

QUACKENBUSH SCANDAL RAISES LEGAL QUESTIONS

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On July 10, 2000, California Insurance Commissioner, Chuck Quackenbush ("Commissioner") resigned following an investigation by the Assembly Finance and Insurance Committee ("Committee"). In addition to exposing the former Commissioner and other top Department of Insurance ("DOI") officials to potential criminal indictments, two legal issues have arisen; namely the confidentiality of market conduct exams and the settlement authority of the Commissioner for violations of the Insurance Code.

This paper discusses (1) the background of the DOI scandal that led to the resignations of Mr. Quackenbush and several of his top officials; (2) the circumstances under which market conduct exam reports can be made public; and (3) the scope of the Commissioner's settlement authority.

Background of the Scandal

In May, the Committee commenced an investigation into the Commissioner's handling of settlements with several insurers of their claims handling practices following the January 1994 Northridge earthquake. The investigation was brought under the auspices of the Committee's authority to oversee the activities of the DOI after a member of the DOI's legal staff tendered the confidential market conduct exams of four insurers, plus settlements of six insurers, directly to the Committee. This individual also criticized the Commissioner for entering into improper settlements of market conduct exams.¹

Over a two-month period, the Committee called approximately 40 witnesses to testify. The witnesses included the Commissioner, members of his executive staff, insurance company executives, and other individuals who were employed to manage or had knowledge relating to two foundations created by the DOI with proceeds from the settlements.

The testimony presented to the Committee revealed that in March 1999, after four months of careful planning, the DOI subpoenaed six of the largest California admitted insurers to appear at the DOI offices in Sacramento to respond to allegations of violations of the Fair Claims Practices Act in connection with Northridge earthquake claims handling activities. The DOI had concluded market conduct exams for four of the insurers, but had not conducted exams on the other two. At the beginning of the meeting, company officials and their counsel were led into a room which contained blown-up newspaper accounts of the insurers' previously litigated claims, plus alternative draft press releases prepared by the DOI. One release detailed heavy fines to be asserted against the insurers, and a more lenient second release reflected insurers' cooperation with the DOI in connection with prospective settlements. In addition, cardboard file boxes labeled as if they contained evidence obtained by the DOI on "illegal" claims activities by the insurers, were placed around the perimeter of the room. It was later revealed that the boxes were empty.

A large congregation of DOI executives and legal staff members were present at these initial meetings which were held over a two-day period. Each insurer was provided a DOI-prepared draft stipulation, which contained enormous monetary penalties, in excess of \$1 billion for four of the larger insurers, plus other large amounts for restitution and public outreach. Testimony at the hearing revealed that the DOI used the empty boxes, news releases and draft stipulations containing the outlandish penalties to intimidate the insurers into quick settlements so that the Commissioner could divert proceeds from the settlements to fund television promotional spots and to make contributions to minority groups in order to enhance his political image in California.

The insurers were greatly angered by the DOI's negotiation tactics. Ultimately, each insurer negotiated directly with the DOI's executive staff for resolution of its Northridge earthquake claims activities. The final settlements reflected either no fine or a very small fine for each of the insurers with a somewhat larger amount to be contributed to "Foundations" created at the direction of the DOI for the stated purpose of outreach, primarily to Northridge earthquake victims. In fact, the Committee concluded that the contributions to the Foundations were improperly diverted to pay for TV commercials involving Commissioner Quackenbush directly, for contributions to non-earthquake minority causes including a football sports camp that the Commissioner's two sons attended, and to pay for a political poll of minority communities to determine attitudes towards the Commissioner.

The Committee was outraged that monies, that should have been designated as monetary penalties or fines payable to the California general fund to benefit all Californians, were in fact diverted to specially created foundations to benefit the Commissioner's political base. Investigations are currently being conducted by the Attorney General's office, the State Auditor and the FBI into the legality of the foundations and alleged kickbacks to several individuals involved with programs that received proceeds from the foundations. It has been alleged that the foundations, which were established as independent, nonprofit entities with their own management, were actually controlled by one of Quackenbush's deputy directors. Mr. Quackenbush has denied any involvement in the creation of the foundations and any wrongdoings in the settlements. However, effective July 10, 2000, he resigned upon learning that one of his top aides would testify that he was ordered by the Commissioner to settle a matter immediately in order to pay for television advertisements.

Confidentiality of Market Conduct Exams

At the core of the Committee's investigation were the market conduct examination reports, which the Commissioner refused to provide to the Committee even after subpoena. The Commissioner claimed the privilege provided under Section 735.5(a) of the California Insurance Code ("Code"), which provides that market conduct examinations are confidential, but that the Commissioner may make them public in the furtherance of any legal or regulatory action which the Commissioner may, in his discretion, deem appropriate.

