

REUNDERWRITING INSURANCE POLICIES IN MARYLAND: PERILS OF A HARD MARKET

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Introduction

The cyclical nature of the insurance marketplace as it shifts between hard and soft markets can create underwriting nightmares for insurers and, in turn, increased employment for their compliance counsel. The problems are obvious. In soft markets, underwriting judgment is either ignored or severely pressured by marketing decisions to increase premium writings and market share. Where the soft markets are being driven by a booming investment economy, pricing for an underwriting profit is deemed to be unnecessary; the potentially enormous investment gains can generate what management considers to be an acceptable combined ratio, even where the underwriting loss ratio is well over 100.¹

Even on familiar, less risky lines of insurance, insurers writing in a soft market may deliberately underprice their policies in order to maintain market share vis-à-vis their competitors. Moreover, under these economic conditions, insurers often expand into new, more risky lines of insurance where they have no underwriting expertise but see opportunities for generating new business. Particularly where the new risks involve long tail claims-made exposures, such as professional liability lines, insurers may have no idea that their products are underpriced. Only after the book of business begins to mature and the unduly optimistic initial loss reserves start to develop towards their true values do the insurers realize their folly. Often this newly found awareness of the underwriting problems coincides with a decline in the investment markets so that there are no investment gains to overcome the underwriting losses. At that point, insurers will typically seek to reunderwrite their problem lines and divest unprofitable business.

Conceptually, reunderwriting a book of business is easy. The options are to raise premiums to an acceptable level, to cancel or nonrenew those risks that are deemed to be unacceptable and, where experience has been particularly poor, to withdraw entirely from the offending lines of business. Unfortunately for insurers, the real world places perils in the way of implementing the simple business decision to reunderwrite. Specifically, state legislatures by statute and insurance departments by regulation have placed impediments in the way of insurers seeking to clean up unprofitable books of business. Insurers often have underwriting manuals containing charts reflecting individual state requirements for such actions, but the effort to condense complex underwriting restrictions into a compact formulaic chart may lead to expensive and difficult compliance problems. Maryland is one of the states that has seemed to generate more than its share of such underwriting difficulties.

The Maryland Regulatory Framework

The Maryland legislature has a long history of placing impediments upon the exercise of underwriting judgment by insurers. This has evolved to the present day where the Maryland Insurance Code² includes Title 27 entitled Unfair Trade Practices And Other Prohibited Practices. Subtitle 5 of Title 27 deals with discrimination, and Subtitle 6 concerns procedural requirements for cancellations, nonrenewals, premium increases, and reductions in coverage. These subtitles interact with each other and, for compliance and enforcement purposes, must be interpreted together. While similar laws in many states are restricted in their application to personal lines coverages, the Maryland legislature has seen fit to include virtually all lines of insurance except life insurance and health insurance within their purview.³ Thus, commercial lines underwriters must be aware of these requirements when implementing underwriting decisions. Private passenger motor vehicle liability insurance policies are exempted from most of the provisions of Subtitle 6, but that is only so that they may be subjected to special detailed statutory rules concerning underwriting procedures which are set forth in Sections 27-605 and 27-607.⁴

Cancellations and Nonrenewals

Section 27-601 deals with required notices that must be sent to insureds by insurers seeking to cancel or nonrenew a

policy. Generally, 45 days notice of the insurer's cancellation or nonrenewal action must be sent to the insured in writing by "certificate of mailing".⁵ The notice must advise the insured of the possible right to replace the coverage through the FAIR Plan or through any other residual market plan for which the insured may be eligible.⁶ A producer may satisfy this obligation on behalf of an insurer, and no notice is required where the producer has replaced the insurance.⁷ In the case of cancellation for nonpayment of premium, the notice period is reduced to 10 days.⁸

Section 27-602 is known as the "Real Reason Rule." As this requirement has evolved, it has proved to be an incredibly difficult stumbling block for unwary insurers. The Rule requires an insurer seeking to nonrenew or cancel either an insurance policy or a binder which has been in effect for more than 15 days to provide the applicant with "a statement of the actual reason or refusal to renew ..."⁹ While many insurers are hesitant to publicly disclose the true reasons underlying their underwriting actions, the legislature has contemplated this potentiality and has explicitly granted a privilege barring actions "against the insurer, its representatives or another person who in good faith provides to the insurer information upon which the statement is based."¹⁰

The real problem with the Real Reason Rule is its mandate that clear and specific reasons for the underwriting action be given. Section 27-602(e) provides as follows:

(e) Clear and specific reasons required.

