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Missouri State Auditor

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LABOR AND INDUSTRIAL RELATIONS

Second Injury Fund



Fund Likely To Become Insolvent Unless Corrective Action Taken

The Department of Labor and Industrial Relations (DOLIR) paid approximately \$68 million during 2006 on Second Injury Fund (fund) claims by injured employees and for administrative costs. The department has responsibility for the fund, which supplements workers' compensation benefits paid to injured workers. On January 16, 2007, the Governor requested the State Auditor's Office (SAO) conduct an audit of the fund. We focused audit objectives on determining (1) whether fund expenditures had been properly disbursed, (2) the fiscal soundness of the fund, (3) the impact of 2005 legislative changes on the fund, (4) the potential impact of a recent Missouri Supreme Court decision on fund solvency, and (5) whether DOLIR projections of future fund performance have been accurate.

Fund insolvency likely in 2008	Based on our review of DOLIR fund projection data, and discussions with officials at the Department of Insurance, Financial Institutions and Professional Registration, DOLIR, the Division of Workers' Compensation, and the Attorney General's Office, the fund will likely become insolvent during 2008. (See page 9)
Legislative changes limit fund revenue and should reduce expenditures	The 2005 legislative change to the workers' compensation law capping the fund surcharge rate at 3 percent limits DOLIR's ability to generate revenues sufficient to cover fund expenditures. Based on our estimates, expenditures are projected to outpace revenues by approximately \$57.5 million from 2007 through 2009, an average of \$19.2 million per year. The legislative changes have also resulted in a reduced number of fund claims. However, it will take several years for the reduced number of claims to result in reduced fund expenditures. (See page 10)
Impact of Supreme Court decision not known	In addition to legislative changes, the fund may also be impacted by a January 2007 Missouri Supreme Court decision. The decision stated permanent total disability benefits are to be paid to an employee's dependent(s) in the event the employee subsequently dies from causes not related to the work-related injury. However, the division does not obtain information regarding the existence of dependents for its case files. Without information on dependents, the potential financial impact of the decision cannot be determined at this time. (See page 12)
No contingency plan exists in the event of insolvency	State statutes do not contain provisions allowing DOLIR to generate additional funds in the event of insolvency. If the fund becomes insolvent, benefits would be in danger of not being paid because state statutes do not guarantee payment of these benefits through any other means. (See page 12)
Pending legislation will not address short-term solvency concerns	Several pieces of pending legislation propose to make changes to control costs of the fund. However, none of the bills currently pending make changes to address the short-term solvency of the fund, therefore additional funding sources are needed to address this short-term insolvency of the Second Injury Fund. (See page 13)

Fund projections could be improved

DOLIR personnel have not always obtained all available information relevant to the future performance of the fund when making fund projections used to set the annual surcharge rate. As a result, fund projections have been inaccurate, leading to high fund balances in the past. (See page 14)

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Abbreviations

DOLIR	Department of Labor and Industrial Relations
DIFP	Missouri Department of Insurance, Financial Institutions and Professional Registration
NA	Not Applicable
PPD	Permanent Partial Disability
PTD	Permanent Total Disability
RSMo	Missouri Revised Statutes
SAO	State Auditor's Office



SUSAN MONTEE, CPA
Missouri State Auditor

Honorable Matt Blunt, Governor
and
Members of the General Assembly
and
Rod Chapel, Director
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The Department of Labor and Industrial Relations (DOLIR) paid approximately \$68 million during 2006 for Second Injury Fund (fund) claims by injured employees and for administrative costs. The department has responsibility for the fund which supplements workers' compensation benefits paid to injured workers. On January 16, 2007, the Governor requested the State Auditor's Office (SAO) conduct an audit of the fund. The Governor also expressed concerns regarding the financial condition of the fund and the impact a recent Missouri Supreme Court decision will have on the fund. We focused our objectives on determining (1) whether fund expenditures had been properly disbursed, (2) the fiscal soundness of the fund, (3) the impact of 2005 legislative changes on the fund, (4) the potential impact of a recent Missouri Supreme Court decision on fund solvency, and (5) whether DOLIR projections of future fund performance have been accurate.

We found fund disbursements have been made properly. However, we also found the fund will likely become insolvent during 2008 because changes in Missouri's workers' compensation law capped the employer surcharge rate at 3 percent. Therefore, DOLIR's ability to assess a fund surcharge rate sufficient to generate enough revenue to cover fund expenditures has been eliminated. Changes to the law should also result in fund expenditure reductions; however, it may take several years to realize the reductions. In addition, a January 2007 Missouri Supreme Court decision will result in additional future fund liabilities; however, the potential financial impact of the decision cannot be determined at this time. We found state law does not provide a sufficient contingency plan to address any potential fund insolvency, and as a result, benefits to injured workers may be in jeopardy unless the department or the General Assembly acts to resolve the fund's pending insolvency. None of the bills currently pending in the General Assembly make changes to address the short-term solvency of the fund. We also found DOLIR personnel responsible for formulating fund projections have not always obtained all available information relevant to the future performance of the fund. Instead, DOLIR has relied on past performance trends. As a result, projected fund expenditures have been overstated while the premium base projections, and therefore revenues, have been understated.

We conducted our audit in accordance with applicable standards contained in *Government Auditing Standards*, issued by the Comptroller General of the United States, and included such procedures as we considered necessary in the circumstances. This report was prepared under the direction of John Blattel and key contributors to this report included Robert Spence, Bobby Showers, and Nicki Russell.

A handwritten signature in cursive script that reads "Susan Montee".

Susan Montee, CPA
State Auditor

Introduction

The General Assembly created the Second Injury Fund (fund) in 1943 to benefit the physically handicapped and individuals with previous work-related disabilities. The legislature established the fund to encourage the employment of previously injured or disabled individuals without exposing employers to liability for previous disabilities. The basis for this legislation rests in the belief that an employer will not hire a job applicant for dangerous work involving the extremities if that applicant has previously become disabled in an extremity.¹ The fund, with 2006² expenditures of \$68 million, supplemented workers' compensation benefits paid to injured workers. Workers' compensation benefit payments totaled approximately \$716 million in 2005.³

When an employee sustains a compensable work injury and the combined effect of the work-related injury and the previous injury or disability results in permanent total disability (PTD), or increased permanent partial disability (PPD), the employer at the time of the current injury is only liable for the compensation resulting from that injury. The additional compensation due to the employee over and above the current injury is paid from the fund. The fund also pays benefits in several other instances described below.

