

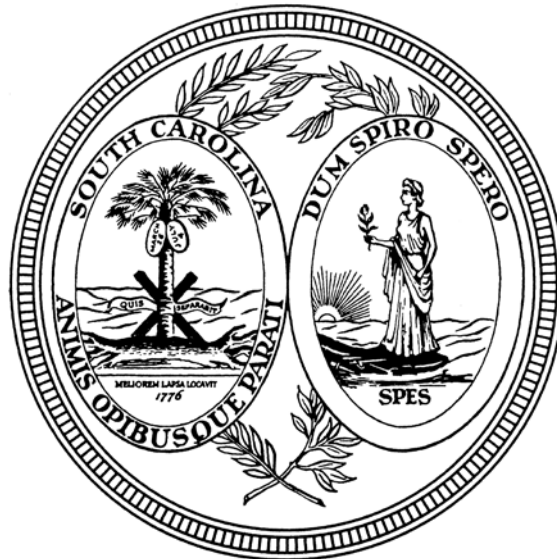


SOUTH CAROLINA GENERAL ASSEMBLY

# Legislative Audit Council

March 2007

## A REVIEW OF THE SOUTH CAROLINA SECOND INJURY FUND



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***A Review of the South Carolina Second Injury Fund***

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# Legislative Audit Council

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## **A REVIEW OF THE SOUTH CAROLINA SECOND INJURY FUND**

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# Synopsis

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Members of the General Assembly requested an audit of the South Carolina Second Injury Fund (SIF). The requesters wanted to know if the fund is meeting its goals and whether it should be continued. They also wanted to know whether the SIF has handled claims efficiently and in compliance with the law.

The Second Injury Fund is a component of the workers' compensation system. The fund seeks to protect employers from potential higher costs of insurance they could incur by employing an individual with a prior disability. State law requires the SIF to reimburse employers or their insurance carriers for workers' compensation benefits paid for an employee who has an injury that is substantially greater because of the employee's prior disability. The SIF is funded by an annual assessment paid by insurance carriers and self-insured employers. The SIF's goals are to advance the hiring and retention of disabled employees and protect employers from increased workers' compensation costs. We found that the Second Injury Fund is not needed and should be phased out. Our findings are summarized below.

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## Advancement of the Disabled

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We found no evidence that the Second Injury Fund has an effect on promoting the hiring and retention of the disabled.

- Most claims to the SIF have been based on "unknown conditions," in which the injured employee did not know that he had a previous disability. Unknown conditions cannot have an effect on employers' hiring decisions.
- Since 1990, the Americans with Disabilities Act (ADA) has protected potential employees and prohibits employers from questioning potential employees about their disabilities or previous injuries. At least 75% of employees in South Carolina are covered by the ADA.
- Arthritis is the most common disability for which the SIF provides reimbursement, cited in 80% of claims over the past three years. Arthritis is also widespread in the population, reported by 21% of adults. It seems likely that the SIF is paying for claims for arthritis that were not related to hiring decisions.
- We found no evidence that the majority of employers are aware of the SIF and its potential benefits.

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## Effects on Workers' Compensation Costs

We found that the Second Injury Fund does not protect employers from increased workers' compensation costs. The SIF primarily redistributes or shifts costs within the workers' compensation system and does not lower the overall costs of workers' compensation. Because of the SIF, the overall costs of workers' compensation are somewhat higher than if there were no SIF. Individual employers may have their costs reduced or increased because of the SIF.

- For larger employers who purchase insurance and have experience ratings, SIF reimbursements should lower their costs directly. However, some claims are accepted for reimbursement long after the injury occurred, and employers' rates are not adjusted because the adjustment period has expired. Also, there are inadequate controls to ensure that insurers adjust their estimates of claim costs and report these adjustments correctly to allow employers to obtain premium reductions.
- Smaller employers and those who belong to self-insurance pools, which account for the majority of claims, do not receive direct benefits from SIF reimbursements. SIF reimbursements lower their overall losses, which in turn lower overall insurance rates. However, increases in SIF reimbursements increase the assessments that employers pay to fund the SIF; lower rates are offset by increased assessments.
- There are 181 individual self-insured companies, accounting for 10% of claims, for which SIF reimbursements are direct revenues and assessments are a direct cost.

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## Cost Effects of SIF Phase Out

Although there would be a short-term increase in workers' compensation costs, phasing out the SIF would yield long-term savings.

- As there are fewer SIF claims, employers have to pay those losses and overall losses would increase, leading to increased rates. Costs will increase in the beginning because employers must continue to pay assessments for claims already in the system until they are paid in full.



- The phasing out of the SIF would provide savings through the gradual elimination of administrative costs. These include the SIF's costs of operation, which average \$1.6 million annually, and costs to handle SIF claims. Recovery agencies charge fees ranging from 7% to 15% of reimbursements to assist in identifying and submitting claims to the SIF. We estimated that S.C. insurance carriers and self-insurers spent from \$7 – \$11 million in FY 05-06 for fees to recovery agencies.
- Insurance department and other insurance industry officials stated that claims would cost less if there were no SIF to reimburse claim payments. Insurers and employers do not have as much incentive to minimize the amount paid on a claim if most of the payments are being made by the SIF.