Although the Committee had been supplied the exams by a member of the DOI's legal staff, the Commissioner asserted that the staff member acted illegally and the exams remained confidential documents within the DOI. Thus, the Committee could not use or make public the exams. Although the Committee did not use the exams, the Senate Insurance Committee, by contrast, boldly published on its website a summary of the market conduct examination reports. This prompted Quackenbush to institute a suit against the Senate Committee for releasing the examination information. The Commissioner contended that the exam reports were protected from public disclosure under Section 735.5, which empowers the Commissioner to determine if they should be publicly disclosed.

The Commissioner alleged in his declaratory and injunctive relief action that under Section 735.5 examination reports are confidential and not subject to subpoena by the Legislature. The Commissioner asserted that (1) the legislative subpoena violated the separation of powers provision of the state constitution;² and (2) that the exams were confidential records and communications³ which hold an absolute privilege from disclosure under the California Evidence Code.⁴

The Commissioner asserted that Section 735.5 gives the Commissioner authority to use, and if appropriate make public, examination documents in furtherance of any legal or regulatory action that he deems appropriate.⁵ The Commissioner also argued that he may disclose examination report matters to other regulators and law enforcement officials in other jurisdictions on the condition that the recipient agrees in writing to hold the matter confidential or the examined company gives its written consent to such disclosure.⁶ Finally, the Commissioner argued that under the "official information" privilege, the DOI has an absolute right to protect the information from disclosure. The policy behind the official information privilege is to protect from public disclosure the opinions, recommendations and deliberations of government officials, where disclosure might impair the respective functions of the executive branch.⁷

The Legislature argued that there could be no absolute privilege to obstruct the Legislature's investigation of potential corruption or malfeasance within state government. Thus, if the Commissioner can quash a legislative subpoena, there would be no oversight mechanism by which the public may scrutinize and hold the Commissioner and his subordinates accountable.⁸ The Commissioner countered with the argument that although the Legislature has broad investigatory powers to conduct investigations in the aid of prospective legislation,⁹ such power is limited and may not be conducted without specific allegations rendered against the Commissioner. Thus, it was argued that the Legislature has no constitutional authority to infringe upon the exercise of the Commissioner's discretion.¹⁰

After Quackenbush's resignation, interim Insurance Commissioner Clark Kelso ordered the DOI to drop the lawsuit. He concluded that continuing to prosecute "this rare constitutional showdown, will in the end, serve no purpose."

Creation of Foundations as a Component of a DOI Disciplinary Settlement

Traditionally, the Commissioner may deny, suspend or revoke a certificate of authority or permit an insurer to pay a monetary penalty for violations of the Code.¹¹ The distribution of proceeds from the monetary penalty is governed by

Section 12975.7 of the Code, which provides that all fines and penalties shall be transmitted to the State Treasurer for deposit into the general fund of the State of California.¹²

The Senate Insurance Committee and Legislative Counsel have asserted that former Commissioner Quackenbush had no authority to enter into agreements with insurers to establish “Foundations” as a means of settling insurers’ market conduct examinations. Rather, they argue that the Commissioner’s authority is limited to issuing fines against such insurers, as set forth in the applicable statutory provisions.

The Commissioner argued that he has broad powers to examine the affairs of insurers and to settle allegations based on such examinations.¹³ This argument is founded on Sections 11415.60(a) and (c) which state:

(a) An agency may formulate and issue a decision by settlement, pursuant to an agreement of the parties, without conducting an adjudicative proceeding. Subject to subdivision (c), the settlement may be on any terms the parties deem appropriate.

* * *

(c) A settlement is subject to any necessary agency approval. An agency may delegate the power to approve a settlement. The terms of a settlement may not be contrary to statute or regulation, except that the settlement may include the sanctions the agency otherwise would lack power to impose.

Accordingly, Section 11415.60 authorizes a state agency to settle actions in lieu of an administrative proceeding. The settlement may be entered into before or after a pleading is issued and before or after a hearing. A settlement may be made under the terms the parties deem appropriate, except they may not be contrary to statute or regulation. Nonetheless, the terms may include sanctions that the agency would otherwise lack power to impose.¹⁴

Notwithstanding the Commissioner’s broad authority, it is acknowledged that his authority is not without limitation. A settlement between the Commissioner and an insurer would be invalid only if it were contrary to the Insurance Code, Regulations or public policy.¹⁵ Since there are no statutes or regulations prohibiting the Commissioner from entering into a settlement or creating a private nonprofit foundation, the question becomes whether establishing the Foundations violated public policy. The Commissioner argued that payments by the insurers to the Foundations were not penalties or fines, but rather were voluntary payments by the insurers in addition to the fines and penalties otherwise imposed by the settlement agreements. The insurers argued that the settlements were proper since the purpose of the Foundations was for earthquake related activities and to benefit earthquake victims. Thus, payments by the insurers were tantamount to a charitable contributions.