Fund revenues are generated by an employer surcharge which is based on each employer's workers' compensation insurance premium. The surcharge is paid by both insured employers and self-insured employers.⁴ The surcharge rate is set annually by DOLIR's Division of Workers' Compensation (division) using a formula which is set in statute.⁵ The formula requires the division to project fund expenditures for the coming year and, in combination with the beginning fund balance, the surcharge rate is set to provide enough revenue to pay expenses for the coming year plus a 10 percent cushion. The General Assembly changed the law in 2005 to cap the surcharge rate at 3 percent. The surcharge rate and the effect of the 3 percent cap are discussed in greater detail on pages 9 and 10.

¹ Slusher, *The Second Injury Fund*, 26 Mo. L. Rev. 328 (1961).

² Unless otherwise identified, all years are expressed as calendar years.

³ Figure represents benefits paid from private insurance, self-insured companies, and self-insured trusts in 2005. The benefit payment data for 2006 was not available, as of February 28, 2007.

⁴ An insured employer includes the fund surcharge, along with an insurance payment, to its insurance company. The insurance company remits the surcharge payment to the state. The division bills self-insured employers for the surcharge and those employers remit payments to the state.

⁵ Section 287.715(2), RSMo.

Benefit Types

Pursuant to state statutes, the fund pays benefits to injured employees in the following instances:

- PTD – If the current injury, in combination with an eligible prior injury or disability, results in a PTD, the fund is liable for the lifetime benefits to that employee. The employer would be liable for the compensation payable for the current injury as if no prior injury existed. The fund has paid PTD benefits since its inception in 1943.
- PPD – In order for an injured employee to be eligible for PPD benefits the employee's prior injury must exceed a 12.5 percent total body disability or 15 percent disability of a major extremity. The fund only pays the portion of the combined injury which exceeds the disability of the most recent injury and the prior injury. The employer would be liable for the compensation resulting from the current injury alone. The fund has paid PPD benefits since 1955.
- Death Benefits – In the event an employee dies while working for an uninsured employer the fund compensates the employee's family for burial expenses and provides death benefits for the employee's dependents. The fund has paid death benefits since 1982.
- Rehabilitation Benefits – In the event an employee is seriously injured, the fund can be used to return the employee to a condition of self-support and self-maintenance. Conditions that may qualify an employee for rehabilitation benefits include: quadriplegia, paraplegia, amputations, and back injuries not responsive only to medical treatments. The fund has paid rehabilitation benefits since 1951.
- Indemnity Benefits – In the event an employee is injured on one job and is therefore unable to work at a second job, the fund compensates the employee for the lost wages of the second job. The fund has paid indemnity benefits since 1993.⁶
- Uninsured Employer Benefits – The fund is liable for the medical bills of employees injured while working for an uninsured employer. By law, the fund is entitled to reimbursement from the uninsured employer. The fund has paid uninsured employer medical benefits since 1980.

⁶ Except during a 2-year period in the 1990's when the statutory provision for this benefit expired.

Attorney General's role and fund expenditures

The Missouri Attorney General defends the fund against claims made against it. Worker filed claims averaged 12,274 per year from 1997 through 2006, and the Attorney General's Office dismissed an average of 7,507 (61 percent) claims for those years. See Appendix III for additional information on claims and dismissals. In 2006, a total of 10,591 claims were filed against the fund. As of January 30, 2007, the Attorney General's Office maintained a backlog of 32,069 fund cases. In addition to payment of the benefits described above, administrative expenses, consisting primarily of Attorney General Office personnel costs, are also paid from the fund.

Table 1.1 depicts itemized fund expenditures and a breakdown of cases filed by type for 2006. Table 1.1 also contains a breakdown of the Attorney General's case backlog as of January 30, 2007.

Table 1.1: Fund Expenditures and Cases Served by Type - 2006

Benefit Type	Amount	Percent of Total	Cases Served¹ 2006	Percent of Total	Cases Backlogged³	Percent of Total
PTD	\$44,424,189	65.0	1,456	25.7	6,216	19.4
PPD	18,036,166	26.4	3,724	66.0	24,521	76.5
Uninsured Employer	898,828	1.3	45	0.8	642	2.0
Indemnity	195,697	0.3	95	1.7	684	2.1
Death	170,483	0.2	9	0.2	6	<0.1
Rehabilitation	151,743	0.2	314	5.6	0	0.0
Administration and Other	4,517,227	6.6	NA ⁴	NA	NA	NA
Total	\$68,394,333	100.0	5,643²	100.0	32,069	100.0

¹ A "served" case is defined as any fund case receiving either an ongoing or settlement payment in a given year.

² Total does not agree to the total number of cases served presented in Appendix III because a case can receive more than one type of benefit.

³ Includes cases that will be dismissed as well as cases that will be served. Information is not available on dismissed cases by type for 2006.

⁴ Not Applicable.

Source: Division of Workers' Compensation and Attorney General's Office data.

For historical information on fund revenues, expenditures, and changes in fund balance, see Appendix I and II.

The fund has experienced an increase in the number of cases settled by lump-sum in recent years. According to an Attorney General's Office official this increase has occurred because the maximum settlement that can be offered to a claimant increased from \$40,000 to \$60,000 in 2001. According to the official, the state increased the amount to encourage fewer claimants to pursue claims in court. Settling claims has resulted in increasing efficiency in handling cases and reducing the fund's potential exposure to long-term liabilities compared to paying benefits over a claimant's lifetime, according to an Attorney General's Office official.

Comparison to other states is difficult

Comparisons of state workers' compensation systems are difficult because of variations in state laws, according to an official at the Workers Compensation Research Institute. Thirty-five states, including Missouri, maintain a second injury fund. While all 35 states pay PTD benefits, Missouri and 17 other states pay PPD benefits. Two of the 17 pay PPD benefits in very limited situations. As shown in Table 1.1, Missouri paid \$18 million in PPD payments in 2006, which represented about 26 percent of total expenditures. However, as shown above, PPD cases account for 66 percent of the cases served in 2006.

Recent Law Changes

Missouri's workers' compensation laws⁷ underwent significant changes, effective August 2005. Changes included (1) more narrowly defining the definition of an "accident", (2) tightening the definition of what constituted a work-related injury, and (3) strengthening penalties for workers' compensation fraud committed by employers and employees. The law changes also included a cap to the fund surcharge rate of 3 percent. See page 10 for additional discussion of the impact of these law changes on fund solvency.