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## Other States' Funds

Our review of other states' second injury funds did not identify any reason that the SIF should be continued. We identified 24 active second injury funds in other states and found that other states have been phasing out their second injury funds. We also identified some significant differences between S.C.'s Second Injury Fund and funds in other states. If the SIF is continued, it should be changed to reduce its size and scope.

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## Claims Handling

Our review of the SIF's claims management did not identify problems. We reviewed a random sample of 100 accepted and 25 denied claims and concluded that the SIF has adequate internal controls for processing claims. Also, we found no material problems with how the claims in our sample were handled.

Evidence indicates the SIF is efficient in claims handling. Compared to states with similar funds, the SIF processes claims more quickly and at a lower average cost.

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**Synopsis**

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# Introduction and Background

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## Audit Objectives

Members of the General Assembly requested an audit of the South Carolina Second Injury Fund (SIF). The requesters wanted to know if the SIF accomplishes its goals of advancing the hiring and retention of the disabled and protecting employers from increased workers' compensation insurance costs; they asked whether the SIF should be continued. They also were interested in a review of how the SIF handles claims. Our audit objectives were to:

- Determine whether the Second Injury Fund should be continued or phased out.
- Review the SIF's claims management to determine whether claims are handled efficiently and in compliance with the law.

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## Scope and Methodology

We reviewed the operations of the Second Injury Fund relevant to our audit objectives. We did not review the Uninsured Employers' Fund, which is also administered by the SIF. The period of our review was generally the past three fiscal years, FY 03-04 through FY 05-06. To complete our review, we used evidence which included the following:

- SIF claims files.
- Interviews with SIF employees, employees of the S.C. Department of Insurance, the National Council on Compensation Insurance, second injury funds in other states, and other relevant organizations. We also received input from interested parties.
- Records of S.C. rate cases.
- Testimony given before S.C. legislative committees.
- SIF policies and procedures.
- Audits and reports concerning the Second Injury Fund.
- Information about second injury funds in other states.

We examined the need for the SIF by considering evidence related to the goals of the fund, its statutory purpose, and the experience of other states. We also considered the effects of phasing out the fund on the costs of workers' compensation. We examined the SIF's claims handling using the criteria in state law governing reimbursements from the SIF, the experience of other states, and good business practice. We assessed the internal controls over the claims handling process and conducted random nonstatistical samples of accepted and denied claims.

The use of computerized data was not central to our audit objectives. We tested the reliability of the SIF's computerized data about claims, and did not identify concerns about its accuracy. This audit was conducted in accordance with generally accepted government auditing standards.

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## Background — The Second Injury Fund

The South Carolina Second Injury Fund (SIF) is a component of the South Carolina workers' compensation system. Workers' compensation is state-mandated insurance that provides benefits if an employee suffers job-related injury, disease, or death, regardless of negligence. According to the SIF's annual reports, its primary mission is to protect employers from potential higher costs of insurance that could occur by employing an individual with a prior disability. If that employee suffers a subsequent work-related injury, medical or disability costs can be substantially higher than if the injury had occurred to an employee without a disability. The goals of the SIF are to advance the hiring and retention of disabled employees and protect employers from increased workers' compensation costs.

The SIF was established in 1972 and placed under the Budget and Control Board (B&CB). The B&CB appoints the director of the SIF, which has 23 employees. SIF staff administers two funds — the Second Injury Fund and the Uninsured Employers' Fund. The Uninsured Employers' Fund pays workers' compensation benefits to injured workers whose employers do not have adequate workers' compensation coverage. We did not review the operations of this fund.

State law requires that the SIF reimburse employers or their insurance carriers for benefits paid for an employee with a prior disability who has another injury that is substantially greater because of the prior disability. For example, if an employee suffered an on-the-job injury to his back, which was worse because of a previous back injury, the SIF might reimburse some of the employer's costs for the claim. State law governs what payments the SIF will reimburse, how employers qualify for reimbursement, and what is considered a prior disability.

- The fund reimburses all benefit payments for lost wages and permanent disability after the first 78 weeks following the injury.
- The fund reimburses 50% of medical payments over \$3,000 during the first 78 weeks after the injury and all medical payments after 78 weeks.

- In order to be eligible for reimbursement from the Second Injury Fund, employers must document that they had knowledge of the prior disability unless the employee concealed the condition from the employer.
- The statute includes a list of 34 specific impairments, such as diabetes and arthritis, that are presumed to be permanent conditions and obstacles to employment.

For the last three fiscal years, the number of claims accepted by the SIF has decreased while assessments have increased (see Table 1.1).

**Table 1.1: SIF Financial Information — FY 03-04 through FY 05-06**

	FY 03-04	FY 04-05	FY 05-06
Claims Accepted	2,219	1,922	1,184
Annual Fund Payouts	\$116,616,089	\$166,947,142	\$147,638,623
Required Assessment	\$127,584,449	\$177,313,527*	\$188,475,672
SIF Administrative Costs	\$1,571,555	\$1,631,138	\$1,582,559

\* The B&CB lowered the assessment by \$75,991,512 from the \$253,305,038 required by law.

