of the calendar year. This requirement is necessary because the cash portion of the alternative composite deposit must be in the name of the Director. Since defaults could occur anytime during the calendar year, the regulation is needed to require that enough cash be released to fund expected workers' compensation benefits for the remainder of the calendar year. The Manager should be able to estimate workers' compensation benefits to be paid to the balance of the calendar year by using the paid-to-date information from the last Self Insurers' Annual Report on the private self insurers defaulting. For any of a number of reasons, the Manager's initial estimate could be inadequate and further funds may therefore need to be released before the end of the calendar year. To address this situation, subsection (g) requires the Manager in consultation with the Self Insurers' Security Fund to advise the Director that additional funds for the remainder of the calendar year are needed and request the Director to release an additional amount to fund the payment of benefits and expenses for the period.

Subsection (h) requires the Self Insurers' Security Fund to annually notify the Manager and Director in writing of the funds needed to operate for the next calendar year. These funds will be funded from the alternative composite deposit. The Security Fund routinely conducts cash flow analyses of its current estates to project funding needed for assessment purposes. This subsection requires a request to the Director to release alternative composite funds to the Security Fund's control, since all surpluses and excess cash is held in the Director's name. A request from the Security Fund will be needed each time it wants funds released from its excess. Doing so once a year should provide most of the funds needed by the Self Insurers' Security Fund with one request.

## Article 11

### Specific Purpose

The proposed amendments to these regulations will make them consistent with the new Labor Code statutes that permit an alternative composite deposit posted by the Self Insurers' Security Fund rather than individually by each self insured

employer to secure workers' compensation liabilities. The new sections will establish provisions for hearings on appeals for the alternative composite deposit assessment.

Section 15430 is the first section in Article 11 of self insurance regulations that discusses self insurance matters that the Director may investigate or that may result in hearings. The hearing procedures themselves follow Section 15430 in Article 11.

New Labor Code Section 3701.8 adds two new subject matters for the Director for which hearings may be held - appeals of deposit assessments, and appeals of penalties for failure to pay a deposit assessment. These subject matters are added as listed subject areas in Section 15430 as new subsections (h) and (i).

#### Necessity

This amendment is necessary to give form and substance to the self insurer and to the Director as to how such proposals are to be made, what procedures to be followed, how hearings will be conducted, and how decisions will be rendered. The existing self insurance hearing process is established and can accommodate the new subject areas. All that is needed is to add the subject areas to the list in Section 15430 for the existing hearing and appeal procedures to apply.

#### TECHNICAL, THEORETICAL, AND/OR EMPIRICAL STUDY, REPORTS OR DOCUMENTS

The Department did not rely upon any technical, theoretical, or empirical studies, reports or documents in proposing the adoption of this regulation.

#### ALTERNATIVES TO THE REGULATION CONSIDERED BY THE AGENCY AND THE AGENCY'S REASONS FOR REJECTING THOSE ALTERNATIVES

No other reasonable alternatives were presented or considered by the Department.

#### ALTERNATIVES TO THE PROPOSED REGULATORY ACTION THAT WOULD LESSEN ANY ADVERSE IMPACT ON SMALL BUSINESS

The Department has not identified any reasonable alternatives or that have otherwise been identified and

brought to the attention of the agency that would lessen any adverse impact on small businesses.

EVIDENCE SUPPORTING FINDING OF NO SIGNIFICANT ADVERSE  
ECONOMIC IMPACT ON ANY BUSINESS

The department is not aware of any significant cost impacts that a representative private person or business would necessarily incur in reasonable compliance with the proposed action. Individual private self insurers may find the new deposit assessment to be higher than current costs for providing individual security deposits. However, because of the need to increase the pre-existing deposit shortfall fund, the costs would have increased substantially even if the composite deposit program were not enacted. Even so, any cost increases should be offset by the release or reduction of individually posted security deposits to participating self insurers, thus making other assets available to those employers. In addition, the deposit assessments are expected to be reduced over time. Costs are determined by the Security Fund's Board of Trustees, not the Department of Industrial Relations, pursuant to Labor Code Section 3701.8.