Court case will impact the fund

In addition to the changes discussed above, the fund will be impacted by a January 2007 Missouri Supreme Court decision⁸ which stated PTD benefits are to be paid to an employee's dependent(s) in the event the employee subsequently dies from causes not related to the work-related injury. The benefits are only due to dependents that were dependents at the time of the work-related injury, however, the Supreme Court did not define dependent, according to division officials. See page 12 for additional information on this issue.

Scope and Methodology

In conducting our review of the fund, we interviewed officials at the Department of Labor and Industrial Relations (DOLIR), the division, the Missouri Department of Insurance, Financial Institutions and Professional Registration (DIFP), and the Attorney General's Office.

To determine whether fund disbursements have been properly made, we relied on audit work performed during SAO's annual statewide financial statement audit work done at the division. The work performed included assessments of internal controls over revenues and expenditures of the fund, and a test of benefit payments which determined payments from the fund had been properly distributed by DOLIR.

⁷ Workers' compensation laws are found in Chapter 287, RSMo.

⁸ *Schoemehl v. Treasurer of the State of Missouri*.

In addition, as part of our review of disbursements, we assessed Attorney General's Office procedures used in determining whether to recommend a case go to trial or be offered a lump-sum settlement. We reviewed case files which included financial and actuarial information used by the Attorney General's Office in making determinations. We consider procedures used to be adequate. Therefore, we did not perform any additional audit work in this area.

To determine the fiscal soundness of the fund, we reviewed the validity and accuracy of DOLIR's solvency projections of the fund. We also reviewed the underlying assumptions behind those projections and validated those assumptions by reviewing the fund's past performance as well as reviewing other relevant information. We reviewed information pertaining to insurance premiums at DIFP as well as information related to fund expenditures at the Attorney General's Office in formulating our projection of fund solvency. Our projection, presented on page 10, represents the average of two DOLIR projection scenarios, the first of which assumes a 5 percent increase in claim payments and a 5 percent reduction in premium base. Both the increase in expenditures and reduction in premium base change at a declining rate versus a flat rate. The other scenario assumes a 5 percent increase in claim payments and no reduction in premium base. Both of these projections assume expenditures increase at a declining rate starting in 2006 and ending in 2010.

To determine the impact of the 2005 legislative changes on the fund, we conducted interviews with officials at DOLIR, DIFP and the Attorney General's Office. DOLIR officials provided information regarding the projections of revenues and expenditures used to calculate the surcharge rate. DIFP officials provided information regarding the impact of the 2005 legislative changes on the insurance premiums charged to employers. We consulted an official at the Attorney General's Office regarding the impact of the 2005 legislation on the number of second injury fund claims and expenditure projections.

To determine the impact of the Missouri Supreme Court case, we requested information from the division regarding the number of cases which fell into the same benefit classification as the *Schoemehl* case, and the dollar value of the benefits paid on those cases.

To determine the accuracy of DOLIR's projections of fund performance, we compared projected revenues and expenditures used in calculating the fund's surcharge rate to actual fund revenues and expenditures. The variances in actual and projected figures were analyzed for trends.

We requested comments on a draft of our report from the Director of DOLIR. We conducted our review of the fund during January and February 2007.

Fund Likely To Become Insolvent Unless Corrective Action Taken

The Second Injury Fund (fund) will likely become insolvent during 2008. This situation has occurred because changes in Missouri's workers' compensation law have limited the division's ability to assess a fund surcharge rate sufficient to cover fund expenditures and expected reductions in fund expenditures may take several years to occur. In addition, a January 2007 Missouri Supreme Court decision will result in additional future fund liabilities. State law has not provided a sufficient contingency plan to deal with fund insolvency, and as a result, benefits to injured workers may be in jeopardy unless DOLIR and the General Assembly act to resolve the fund's pending insolvency.

In addition, DOLIR's projections of fund revenues and expenditures have not always resulted in accurate predictions of fund performance. This situation has occurred because the department has not always obtained all relevant information that has been available from the Attorney General's Office and DIFP. As a result, DOLIR has overestimated expenditures and underestimated revenues in recent years.

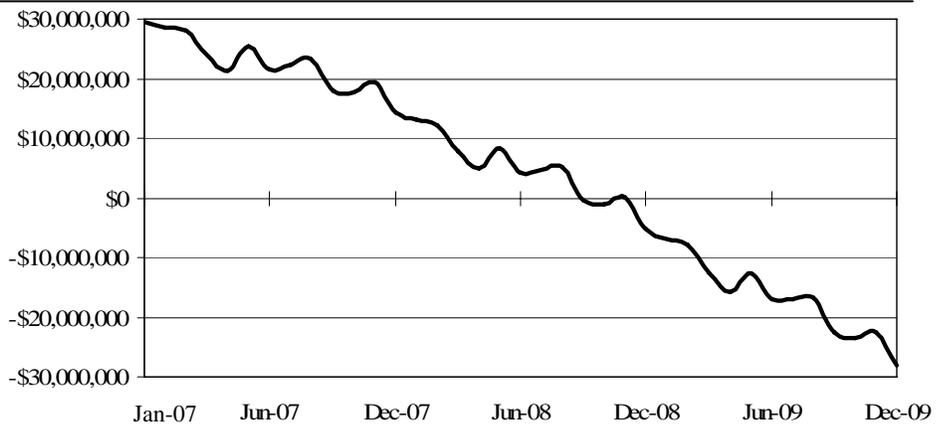
Fund Insolvency Likely In 2008

DOLIR projects the fund will become insolvent during calendar year 2008. According to a DOLIR official, the exact timing of the insolvency is difficult to predict due to the uncertainty of several factors, including the effect of the 2005 workers' compensation law changes on the workers' compensation insurance premium base, and the level of expenditures from the fund. However, DOLIR financial management personnel have generated projections for numerous fund performance scenarios based on various levels of premium base (revenue) and expenditure growth. Based on those scenarios, department officials have used a range of June to December 2008, as estimated dates the fund will become insolvent.

Based on our review of DOLIR data, and discussions with officials at the DIFP, DOLIR, the division, and Attorney General's Office, Figure 2.1 represents our projection⁹ of the fund's solvency.