Source: Second Injury Fund

The Second Injury Fund receives no state general funds and is funded through an annual assessment on all insurance carriers and self-insured employers. The total amount collected is based on the previous year's total SIF disbursements — 175% of all disbursements less the net assets in the fund as of the end of the preceding fiscal year. According to an official from the SIF, individual assessments for each insurance carrier and self-insured employer are based on their workers' compensation losses for the previous year. The calculation also includes the ratio of (1) the total amount the SIF needs to collect to (2) the total amount of workers' compensation losses.

SIF payouts in FY 03-04 totaled \$166,947,142, an increase of 43% from the total payouts from FY 02-03 (\$116,616,089). Agency officials stated that this increase in payments was a result of an influx of claims following public discussions about closing the fund. As a result of this increase in disbursements, the required assessment for FY 04-05 was \$253,305,038 — a 99% increase from FY 03-04 (\$127,584,449). The Budget and Control Board intervened and set up a plan for employers to pay a reduced assessment. Second Injury Fund officials stated that because assessments are calculated by subtracting the fund's assets on hand, reducing the assessment for one year actually results in an increase by the same amount on the assessment for the next year. Carriers eventually incur this cost in future assessments.

In 2003, the General Assembly passed legislation that eliminated SIF reimbursements for unknown conditions. Previously, employers could receive reimbursement from the fund in cases where neither the employer nor the employee knew about the employee's previous disability. A 1988 LAC report recommended against this practice, primarily because ignorance of a condition does not relate to the SIF's mission to advance the hiring and retention of the disabled (see p. 7). Since the elimination of claims for unknown conditions, the number of claims accepted by the fund has dropped 47% from 2,219 in FY 03-04 to 1,184 in FY 05-06. In FY 05-06, unknown conditions still accounted for 65% of all SIF open claims.

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## **Workers' Compensation Insurance Rates and Premiums**

In order to consider how the Second Injury Fund affects employers' costs, it is necessary to explain how employers pay for workers' compensation coverage. Employers may purchase insurance to cover their workers' compensation costs. They may also self-insure, setting aside their own funds to pay losses. Those who self-insure are regulated by the South Carolina Workers' Compensation Commission (see p. 12).

Premiums are the amount the employers pay to purchase workers' compensation insurance. The premiums charged by insurance companies are based on loss costs determined by the National Council on Compensation Insurance (NCCI). These loss costs must be approved by the S.C. Department of Insurance (DOI). Insurance companies use these approved loss costs and add additional expenses to determine their premiums, the amount they will charge. Their premiums do not have to be approved by the DOI.

The NCCI is a nonprofit organization which deals with workers' compensation data, statistics, and research. It collects information about workers' compensation claims and payments from insurers in 39 states, including South Carolina. South Carolina law (§38-73-510) requires workers' compensation insurers to be a member of a rating organization, and the NCCI is the only licensed advisory rating organization in South Carolina.

In the workers' compensation field, the term "losses" means medical benefits paid to or for the benefit of persons injured in workplace accidents, and lost wages and other compensation paid for those accidents. Loss costs include these benefits and the cost of providing them. The NCCI determines the loss costs for South Carolina, which are based on historical data reported by insurers for losses that have already occurred. The NCCI adjusts that data to account for inflation and other trends to establish the amount needed to pay expected losses in each of approximately 550 employer classifications. The classification system groups businesses together that share common exposures to workplace injuries. For example, office workers have less risk of workplace injury than construction workers. Each classification is assigned a rate that insurers use to develop premiums.

The NCCI adjusts the rates for some employers based on their individual losses. For employers that are eligible (larger employers, generally those whose premium for the most recent 24 months is at least \$9,000), the NCCI determines their experience rating. According to an NCCI official, slightly more than half of insured employers in South Carolina are experience rated. Experience rating compares an employer's individual loss experience to the average loss experience of employers in the same classification. If an employer's past experience is better or worse than average, the employer's premium is adjusted down or up accordingly via a modification factor.

As stated above, the loss costs determined by the NCCI are not the entire premium because they do not include the costs for several types of expenses incurred by companies. Each insurance company considers its individual expenses, including rent, taxes, license fees, loss prevention activities, Second Injury Fund assessments, and profit. The rates are adjusted to incorporate these expenses and any discounts to determine the premium. Since 2003, the expenses charged by insurers have not been regulated by the South Carolina Department of Insurance. The Department of Insurance does determine rates for employers in the assigned risk plan. These employers, who cannot otherwise obtain insurance coverage, account for approximately 12% of S.C. premiums.