The Chairman of the Senate Insurance Committee recently asked the Attorney General to issue an opinion to clear up this issue. In late July, the Attorney General issued his opinion, which focused on whether the Commissioner may include, as a term of settlement in a regulatory enforcement case, that the insurer pay funds directly to a charitable foundation. The Attorney General concluded that in settlement of a regulatory action, the Commissioner can direct an insurer to pay funds to a private charitable foundation, so long as the activities of the Foundation are consistent with the purposes for which the DOI was created. If, on the other hand, the Foundations’ activities are unrelated to the DOI’s regulatory functions, the Commissioner lacks the authority to enter into such settlements.

The opinion can be viewed as being positive for insurers. First, the opinion generally recognizes the Commissioner’s authority to enter into settlement agreements, which include the creation of private charitable foundations. Moreover, the insurers’ settlements contain language to the effect that the Foundations would sponsor a variety of efforts to, among other purposes, communicate with and educate consumers regarding their rights in the context of insured “catastrophic losses.” Therefore, the settlements could be viewed as furthering the purposes of the DOI.

Conclusion

The motives behind former Commissioner Quackenbush’s settlements with the insurers are alleged by the Legislature to be wholly politically driven. Seven legislative proposals directly related to the Commissioner’s scandal have recently been contemplated or introduced before the California Legislature. If passed, they could dramatically change how the DOI is operated and insurance companies are regulated.

One measure, which would have allowed Californians to decide whether the Insurance Commissioner should be an appointed office as opposed to an elected office, appears to be dead. Another would prohibit contributions to the Commissioner by insurers. This, of course, faces stiff opposition by the insurance industry. Another would require that any settlement between insurers and the DOI provide restitution to policyholders.

Further, legislation has been introduced which would limit the scope of the Commissioner's authority over settlement of administrative actions. Under that bill, the Commissioner would not be allowed to approve settlements unilaterally or to allow insurers to contribute to nonprofit groups instead of paying regulatory fines. Legislation pertaining specifically to the Northridge earthquake would provide an additional year to file claims by claimants for quake-related damage, notwithstanding that the statute of limitations has long since passed from the 1994 Northridge earthquake. Legislation has also been proposed which would prohibit the use of the Commissioner's name, likeness or voice in public outreach advertising where the ads are paid for with funds from Department enforcement activities. Finally, the Chairman of the Senate Insurance Committee has agreed to take up an "Insurance Policyholder Bill of Rights." The bill is expected to focus on insurance carriers and would include provisions such as requiring that all market conduct examinations of insurers be made public.

These legislative proposals are the direct result of the actions of the former Commissioner. The next several months will determine whether any criminal indictments will be issued and whether any of the legislation will be enacted.

Endnotes

1. This individual was suspended and is on indefinite leave of absence pending an investigation into illegal disclosure of confidential information, as well as possible disciplinary action by the California State Bar.
2. Cal. Const. Art. III Section 3.
3. Cal. Ins. C. Section 735.5 and Section 12919.
4. Cal. Ins. C. Section 1040.
5. Cal. Ins. C. Section 735.5(a).
6. Cal. Ins. C. Section 735.5(b).
7. *Nat'l Labor Relations Bd. v. Sears, Robust & Co.*, 41 U.S. 132, 150 (1975).
8. *See In re Battelle*, (1929) 207 Cal. 227, 244.
9. Cal. Const. Art. IV Section 17.
10. 14 Apps. Cal. Atty. Gen. 161, 174-175 (1949).
11. *See* Section 704, 704.5 and 704.7 Cal. Ins. Code.
12. *Also see* Section 12975.7 Cal. Ins. Code.
13. *See* Sections 730 *et seq.* Cal. Ins. Code 790.04 - Specific Exam Authority to Determine Whether the Insurer Has Engaged in Unfair Competition or Any Unfair Act or Practice.
14. *Also see, Rich Vision Center, Inc. v. Board of Medical Examiners*, 144 Cal.App.3d 110 (1983).
15. *See, Rich, supra.*