⁹ See discussion of the assumptions used on page 7.

Figure 2.1: Fund Balance Projection - January 2007 through December 2009



Source: SAO projections based on DOLIR data

The above fund balance projection shows a fund balance of approximately \$14 million at the end of 2007, negative \$5 million at the end of 2008, and a negative \$28 million at the end of 2009. DOLIR and division officials stated our projection represented a fair assessment of future fund performance.

Legislative changes limit fund revenue and should reduce future expenditures

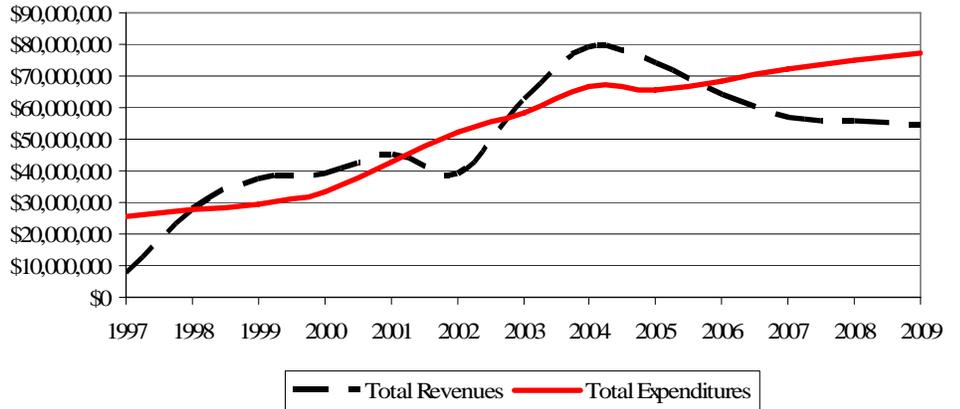
Legislative changes to the workers' compensation law¹⁰ capping the fund surcharge rate at 3 percent limits DOLIR's ability to generate revenues sufficient to cover fund expenditures. Based on our estimates, expenditures are projected to outpace revenues by approximately \$57.5 million from 2007 through 2009, an average of \$19.2 million per year and may continue to outpace revenue in future years. This result is consistent with information presented in the fiscal note for Senate Bill 1 which stated "capping the rate at 3.0 percent would reduce receipts by \$27,871,046 in calendar year 2006, \$46,451,744 in calendar year 2007 and \$65,032,441 in calendar year 2008."

The surcharge rate calculation is defined by statute. Prior to the legislative changes capping the surcharge rate at 3 percent, the formula ensured a surcharge rate which would result in sufficient revenues, in combination with the starting fund balance, to cover projected expenditures plus a 10 percent cushion. Historically, the surcharge rate has exceeded 3 percent in 3 of the previous 11 years, with a high of 4 percent in 2003 and 2004.

In addition, changes to the law are expected to reduce workers' compensation claims, which should result in a reduction in commercial insurers' premiums charged to employers. Reducing the premium base,

¹⁰ See Senate Bill 1 and 130 from 2005.

Figure 2.2: Fund Revenues and Expenditures - 1997 through 2009



Source: SAO projections based on DOLIR data.

Using our expenditure projections, the surcharge formula results in a rate for 2008 of 3.5 percent, however the current statutes cap the rate at 3 percent. The 3.5 percent rate would increase employer fund payments, and generate sufficient revenue to maintain fund solvency through 2008. The following example illustrates the impact of this rate on an individual employer. Assuming an employer paid a workers' compensation insurance premium of \$1,000 in 2008, the employer would pay a \$30 fund payment¹¹ at the statutorily capped rate of 3 percent. Using the estimated rate of 3.5 percent for 2008, this same employer's fund payment would increase \$5, from \$30 to \$35.¹²

Law changes should result in reduced future fund expenditures

Changes to the 2005 workers' compensation law have resulted in reduced fund claims, according to a DOLIR official. The number of fund claims declined by 21 percent from 2005 to 2006 compared to about 6 percent from 2003 to 2005, according to division data. See Appendix III for historical claims filed. However, according to an Attorney General's Office official, it will take several years for the reduced number of claims to result in reduced fund expenditures. According to the official, it takes a fund claim

¹¹ Amount represents the \$1,000 workers' compensation insurance premium times 3 percent.

¹² Amount represents the \$1,000 workers' compensation insurance premium times 3.5 percent.

approximately 2 to 3 years to be completed because of the nature of employee injuries involved. As of January 30, 2007, the Attorney General's Office had 32,069 open fund cases. Therefore, based on our analysis of future fund revenue and expenditures, although future fund expenditures are expected to decline, expenditures will exceed revenue through 2009.¹³

The information presented above is consistent with the initial fiscal note for Senate Bill 1 which also shows reductions in fund benefit payments will be minimal for fiscal years 2006 to 2008. The final fiscal note states the fiscal impact of Senate Bill 1 on fund expenditures is unknown.

Impact of *Schoemehl* decision not known

The *Schoemehl* case involves a PTD case in which the division awarded a weekly judgment of benefits to an injured worker. The Missouri Supreme Court's decision stated weekly PTD benefits are to carry forward to dependents of a deceased employee. However, the division does not obtain information regarding the existence of dependents for its case files. Without information on dependents, the potential financial impact of the decision cannot be determined at this time, according to DOLIR officials. As of January 30, 2007, the division had 745 similar PTD cases where weekly lifetime payments were being made, and the division paid \$17.8 million on those cases in 2006, for an average of approximately \$23,900 per case. According to information provided by the division, an average of 13 PTD lifetime payment recipients died per year from 2001 through 2006. Division personnel did not know how many of these claimants, if any, had dependents at the time of their injury. The *Schoemehl* decision will result in benefits continuing to be paid in those PTD cases where a recipient dies leaving a dependent, but does not result in new benefit cases.

An official at the Attorney General's Office stated the defense of future PTD claims would need to take into account the existence of dependents at the time of the injury.

No contingency plan exists in the event of insolvency

State statutes do not contain any provisions allowing the division to generate additional funds in the event of insolvency. One state statute¹⁴ does contain a provision to allow the division to use workers' compensation administrative funds to supplement the fund, if needed. The fiscal note for Senate Bill 1 also mentioned using workers' compensation administrative funds as a possible solution in the event of insolvency. However, the administrative fund does not have sufficient funds to avoid the insolvency of

¹³ Because the impact of the 2005 legislative changes on expenditures past 2009 is not fully known, an accurate projection of future expenditures is not available.