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**Chapter 1**  
**Introduction and Background**

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# Audit Results

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The South Carolina Second Injury Fund (SIF) is not needed and should be phased out. We found no evidence that the fund advances the hiring and retention of the disabled or lowers the costs of worker's compensation. We did not identify negative consequences in states that have ended their second injury funds. If the fund were phased out, there would be a short-term increase in employers' workers' compensation costs, but long-term savings would result. Based on a sample of claims and limited comparative performance data, we did not identify problems with the SIF's claims management. The SIF has handled claims efficiently and in compliance with the law.

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## Advancement of the Disabled

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A primary goal of the SIF is to promote the hiring and retention of the disabled in South Carolina. We found no evidence to support the claim that the SIF has been successful in realizing this goal.

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## Unknown Conditions

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Employers making hiring decisions are unlikely to know about potential employees' previous disabilities. A large percentage of the reimbursements from the Second Injury Fund have been for "unknown conditions." An employee would be considered to have an unknown condition if the employee was unaware of the disability that made his second injury more severe. The General Assembly passed legislation to eliminate this category of reimbursement in 2003. However, claims based on unknown conditions are still accepted if the accident or injury occurred prior to June 25, 2003, the effective date of the new legislation. By covering unknown conditions, the Second Injury Fund has been counterproductive with regard to its goal of promoting the employment of the disabled. If an individual's disability or condition is unknown by either the employee or their employer, then their disability status was clearly not considered in the hiring process. In FY 05-06, 66 % of SIF claims were for unknown conditions. While this is a decrease from 86 % in FY 02-03, before the change in the law, reimbursements for unknown conditions are still a substantial part of SIF payments.

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## Americans With Disabilities Act

Because of legal and other reasons, employers are unlikely to have knowledge of the previous injuries or disabilities of a potential employee. The Americans with Disabilities Act (ADA) of 1990 protects potential employees by providing qualified individuals with disabilities an equitable opportunity. The law prohibits employers from questioning potential employees about their disabilities or other injuries they have received. The ADA specifically protects those who: (1) have a disability; (2) have a history of disability; (3) are perceived to have a disability.

Some have argued that the existence of the ADA has supplanted the need for second injury funds nationally. However, the ADA and the SIF serve two different functions for employers and disabled workers. The ADA seeks to prevent the occurrence of discrimination on the basis of disability, while the SIF seeks to promote the hiring of the disabled by protecting employers from excessive costs associated with these hirings. While ADA and SIF are different in function, the requirements of the ADA present an impediment to the stated goals of SIF. If the ADA prevents employers from asking potential employees about disabilities or injuries, how then can SIF encourage these employers to hire the disabled? The SIF could affect a hiring decision only in cases where prior disabilities are physically evident to the employer or in cases where the applicant chooses to disclose a prior disability.

Most employees in South Carolina are covered by the ADA. Proponents of the SIF have suggested that the fund is important because it aids those employees who are not covered by the anti-discrimination provisions of the ADA. The ADA covers employers with 15 or more employees. Data from the Employment Security Commission is available for employers who employ fewer than 10 or fewer than 20 employees (but not 15). This data reveals that between 76% and 87% of South Carolina employers are not covered by the Americans with Disabilities Act. However, when considering the number of employees who work for these employers who are not covered by the ADA, the picture is different. Between 15% and 25% of S.C. employees are not covered by the ADA. So, while at least three-fourths of S.C. *employers* are not covered by the ADA, at least three-fourths of *employees* in S.C. work for employers that are covered under this legislation.

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## Covered Conditions

The most common previous condition reimbursed by the SIF is also not clearly related to employers' hiring decisions. The law regarding SIF reimbursement specifies 34 conditions which are eligible for reimbursement through the fund. The most frequent condition cited in SIF claims is arthritis.

Over the last 3 fiscal years (FY 03-04 – FY 05-06), an average of 80% of claims accepted by SIF have involved arthritis. While arthritis has many forms and can be severe and debilitating, it is reported by 21% of U.S. adults. It seems likely that the SIF is paying for claims for arthritis that were not related to hiring decisions. It is uncertain if SIF should provide reimbursement for a condition affecting such a high percentage of the population.

The disabilities and conditions covered by the SIF are often unrelated to employment decisions or the ability of an individual to perform specific work-related tasks. Questions about the conditions covered by SIF stem from the question of what constitutes a serious disability. The ADA defines a disability as “a physical or mental impairment that substantially limits one or more major life activities.” Heart disease, diabetes, and arthritis are not covered under the ADA. It is questionable whether the SIF should provide reimbursement for conditions which frequently do not affect an employee’s ability to perform a job.

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## SIF Marketing Efforts and Population Data

We found no evidence that the majority of employers are aware of the SIF. SIF officials stated that it takes several measures to educate employers on its existence, practice, and benefits. SIF provides education through a brochure, website, membership in the South Carolina Workers’ Compensation Education Association, and presentations at conferences and seminars. Some of these presentations are given in conjunction with the S.C. Commission for the Blind and the S.C. Vocational Rehabilitation Department. However, according to the Commission for the Blind, SIF’s purpose during these presentations is to encourage employers to hire blind individuals and to dispel myths about the hiring of the blind. SIF does not use these opportunities to specifically educate employers about the fund. Also, it seems likely that a small minority of S.C. employers would have been made aware of the SIF through these sessions.