- (1) The reason given in the statement of actual reason must be sufficiently clear and specific so that an applicant of reasonable intelligence can identify the basis for the insurer's decision without making further inquiry.
- (2) The use of generalized terms such as 'personal habits', 'physical handicap or disability', 'living conditions', 'poor morals', or 'violation or accident record' does not meet the requirement of this subsection.

Thus, before even reaching this issue of whether an insurer is using appropriate standards for imposing its underwriting rules, an issue discussed below, the Real Reason Rule may be breached by an attempt to "mechanize" the nonrenewal or cancellation form by utilizing generic explanations or phrases.

A confusing element of the Real Reason Rule is found in Section 27-602(b)(1), which specifically makes Section 27-602 applicable to the Maryland FAIR Plan and to other programs instituted to assure the availability of insurance unless they are specifically excluded. On first blush, this provision seems to limit the section's applicability to residual markets, but the provision has been interpreted as expansive rather than limiting.¹¹

Breaches of the 45-day notice requirements or the Real Reason Rule are generally fatal insofar as the insurer's efforts to withdraw from the offending policy are concerned. The statutory penalty for noncompliance with these provisions is to require the insurer to remain on the risk unless the person seeking the coverage:

- (i) no longer wishes the coverage;
- (ii) has obtained other substantially equivalent coverage; or
- (iii) fails to tender or pay the premium after reasonable demand for the premium has been made.¹²

Thus, the insurer will be forced to renew the subject policy, or to withdraw the cancellation notice, pending a better try at the next underwriting opportunity; this will most likely occur on the next policy anniversary.

In its interpretive rulings, the Maryland Insurance Administration has discussed and construed the requirements of these provisions as follows:

The MIA contends that the Nonrenewal Notice did not satisfy the 'actual reason' requirements of § 27-602 for four reasons. First, the MIA contends that the 'actual reason' for the nonrenewal has to be in the nonrenewal notice itself. Second, the MIA contends that a § 27-602 'actual reason' notice must be tailored to each individual insured and, consequently, cannot be a standard or boilerplate form. Third, and related to

the second reason, the notice must contain the specific facts upon which a proposed nonrenewal was based rather than a generalized description. In other words, if the proposed nonrenewal is based upon claims history, the insurer must provide accurate information about each claim rather than relying upon a noninformative summary such as 'poor claims history.' Fourth, to be lawful, an 'actual reason' must contain the underwriting standards under which the proposed action was taken, and the application of these underwriting standards must be 'reasonably related to the insurer's economic and business interests.'¹³

Section 27-602 has recently caused a significant problem for Royal Insurance Company of America ("Royal") in connection with its coverage of property owned by the State of Maryland. Royal's coverage provided policy limits of \$500,000,000. In the face of the current hard market, Royal attempted to nonrenew the subject policy, stating as the single reason for its action:

The reasons for non-renewal is (sic) 'WE ARE FACED WITH THE POSSIBILITY OF A SUBSTANTIAL REDUCTION IN THE CAPACITY, TERMS AND CONDITIONS OF OUR REINSURANCE WHICH WILL LIMIT OUR ABILITY TO CONTINUE YOUR INSURANCE BEYOND THE EXPIRATION OF YOUR CURRENT POLICY. THEREFORE, WE ARE NOT RENEWING YOUR POLICY.'¹⁴

The hearing officer found that this language was defective in two respects:

...[f]irst, the notice was unlawfully 'generalized,' using generic language identical to that of other nonrenewal notices sent by Royal. There is no material difference between the terms prohibited in § 27-602(e), such as 'violation and accident record,' and the generic phrase in Royal's Notice that states that Royal was 'faced with the possibility of a substantial reduction in capacity, terms and conditions of our reinsurance.' For this reason alone, Royal's notice violates § 27-602.

Second, the Nonrenewal Notice violates § 27-602 for the additional and independent reason that it failed to contain the underwriting standard applied to the State in this case and it failed to set forth all of the reasons presented by Royal to justify its action.¹⁵

The opinion in *Royal* went on to analyze the three reasons for the underwriting action as contained in Royal's testimony at the subsequent hearing and concluded:

It is inconceivable that any 'applicant' of 'reasonable intelligence' could know from the face of the Notice, and 'without further inquiry,' that these three reasons were the actual reasons for Royal's decision.¹⁶

Thus, Royal was found to have violated Section 27-602, and the insurer was ordered to renew the State's policy pursuant to Section 27-609.