¹⁴ Section 287.715(2), RSMo.

Pending legislation will not address short-term solvency concerns

the Second Injury Fund, according to a division official. According to division officials, there is no contingency plan in place in the event of insolvency and the division does not know what would happen with benefit payments. According to division legal counsel, benefits would be in danger of not being paid because state statutes do not guarantee payment of these benefits through any other means.

Several pieces of pending legislation¹⁵ propose to make changes to control costs of the fund. However, none of the bills currently pending make changes to address the short-term solvency of the fund.

One proposed change eliminates the fund starting January 1, 2008. While this change would eliminate the insolvency problem of the fund in the long-term, funding would still be necessary to pay benefits to pending claims in 2008 and future years. Such a change would also require legislative changes to address workers with prior injuries and the extent to which their injuries are compensable under the regular workers compensation process. The cost of compensating workers for these types of injuries would not be eliminated, but would need to be covered by the employer or the employer's private insurance policy. Increasing private insurance coverage would likely result in increases to insurance premiums to employers.

Another proposed change is the elimination of PPD benefits on future claims. Elimination of PPD benefits would reduce expenditures, however, due to the 2- to 3-year time lag cases must go through before benefits are paid out, the effects of the reduction in benefits would not be felt immediately. The fund would still face insolvency for 2008 and 2009, PPD benefits for 2006 totaled \$18 million. In comparison, expenditures are projected to exceed revenues by \$19.5 million in 2008, and \$22.8 million in 2009.

Several proposals are intended to reverse the effects of the Supreme Court's *Schoemehl* decision. The language in the bills to remove the effects of the *Schoemehl* decision will impact the long-term liabilities of the fund by limiting dependents of PTD claimants from receiving benefits once the claimant passes away. However, based on information available, the decision is not expected to have an impact on the short-term solvency of the fund.

¹⁵ Workers' Compensation bills pending in the General Assembly as of April 4, 2007 include: Senate Bills 277, 606, 665, and 668, and House Bills 629, 685, 1147, and 1278.

Fund Projections Could Be Improved

DOLIR's financial management section provides fund projections used to set the annual surcharge rate and monitor fund solvency. However, section personnel have not always obtained all available information relevant to the future performance of the fund. Instead, recent expenditure and revenue projections have been primarily based on past performance trends, according to a DOLIR official. For example, DOLIR has not been aware information on future fund expenditures has been available from the Attorney General's Office, according to the official. The Attorney General's Office has specific knowledge of the number of cases expected to be finalized in the coming year and has information regarding trends in the settlements reached in past years and how they will affect future expenditures, according to an Attorney General's Office official. Based on current history, DOLIR's current projection of a 5 percent increase in fund expenditures may be overstated, according to the official.

More timely revenue information is available

In order to project fund revenues, DOLIR projects the workers' compensation premium base, which the surcharge rate will be charged against. However, DOLIR officials have not obtained the most current information available from DIFP regarding workers' compensation insurance rates. For example, insurance company rate change information is available on an ongoing basis from DIFP. Insurance officials provided us with the 2006 rate reduction which reflected a 2.2 percent reduction for the market as a whole. However, DOLIR officials did not know this information has been available and DIFP has not shared the information with the department, according to a DOLIR official. Instead, DOLIR normally uses a DIFP report that includes 10-month old premium base information.¹⁶

Inaccurate projections resulted in high fund balances

Inaccurate projections resulted in the fund experiencing its highest year end fund balances in a decade in 2005 and 2006. (See Appendix I for historical information.) For these years, we found projected expenditures were overstated, while the premium base projections, and therefore revenues, were understated. These two factors combined to result in an accumulating fund balance the past two years. The high fund balances have resulted in the division calculating a 3 percent surcharge and the fund remaining solvent for 2006 and 2007. Therefore, the statutory cap rate did not become a factor when setting the 2006 and 2007 rates.

Actuarial reports not useful

State statute¹⁷ requires the division to contract for an actuarial study "to determine the solvency of the fund, appropriate funding level of the fund,

¹⁶ The timing of the premium base report and DOLIR's surcharge rate calculation are set by statute. Therefore, the premium base information used is the most current available.

¹⁷ Section 287.220(6), RSMo.

and forecasted expenditures from the fund." However, our review of the two latest reports¹⁸ disclosed the actuarial projections contained inaccuracies. The reports' projected expenditures have been understated by as much as 32 percent in 2004 and overstated by as much as 28 percent in 2006. Projections of the premium base, and therefore revenue, have also been consistently understated. Division officials stated because of these inaccuracies and because the information becomes outdated quickly, the actuarial reports have been of little to no use in helping project future fund activity. The division spent approximately \$27,000 on its most recent actuarial report in 2005. Proposed legislation¹⁹ would require the completion of actuarial reports on an annual basis.

Conclusions

Legislative changes implementing the 3 percent surcharge cap have eliminated the division's ability to assess an employer surcharge rate sufficient to cover fund expenditures. As a result, the fund will become insolvent during 2008 unless corrective action is taken. Prior to the legislative changes in 2005, the surcharge rate formula, in place since 1993, was a self-adjusting fund mechanism which used a variable surcharge rate to ensure revenues were sufficient to cover expenses. While the 2005 changes are expected to result in fund expenditure reductions, the changes will also impact the premium base, and therefore, the revenue side of the surcharge equation. In the event the premium base drops, a 3 percent surcharge rate will result in less revenue than it did in prior periods. The lack of a variable surcharge rate does not allow the fund to collect adequate funds to remain solvent.

A January 2007 Missouri Supreme Court decision will result in additional future fund liabilities. The short-term impact, through 2009, of the *Schoemehl* decision on fund solvency is likely to be minimal based on the relatively few lifetime PTD recipients who have passed away in recent years. Because there are only 745 active claims being paid that this decision could potentially impact, an additional liability would only be incurred if any of those 745 claimants passes away and had a dependent to claim the benefits. Information on potential dependents of the 745 active lifetime PTD recipients would need to be obtained to accurately project the potential impact of the *Schoemehl* decision. Determining a more specific impact of the *Schoemehl* decision would assist the General Assembly in determining the extent of action to be taken to cover expected shortfalls in funding.