No evidence exists to evaluate the effect of the SIF on employment. Population data from the U.S. Census Bureau is not available to provide confirmation that the goals of SIF have been achieved. The SIF began operation in 1972. Data from 1990 indicates that in S.C. approximately 30% of disabled individuals between ages 16 and 64 were employed. In 2005, around 32% were employed. However, there is little historical census data available, and no data regarding the employment status of the disabled before 1990. Also, we found no evidence to confirm whether or not disabled individuals have higher rates of workplace injury.

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## Conclusion

Overall, we found no evidence to support the assertion that the Second Injury Fund has increased the hiring of, or promoted the retention of, disabled individuals in South Carolina. Those making hiring decisions are, and have been, unlikely to know about the Second Injury Fund and its potential benefits. It is also unlikely that they are knowledgeable about the previous injuries of the applicants they consider.

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## Effect on Workers' Compensation Costs

One of the goals of the Second Injury Fund (SIF) is to protect employers from increased workers' compensation costs. We found that the SIF primarily redistributes or shifts costs within the workers' compensation system. The SIF does not lower the overall costs of workers' compensation. In fact, because of the SIF, the overall costs of workers' compensation are somewhat higher than if there were no SIF. However, individual employers may have their workers' compensation costs lowered or raised because of the SIF as discussed below. If the SIF were phased out, there would be a short-term increase in workers' compensation costs, but savings would result over the long term.

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## Cost Effects for Employers Who Purchase Insurance

Approximately 56% of the SIF claims for FY 03-04 through FY 05-06 were made on behalf of employers who purchase insurance, as opposed to those who are self-insured (see p. 12). For FY 04-05 and FY 05-06, the overall costs of workers' compensation were shifted from self-insured employers to employers who purchased insurance. Insurers overall paid an average of 36% more in assessments to the Second Injury Fund than they obtained in reimbursements. During the same period, self-insured employers paid an average of 24% more in assessments to the SIF than they obtained in reimbursements.

SIF reimbursements lower costs directly for some employers who purchase workers' compensation insurance, those who are large enough to have an experience rating (see p. 5). Insurance companies are required to report claims and how much they estimate the claim will cost to the National Council on Compensation Insurance (NCCI). They are required to make updated reports on claims annually or when certain changes occur. If a claim is accepted for reimbursement by the Second Injury Fund, the insurer must reduce its estimate of what the case will cost (S.C. Code §42-9-400(1), (see p. 11). Since the losses of the insured employer would be reduced by the SIF reimbursement, its experience rating would be more favorable and its premium would be lower.

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## Issues Related to Changes in Experience Ratings

We identified two issues relating to changes in employers' experience ratings as a result of SIF reimbursements. As a result of these conditions, employers may not benefit from their SIF reimbursements; rather, insurers alone would receive any benefits.

*In some cases, the claims are accepted for reimbursement long after the injury occurred, and experience rating adjustments are not made because the time has expired.*

There is no limit on when insurers may pursue reimbursement from the SIF. Although insurers must notify the SIF of a possible claim no later than after the payment of the first 78 weeks of compensation (S.C. Code §42-9-400(f)), there is no time limit on when they must submit evidence to support the claim. Many SIF claims are accepted long after the loss occurred. In FY 05-06, 27% of the claims accepted by the SIF were more than four years old. Although the insurer must report the effects of SIF reimbursements to the NCCI whenever they occur (up to ten years after the loss occurred), according to NCCI rules, a change in the employer's cost for a case would only result in a change in the experience rating for the current and two preceding experience rating periods. SIF reimbursements for older claims would not be reflected in the employers' experience ratings, so the employers would not benefit directly from the reimbursements.

*There are inadequate controls to ensure that insurers adjust their estimates of what the claim will cost and report these adjustments correctly to the NCCI.*

In order to receive reimbursements for SIF cases, insurers or employers must certify to the SIF that they have reduced their cost estimate for the claim. However, there is no independent verification that they have done this or reported these adjustments correctly to the NCCI. This was cited as a concern by the administrative law court judge when ruling on the NCCI's most recent request for a rate increase in 2006. Also, officials who testified in 2006 legislative hearings raised concerns that in some cases insurers may not report SIF reimbursements to the NCCI, which would prevent their insured employers from obtaining adjustments in their experience ratings, and thus lower premiums. The Small Business Chamber of Commerce reported that it commissioned a study which found several problems in reporting and identified cases where appropriate changes had not been made. We were unable to verify these findings.

The S.C. Department of Insurance has an ongoing market conduct examination of the NCCI. We considered the scope of this review and believe that it will clarify the nature and extent of data and reporting problems with SIF reimbursements. The results are scheduled to be published in spring 2007. If there is a problem, statutory change would be needed to improve controls over reporting of SIF reimbursements.