¹⁸ The two latest reports are dated October 2001 and March 2005 and included projections for calendar years 2002 through 2004 and 2005 through 2007, respectively.

¹⁹ Senate Bills 665 and 668, and House Bill 1147.

Action is needed because state statutes provide no contingency plan or funding available to cover the expected shortfall. In addition, pending legislation does not address the short-term solvency concerns of the fund, therefore additional funding sources are needed to address this short-term insolvency of the Second Injury Fund.

Much of the information used by DOLIR to project future fund performance has not been timely and the department has not taken advantage of information available from the Attorney General's Office and DIFP. Using information from those two agencies would assist DOLIR in making more accurate projections of fund performance.

The department has found contracted actuarial studies have not been useful in developing funding forecasts. Current legislation proposing annual actuarial reports does not appear necessary. Therefore, the department should evaluate the appropriateness of contracting for this service and advise the General Assembly of its findings.

Recommendations

We recommend the General Assembly:

1. Take action to ensure fund solvency in 2008 and in the future.

We recommend the Department of Labor and Industrial Relations:

2. Determine how many of the 745 current PTD lifetime recipients had dependents at the time of their injuries. With this information, determine the long-term impact of the *Schoemehl* decision on the fund and inform policy makers.
3. In conjunction with the General Assembly, develop a contingency plan to address potential fund shortfalls.
4. When developing fund projections, ensure all available information relevant to the fund is obtained, including input from DIFP and the Attorney General's Office.
5. Evaluate the usefulness of contracted actuarial studies and report findings to the General Assembly.

Agency Comments

DOLIR Comments

1. *It is the Department's understanding that Audit Recommendation 1 is directed to the General Assembly. Action required to ensure Fund solvency in 2008 and in the future will be discussed in the Department's*

response to Audit Recommendation 3. The Department agrees that to ensure Fund solvency in 2008 and in the future, immediate action is required.

- 2. In order to accomplish this recommendation, the Division will need statutory or court ordered authority to obtain information regarding the existence of dependents in cases impacted by the Schoemehl decision. The Department and the Division concur that the long-term impact of the Missouri Supreme Court's decision in Schoemehl must be determined.*

On March 20, 2007, the Missouri Supreme Court denied a motion for rehearing in Schoemehl, which requested that the Supreme Court reconsider and at the very least clarify its holding in Schoemehl. Based upon how the Labor and Industrial Relations Commission and the Attorney General's Office determine who has been granted benefit rights under Schoemehl, a projection of the costs of those benefits will need to be made through an actuarial study. To project the costs of those benefits, as noted on page 12 of the draft copy of the April audit report, the Division would need to "obtain information regarding the existence of dependents for its case files." The Division does not have this information, because prior to the Supreme Court's decision in Schoemehl the Division had neither a reason nor statutory authority to capture that information in permanent total disability cases.

In his January 16, 2007 letter to the State Auditor, Governor Blunt specifically noted that the Missouri Supreme Court's decision in Schoemehl is a potentially complicating issue facing the Fund. The April draft audit report simply echoes that concern, stating at page 9 that the Supreme Court's "decision may result in additional future fund liabilities." The April draft audit report at page 12 states, without explanation or citation to authority, that the Schoemehl decision "does not result in new benefit cases." The April draft audit report does not consider the potential impact if the Schoemehl decision is applied retrospectively or if it is applied to any of the 32,069 pending Second Injury Fund cases identified by the Attorney General's Office and referenced on page 5 of the April draft audit report.

Despite references to data on page 12 showing average lifetime permanent total disability payments in 2006 of \$23,900 and an average of 13 PTD lifetime recipient deaths per year, the April draft audit report provides no analysis of that available information in terms of Schoemehl's impact on the Fund's solvency. Nothing in the draft audit report indicates that the potential impact of the Schoemehl decision is

reflected in the State Auditor's projections of Fund expenditures from 2007 through 2009 referenced on pages 10, 11 and 13 of the April draft audit report. Although it is noted at page 12 of the April draft audit report that the Attorney General's office advised that "the defense of future PTD claims would need to take into account the existence of dependents at the time of the injury." That potential impact of Schoemehl on the settlement value of Fund claims and defense costs was not explored in terms of its effect on Fund solvency. Rather, at page 13 of the April draft audit report the State Auditor states summarily that "based on information available, the [Schoemehl] decision is not expected to have an impact on the short-term solvency of the fund." This implies that the auditor expects no awards or settlements will be made based on the Schoemehl decision in 2007, 2008, or 2009.

SAO Comments

Based on information shown on page 12 of the report, if all of the PTD claimants who died in 2007 and 2008 had dependents, the maximum estimated impact of the *Schoemehl* decision would be approximately \$300,000 per year. Our projections of fund solvency did not reflect the potential impact of the *Schoemehl* decision. However, any additional expense to the fund as a result of the *Schoemehl* case would be minimal to the fund as a whole.

The Senate has passed Senate Bill 668 which is intended to address the *Schoemehl* decision and this bill is now in the House. In the fiscal note to this bill the Office of Administration indicates that the *Schoemehl* decision would have minimal impact for the state. The methodology used by the Office of Administration in this fiscal note confirms our estimated projections showing minimal impact on the Second Injury Fund as a result of the *Schoemehl* decision.

3. *As noted above, in Audit Recommendation 1, "Take action to ensure fund solvency in 2008 and in the future," the Department and the Division will work to provide information in conjunction with the General Assembly to develop a Second Injury Fund solvency contingency plan to address the projected pending shortfalls in the Fund. If requested, the Division will be available to provide information to the members of the General Assembly and those responsible for the Fund's solvency.*

On page 10 of the April draft audit report, the auditor projects a negative \$5 million Fund balance at the end of 2008. According to the April draft audit report at page 11, using the auditor's "expenditure

projections, the surcharge formula results in a rate for 2008 of 3.5 percent....” According to the auditor: “The 3.5 percent rate would increase employer fund payments, and generate sufficient revenue to maintain fund solvency through 2008.” Using the anticipated premium base, a one-half percent increase in the surcharge rate is currently expected to generate \$9 to \$9.5 million. Using the auditor’s projections, a surcharge rate increase from 3.0 percent to 3.5 percent in 2008 would result in a Fund balance of \$4 to \$4.5 million at the end of 2008. However, in order for the Division to require a 3.5 percent surcharge rate, rather than the current statutory maximum 3.0 percent surcharge rate, an immediate statutory change would be necessary as the Division is required by law to calculate the 2008 Fund surcharge rate by October 31, 2007, and to notify all insurance companies and self-insured employers.

Continuing with the auditor’s projections, at page 10 of the April draft audit report the auditor projects a negative \$28 million Fund balance by the end of 2009. If a 3.5 percent surcharge rate in 2008 will result in a Fund balance of \$4 to \$4.5 million at the end of 2008, an additional \$23.5 to \$24 million will be needed to avoid the negative Fund balance at the end of 2009 as projected by the auditor. To generate that additional \$23.5 to \$24 million using the anticipated premium base will require raising the 2009 annual Second Injury Fund surcharge rate to 4.5 percent.

As noted on page 10 of the April draft audit report, the auditor estimates that “expenditures are projected to outpace revenues by approximately \$57.5 million from 2007 through 2009, an average of \$19.2 million per year and may continue to outpace revenues in future years.” Thus, the annual surcharge rate projected to be 4.5 percent in 2009 would need to be increased by a minimum of one percent in each of the successive years. This highlights that solvency of the Second Injury Fund is not solely a revenue issue. Raising the surcharge rate imposed on Missouri businesses, as suggested in the April audit report is not a solution, but only a short-term approach to the problem. A long-term solution to Second Injury Fund solvency must include controlling expenditures.

The Department and the Division are always willing to provide assistance, when requested, to the General Assembly in formulating policy and drafting legislation. The contingency plan for Second Injury Fund solvency may have various components to provide funding based on the severity of the cash shortage, including, but not limited to, a short-term cash flow loan, an emergency surcharge, statutory changes

to the funding formula, or substantive changes to the Fund. It is unfortunate that the April draft audit report was not issued in time for the legislature to consider all options prior to the March 1 and April 1 deadlines for filing proposed legislation during the current session. With less than four weeks remaining in the 2007 regular legislative session, to affect the funding issues of 2008, the General Assembly is left with three options: (1) attaching a Second Injury Fund solvency proposal to pending legislation, (2) addressing Second Injury Fund solvency in a special legislative session, or (3) addressing Second Injury Fund solvency in the 2008 regular legislative session with an emergency clause.

It should be noted that due to the existing funding formula and statutory timelines in section 287.715, RSMo, any legislative changes directed toward revenues and enacted during the 2008 legislative session will have no impact on Second Injury Fund revenues until April 2009, well beyond the projected insolvency of the Fund.

The April draft audit report focuses only on the revenue side of the Second Injury Fund equation and makes no assessment regarding the reasons why expenditures from the Fund have increased dramatically since 1993, when the last major legislative changes to the Second Injury Fund went into effect. Those legislative changes included adding a category of benefits for second job wage loss, establishing thresholds to qualify for Second Injury Fund permanent partial disability benefits, requiring the attorney general to use assistant attorneys general to provide legal services, and replacing the flat Second Injury Fund and Workers' Compensation Administrative Fund rates with a complicated formula that requires the Division to set surcharge and tax rates based on projections of revenues, balances, and expenditures.

Also not discussed in the April draft audit report is any contingency plan that would need to address controlling expenditures. Control of Second Injury Fund expenditures is not within the statutory authority currently available to the Division. It is the statutory responsibility of the State Treasurer as custodian of the Fund, who "shall be named as a party, and shall be entitled to defend against the claim," as well as the Attorney General, "to provide legal services as may be required in all claims made for recovery against the fund." Section 287.220.2, RSMo. The Division will be available, when requested, to provide information and data to the General Assembly and all interested stakeholders. The Division has begun research and outreach efforts on possible solutions that might be used as part of a Second Injury Fund solvency contingency plan.

SAO Comments

As stated in our report, it takes several years for a Second Injury Fund claim to result in an expenditure from the fund. For this reason, when we were considering potential issues impacting the short-term solvency of the fund, expenditure side changes would have little impact on short-term solvency. While we obviously agree that controlling expenditures would have an impact on fund solvency in the long-term, it will not have an impact on the solvency of the fund in the short-term.

This audit report does not recommend that the surcharge rate be raised. The report does provide an example of the impact of raising the surcharge formula rate from 3 to 3.5 percent.

The audit report states the law does not provide an adequate contingency plan. In the fiscal note to Senate Bill 1, the department provided information indicating the proposed changes would significantly reduce revenue to the Second Injury Fund and suggested the Administrative Fund could be used in the event of insolvency. Since the department has oversight and primary management responsibility for the fund, it should take the lead in providing the General Assembly the information necessary to address the solvency of the Second Injury Fund. However, in the two years since the passage of Senate Bill 1 the department has not developed any plans to address the impending solvency problem and the Administrative Fund does not contain adequate funds to address the insolvency.

The Governor requested the SAO to audit the Second Injury Fund in a letter dated January 16, 2007. This audit report is being released approximately 100 days after this request which is very timely considering the complexity of the issues addressed in this report. The General Assembly has several bills in process to which amendments could be added to address the problems noted in this audit report. Any bills passed by the General Assembly during this session would be in sufficient time to correct the 2008 insolvency problems.

4. *The Department has consulted with the predecessor of DIFP in the past when developing Fund projections and been told that DIFP does not make projections. The Department and the Division will be happy to seek input from both DIFP and the Attorney General in making the projections necessary to set the Fund surcharge rate for 2008. Under Section 287.715, RSMo, the surcharge rate for the following year must be calculated by October 31 of the current year. The Division must use information current and available on October 31 to make the necessary projections and calculations. It is the Division's understanding that the*

most current and available insurance premium base data certified by DIFP is used to calculate the annual Fund surcharge rate.

The Department and the Division have consistently provided the Attorney General's Office with statistical information maintained by the Division. The Attorney General's Office has not shared with the Department or the Division statistical data or projections referenced on page 14 of the April draft audit report showing that the Attorney General's Office has "specific knowledge of the number of cases expected to be finalized in the coming year" or that the Attorney General's Office "has information regarding trends in the settlements reached in the past years and how they will affect future expenditures."

The Division has, by letter dated March 19, 2007, requested from the Attorney General's Office information from that office's statistical database and a trend line. That information referenced on page 14 of the April draft audit report will be immediately necessary to provide assistance in the next four weeks to the General Assembly and interested stakeholders in developing a contingency plan in order to ensure Fund solvency in 2008 and in the future. The Department and the Division look forward to a response to the Division's March 19, 2007 letter requesting information from the Attorney General's Office.