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### Cost Effects for Other Insureds and Indirect Effects

Nearly half of S.C. insured employers are too small to have experience ratings. These employers do not receive direct benefits from SIF reimbursements. However, they receive indirect benefits because SIF reimbursements lower the losses they report. This lowers their loss costs, which results in lower overall loss costs and rates. However, since the total amount of SIF reimbursements determines the total amount of the assessments that insurers and employers pay (if more reimbursements are paid, the assessments are higher), indirect effects lowering costs are offset by increases in assessments.

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## Recommendation

1. The General Assembly should review the results of the market conduct examination of the National Council on Compensation Insurance and, if warranted, amend state law to improve controls over the reporting of Second Injury Fund reimbursements.

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### Cost Effects for Self-Insured Employers

Self-insured employers represent a sizeable portion of the workers' compensation market, accounting for 44% of SIF claims in the past three fiscal years. Employers have the option of self-insuring against workers' compensation losses. Employers may participate in a self-insurance pool with similar companies or pay losses as an individual self-insured company. The S.C. Workers' Compensation Commission (WCC) approves and regulates self-insured employers. Self-insured companies and pools must meet financial requirements and provide workers' compensation benefits as required by law. The WCC's regulation is designed to ensure that the companies are financially capable of providing the required benefits. The WCC does not regulate the rates charged by the self-insurance pools.

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## Self-Insured Pools

There were 13 self-insured pools which had claims accepted by the SIF from FY 03-04 through FY 05-06. Their approximately 1,700 claims in those three fiscal years accounted for 34% of the claims accepted by the SIF.

Individual participants in self-insured pools do not have their costs directly lowered as a result of their SIF reimbursements. According to workers' compensation officials, reimbursements from the SIF are handled just like revenue from any other source and serve to lower the overall amount of funds needed by the pool to meet its obligations. Therefore, SIF reimbursements lower the costs for all of the participants in the pool whether or not the individual participant had SIF reimbursements. SIF assessments to the pool increase the amount of funds needed to meet the pool's obligations and raise costs for individual participants regardless of their involvement with the SIF. If the SIF were phased out or reduced in scope, the overall effect on employers in self-insured pools would be similar to that for employers who purchase insurance. They would experience short-term increases in their costs and long-term savings (see p. 14).

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## Self-Insured Companies

There were 181 self-insured companies who were assessed by the SIF from FY 03-04 through FY 05-06. These companies had 10% of the claims accepted by the SIF during these three fiscal years.

Since self-insured companies do not pay for insurance to cover their workers' compensation losses, any reimbursements received from the SIF are a direct credit against the losses paid by the company. Any assessments that companies pay are a direct cost. If the SIF were phased out or reduced in scope, companies' workers' compensation losses would increase since they would no longer receive reimbursements from the SIF. However, after the phase-out period, the companies would no longer have to pay SIF assessments. The overall cost effects for self-insured employers would be similar to those of other employers (see p. 14).

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## **Cost Effects of SIF Phase Out**

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Although there would be a short-term increase in workers' compensation costs, phasing out the SIF would yield long-term savings.

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### **Short-Term Increase in Cost**

The NCCI develops the loss costs for workers' compensation from information reported by insurers. When a claim is accepted for reimbursement by the Second Injury Fund, insurers lower their estimated loss for that claim. If there were no SIF, the losses would no longer be reduced, so loss costs (and rates) would increase.

Based on estimates developed by the NCCI in 2006, there would have been a one-time increase in loss costs of approximately 16% if the SIF had been eliminated at that time. This increase could result in a short-term increase in the cost of workers' compensation insurance. However, as a result of the decrease in the number of SIF claims following the elimination of reimbursements for unknown conditions (see p. 4), reimbursements are already being cut back, and some of the projected increase in insurers' loss costs has already occurred. If the SIF is scaled down and pays less in reimbursements, then loss costs are increased gradually, which would result in a smaller increase in the future if the fund were done away with entirely.

Increases in loss costs would not be immediately offset by decreases in the assessments for the SIF, as there are many accepted claims for which benefits will be paid for years in the future. However, SIF assessments would decrease until all the claims were paid.

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### **Savings from Phasing Out the SIF**

In addition to savings from the gradual reduction in SIF assessments, there are other sources of workers' compensation savings that would be realized over time from discontinuing the SIF.

#### **Administrative Cost Savings**

The phasing out of the SIF would provide savings through the gradual elimination of administrative costs. Over the last three fiscal years, the average annual operating costs of the SIF were approximately \$1.6 million. These costs include payroll, supplies, travel, and other expenditures.



Another administrative cost associated with the SIF relates to the practice of hiring recovery agencies to aid in the determination of and submission of relevant claims to the SIF. These agencies, which work on a contingency basis, add a cost to the workers' compensation system. Recovery agency officials, SIF officials, and insurers reported that companies charge different fees, ranging from 7% to 15% of the total amount reimbursed to the employer by SIF. Based on data received from SIF, information from recovery agencies and others in the field, we estimated that \$7.3 to \$11.1 million was spent by South Carolina insurance carriers and self-insurers in FY 05-06 for fees to recovery agencies. This would include administrative costs for the claims they handled and their profits. The insurance companies and self-insured employers who did not use recovery agencies incurred their own administrative costs to obtain reimbursements from the SIF. However, we could not quantify these costs.

The administrative costs associated with the SIF would be steadily eliminated by phasing out the SIF. As the fund is phased out, it would continue to incur some costs; however, these costs would continue to decrease as the number of claims accepted continued to decline. Once the fund was closed, these administrative costs would be eliminated from the workers' compensation system, providing savings for employers and insurance carriers throughout the state.

### **Savings in Lower Claims Costs**

Although there is no way to obtain evidence to quantify these savings, officials from the Department of Insurance and the insurance industry agreed that claims would cost less if there were no SIF to reimburse claim payments. Insurers and employers do not have as much incentive to minimize the amount paid on a claim if someone else (i.e., the SIF) is paying. If the SIF were eliminated, NCCI has estimated a 30% gain in efficiency for claims that would have been reimbursed by the SIF. The NCCI's estimate includes administrative cost savings discussed above.

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## **Recommendation**

2. The General Assembly should enact legislation to phase out the Second Injury Fund by closing the fund to claims for injuries occurring after a specified date.

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## Other States' Second Injury Funds

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We identified 24 fully active second injury funds in the U.S., although other states have non-comparable agencies that have similar purposes. We found that states have been phasing out their second injury funds. We also identified some significant differences between S.C.'s Second Injury Fund and funds in other states. If the South Carolina SIF is continued, certain changes would reduce its size and cost.

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### Funds Being Phased Out

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Since 1990, 16 funds have closed, though many of them are still in the process of paying off claims that were accepted prior to a cutoff date (see Table 2.1). Fund administrators cited a variety of issues that led to the closing of their funds. These included excessive costs and the passage of the Americans with Disabilities Act (ADA) which replaced the SIF's purpose. We asked representatives from many closed funds about significant effects, particularly negative ones, that had occurred following the closing of second injury funds. None reported any negative consequences.

Georgia's second injury fund is similar to South Carolina's SIF. Georgia closed its fund to injuries occurring after July 1, 2006, and any claim must now be accepted within 36 months once the notice of intent to file has been submitted. According to a Georgia official, Georgia's fund was closed primarily over concern that it was no longer serving its originally intended purpose. Georgia officials did not yet have an estimate of the effect of closing the fund on employers' costs. This assessment should be available by July 30, 2007.

**Table 2.1: Second Injury Funds Closed Since 1990**

STATE	YEAR CLOSED
Alabama	1992
Colorado	1993
Connecticut	1995
District of Columbia	1999
Florida	1998
Georgia	2006
Kansas	1993
Kentucky	1996
Maine	1992
Minnesota	1992
Nebraska	1997
New Mexico	1996
Rhode Island	1998
South Dakota	2001
Utah	1994
West Virginia	2003

This list does not include Oklahoma, whose fund was closed but then reopened in a different form, or Vermont, which in 1999 repealed legislation regarding a second injury fund that was never operational.

## Fund Characteristics

We sent questionnaires to 37 states for which we could find contact information, and that we believed had a fund that still had active claims. We received replies from 29 of these states. From these questionnaires and a series of follow-up phone interviews, we confirmed that there are 24 fully active second injury funds in the U.S. These funds vary widely in their size, scope, and operation, and not all are comparable to South Carolina's fund.

We found that South Carolina's SIF is very large in scope compared to funds in other states. South Carolina's payouts for FY 05-06 totaled \$147.6 million. Only three states had annual payouts greater than \$75 million. The average annual payout for reporting states was \$27 million. As of January 2007, South Carolina had 9,245 open claims. The number of active claims for other funds ranged from 7,660 (Georgia) to 18 (Pennsylvania).

We identified three features of South Carolina's fund that made it larger than other funds.

**Point of Liability** — South Carolina's SIF assumes more liability for claims than funds in other states. The point of liability is the time period after which a second injury fund will begin reimbursing payments for injuries. The most common point of liability for second injury funds is 104 weeks. South Carolina's fund begins reimbursements after 78 weeks, which is sooner than all other funds we reviewed.

**Injuries covered** — South Carolina's fund assumes liability for more disabilities than funds in other states. Many states' statutes establishing second injury funds, including South Carolina's, list specific conditions that qualify as pre-existing disabilities. Most states that do include lists have between 20 and 30 qualifying conditions; South Carolina has 34 listed conditions. One of these is an open-ended, catch-all category that could encompass most disabilities not appearing in the list. This contributes to the broad coverage of S.C.'s fund.

**Time limits for accepting claims** — Currently, there is no time limit for submitting a claim for acceptance to the South Carolina SIF. Carriers and insurers must submit notice to the fund that they intend to seek reimbursement within 78 weeks of starting to pay benefits to the claimant. However, once this intent has been filed, there is no additional timetable requiring the claim be submitted or accepted. Other states have limits on when claims must be made to their second injury funds. For example, in Florida proof of the claim must follow notice of the claim within one year. Excessive delays in submitting claims may result in higher workers' compensation costs for employers (see p. 11).