5. *The Department recognizes the value of an actuarial study that is accurate and based on reliable data. If an outside actuarial is used, writing a multi-year contract to use the services of a single actuarial firm to conduct successive actuarial reviews would provide consistency in understanding the complex issues facing the Fund.*

The Department may need to explore the possibility of having the services of a full-time, independent actuary on retainer who would be familiar with all the details of the Fund program and who could immediately explore options and evaluate opportunities as the premium base shifts. Other options include having a Certified Public Accountant manage the future solvency issues of the Fund. It should be noted that solvency of the Fund is impacted to a considerable degree by payouts that are tied to the defense of the Fund that are statutorily placed upon the State Treasurer, as custodian of the Fund, and the Attorney General's Office. Both receive appropriations from the Fund to accomplish their statutory responsibilities. For example, FY2007 appropriations for the State Treasurer's Office total \$60,348.26 from the Fund for personal service, equipment and expense, and fringe benefits. FY2007 appropriations for the Attorney General's Office total \$3,768,449.74 from the Fund for personal services, equipment and

expense, leasing, STOB transfer, and fringe benefits. Currently, there are no appropriations from the Fund to the Division for staff or actuarial studies. Missouri employers currently pay for those expenses through the Workers' Compensation Administrative Fund.

Historical Financial Information and Surcharge Rates

Table I.1 depicts revenue and expenditures by categories, and balances and surcharge rates for calendar years 2000 through 2006.

Table I.1: Revenue and Expenditure Detail - 2000 through 2006

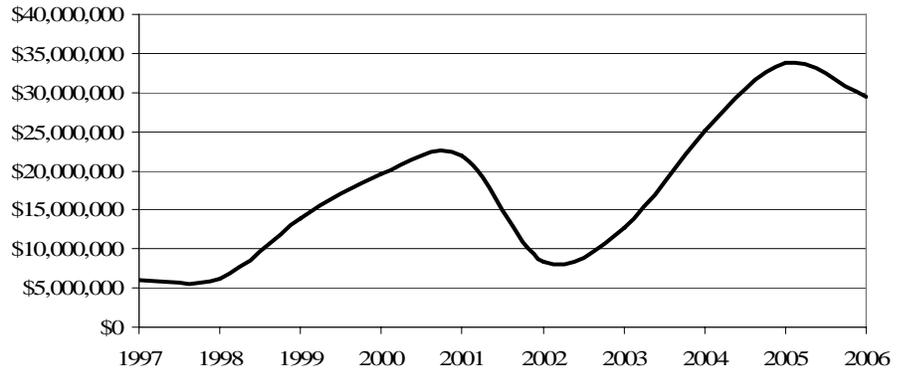
	2000	2001	2002	2003	2004	2005	2006
Beginning Balance	\$13,964,003	19,641,860	21,925,158	8,344,756	12,706,108	25,187,451	33,885,991
Revenue							
Surcharge Collections	\$37,745,013	43,825,511	38,194,218	62,387,227	78,514,651	72,990,094	62,150,266
Interest	899,089	1,258,552	498,251	179,643	337,144	895,870	1,515,608
Other	213,041	149,794	159,536	211,883	130,453	197,051	278,478
Total Revenue	\$38,857,143	45,233,857	38,852,005	62,778,753	78,982,248	74,083,015	63,944,352
Expenditures							
Benefits	\$29,913,151	39,336,963	48,722,946	53,962,702	62,431,668	60,995,159	63,877,106
Personal Service	1,389,429	1,586,330	1,581,857	1,581,679	1,655,821	1,733,724	1,768,410
Administration	1,875,706	2,028,266	2,127,604	2,873,020	2,413,416	2,655,592	2,748,817
Total Expenditures	\$33,178,286	42,951,559	52,432,407	58,417,401	66,500,905	65,384,475	68,394,333
Ending Balance	\$19,642,860	21,925,158	8,344,756	12,706,108	25,187,451	33,885,991	29,436,010
Surcharge Rate	3.0%	2.5%	2.5%	4.0%	4.0%	3.5%	3.0%

Source: Division of Workers' Compensation records.

Historical Fund Balance

Figure II.1 depicts the historical fund balance of the fund.

Figure II.1: Fund Balance - 1997 through 2006



Source: Division of Workers' Compensation records.

Historical Claims Filed and Dismissed, and Cases Served

Table III.1 contains information on the number of Second Injury Fund claims filed and dismissed, and the number of cases served from 1997 through 2006.

Table III.1: Claims Filed and Dismissed, and Cases Served – 1997 through 2006

Year	Claims Filed	Claims Dismissed	Cases Served¹
1997	9,740	7,147	3,431
1998	10,382	6,605	3,998
1999	11,110	7,022	4,487
2000	12,060	6,859	3,970
2001	13,255	7,273	4,626
2002	14,199	7,765	5,177
2003	14,157	7,435	5,218
2004	13,882	7,912	5,642
2005	13,363	8,225	5,616
2006	10,591	8,824	5,621

¹ Cases served is defined as the number of cases which received a payment of any kind during the year.

Source: Division of Workers' Compensation data.

Governor's Letter Requesting Second Injury Fund Audit



OFFICE OF THE GOVERNOR
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(573) 751-3222

MATT BLUNT
GOVERNOR

January 16, 2007

The Honorable Susan Montee
Missouri State Auditor
State Capitol Building
Jefferson City, Missouri 65101

Dear Ms. Montee:

It has come to my attention that Missouri's Second Injury Fund ("the fund") soon may be depleted of resources. Potentially complicating the issue is the Missouri Supreme Court's recent decision in *Schoemehl v. Treasurer of the State of Missouri* to extend benefits paid from the fund to dependents for the duration of their lives following the death of the covered worker. The fund plays a vital role in compensating injured employees when a current work-related injury combines with a prior disability to create a more serious condition for which the employee is to be compensated. In light of these recent events and in the public interest in this issue, I am exercising my authority under section 26.060, RSMo, and requesting you to audit Missouri's Second Injury Fund to determine if the resources of the fund are being disbursed properly.

If you have any questions, please contact my general counsel, Henry Herschel, or myself at (573) 751-5218.

Sincerely,

A handwritten signature in black ink that reads "Matt Blunt".

Matt Blunt