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## Conclusion

Our review of other states' funds did not identify any reason that the SIF should be continued. Although other states' funds may differ significantly from South Carolina's SIF, some characteristics of these funds could be used to reduce the scope of S.C.'s SIF. The point of liability where the fund begins reimbursing costs could be changed from 78 weeks to 104 weeks. The number of conditions listed in the statute as pre-existing disabilities could be reduced. When a large number of conditions are assumed to be a prior disability, the second injury funds can become liable for claims that may not meet the purpose of the fund (see p. 8). Also, a time limit on accepting claims could ensure that eligible employers receive premium reductions as a result of SIF reimbursements (see p. 11).

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## Recommendation

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3. If the General Assembly does not phase out the Second Injury Fund, S.C. Code §42-9-400 should be amended to:
    - Change the SIF's point of liability from 78 weeks to 104 weeks.
    - Reduce the number of conditions considered pre-existing disabilities.
    - Add a time limit for filing claims once the notice of intent to file has been submitted.
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## Claims Management

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One of our objectives was to determine whether Second Injury Fund claims are handled efficiently and in compliance with the law. We reviewed a random sample of 100 accepted claims and 25 denied claims from FY 03-04 through FY 05-06. We concluded that the agency has adequate internal controls in place for processing claims, and we found no material problems with how the claims in our sample were handled.

The SIF requires certain documentation for a claim to be accepted. In our sample, we found that all files reviewed contained:

- Documentation that the decision to accept or deny was reviewed by two supervisors.
- Evidence of narratives from medical professionals regarding the relationship of the subsequent injury to the pre-existing condition.
- Evidence of employer knowledge of the employee's pre-existing condition, as required by §42-9-400(c) and §42-9-410(d) of the S.C. Code of Laws.

For injuries occurring prior to June 25, 2003, the employer knowledge requirement could be fulfilled if the employee was not aware that the condition existed prior to the subsequent injury. In cases in this category, all files contained statements from the employees that they were unaware of their conditions.

We also reviewed reimbursement requests for the claims in our sample. We found, with few exceptions, that at least two SIF staff members verified reimbursement amounts and SIF staff documented any changes to reimbursement amounts.

For both accepted and denied claims, we were able to match the data in the paper files with the data in electronic form on the agency's claims management system. Based on this review, we did not have concerns about the validity of the SIF's electronic claims data.

## Comparative Data

Evidence indicates that the South Carolina SIF is efficient in handling claims. The SIF publishes data in its annual report on two performance measures — the average number of days to pay claims and the administrative cost per claim. For these measures, the SIF compares South Carolina to Georgia and Louisiana (see Table 2.2).

**Table 2.2: Performance Measures for SIF Claims**

STATE	AVERAGE NUMBER OF DAYS TO PAY A CLAIM		AVERAGE ADMINISTRATIVE COST PER CLAIM	
	FY 04-05	FY 05-06	FY 04-05	FY 05-06
Georgia	112	150	\$ 90.08	\$100.66
Louisiana	120	120	\$152.07	*
South Carolina	21	11	\$ 71.97	\$ 68.32

\*Data not available.

Source: Second Injury Fund

We conducted a limited review and found that Georgia and Louisiana have funds whose operations can be appropriately compared to South Carolina's. Also, based on conversations with Georgia and Louisiana officials and a review of the data used by the South Carolina SIF to compute its measures, we did not identify problems with the validity of the SIF's reporting of comparative performance data.

# Agency Comments

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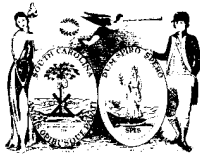
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**Appendix**

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# The South Carolina Second Injury Fund



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March 20, 2007

Mr. George L. Schroeder, Director  
Legislative Audit Council  
1331 Elmwood Avenue, Suite 315  
Columbia, SC 29201

Dear Mr. Schroeder:

Thank you for the opportunity to comment on the final draft report "*A Review of the South Carolina Second Injury Fund*". We appreciate the professionalism shown by your staff, led by Jane I. Thesing, in conducting the audit.

As the administrators of the Fund, we take no position on the audit objective as to whether the Second Injury Fund should be continued or phased out. The S.C. Legislature is currently working on proposed Workers' Compensation Reform legislation, which will include language concerning the Second Injury Fund.

The audit substantiates that the agency's long standing objectives:

- Prompt determination of eligibility
- Efficient claims processing and payments
- Containment of claims cost
- Sound fiscal management

and our agency's values:

- Administer claims in a fair and impartial manner
- A highly professional and well-trained staff
- Continuous improvement of services

have resulted in the efficient handling of claims and the compliance of S.C. Workers' Compensation laws, rules and regulations. The audit confirms our comparison to "like" funds in Georgia and Louisiana. It validates that we are the "benchmark" for other funds to emulate in the area of claims management.

We will continue to work with legislators, their staff, and any other interested parties in the reform of the Second Injury Fund and the S.C. Workers' Compensation System.

Sincerely,

A handwritten signature in black ink, appearing to read 'William E. Gunn'. The signature is fluid and cursive, written over a white background.

William E. Gunn  
Interim Director



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