Discrimination in Underwriting

Subtitle 5 of Article 27 deals with discrimination in underwriting and procedurally is linked with Subtitle 6 as discussed above. The basic focus of the subtitle is found in Section 27-501, which provides a thorough and complex framework for ferreting out and prohibiting discrimination in insurance underwriting, albeit with some safe harbors for insurers seeking to avoid compliance problems.¹⁷ The key provisions of Section 27-501 are as follows:

(a) In general.

(1) An insurer or insurance producer may not cancel or refuse to underwrite or renew a particular insurance risk or class of risk for a reason based wholly or partly on race, color, creed, sex, or blindness of an applicant or policyholder or for any arbitrary, capricious, or unfairly discriminatory reason.

(2) Except as provided in this section, an insurer or insurance producer may not cancel or refuse

to underwrite or renew a particular insurance risk or class of risk except by the application of standards that are reasonably related to the insurer's economic and business purposes.

* * *

(f) Policy to remain in effect. In the case of cancellation of or refusal to renew a policy, the policy remains in effect until a finding is issued under § 27-505 of this subtitle if:

(1) the insured asks the Commissioner to review the cancellation or refusal to renew before the effective date of the termination of the policy; and

(2) the Commissioner begins action to issue a finding under § 27-505 of this subtitle.

* * *

(g) Burden of persuasion. At a hearing to determine whether this section has been violated, the burden of persuasion is on the insurer to show that the cancellation or refusal to underwrite or renew is justified under the underwriting standards demonstrated.

When insureds or applicants complain to the Insurance Commissioner about the cancellation or failure to renew policies, the Commissioner will typically begin an investigation of the insurer's action under Section 27-501. The effect of that investigative process, if it is started before the effective date of the termination of the subject policy, is to hold the otherwise terminating coverage in effect until the Commissioner issues a ruling on the complaint under Section 27-505. When the Commissioner ultimately rules on the complaint, the insurer will either be ordered to stay on the risk or allowed to terminate the held-in-effect policy after a short period.

Even where the insurer obtains a ruling from the Commissioner that the policy termination is proper, the matter may not be concluded. If the Commissioner finds in favor of the insurer and the insured requests a hearing in timely manner, the Commissioner must hold a hearing and the Commissioner's ruling is stayed pending the outcome of the hearing.¹⁸

Limitations on Premium Increases

In a soft market with static or decreasing pricing of policy premiums, the involuntary continuation of the terminating policy does not create any undue difficulty. In a hard market, where policy premiums may soar by double and triple figure percentages, however, Maryland's regulatory scheme imposes a new and unexpected pitfall. Normally insurers renew expiring policies at the premiums then in effect. Maryland's legislature was concerned about insurer's attempts to significantly increase premiums with inadequate notice to insureds. Thus it enacted Section 27-604, which provides in pertinent part as follows:

(b) Whenever an insurer intends to increase a premium for a particular policy written in the State by 20% or more, the insurer shall notify the insured and insurance producer of the increase.

(c) The notice shall be sent by first-class mail to the insured and insurance producer at least 45 days before the effective date of the proposed premium increase.¹⁹

The requirements of Section 27-604 can create a dilemma for the unsuspecting insurer attempting to nonrenew or cancel a problem policy. Normally the insurer will give the required 45-day notice of policy termination as required by Section 27-601 but, not expecting a renewal, will not give notice of a premium increase greater than 20 percent. Then when the policy is held in effect by the Commissioner's order pursuant to Section 27-501(f), the renewal premium increase is limited to less than 20 percent over the premiums of the expiring policy, even where the insurer's filed rates would generate a larger increase.

Withdrawal From Lines of Business

For many years, Maryland has restricted the right of insurers to withdraw from an entire line of business. These restrictions were imposed to protect insureds from market dislocations caused by significant withdrawals and subsequent availability problems.

Section 27-603 sets forth the basic requirements of a withdrawal plan.²⁰ Generally the plan must be filed 180 days before the proposed withdrawal, but in cases of financial impairment, substantial changes in applicable reinsurance or significant financial losses, the Commissioner can allow the withdrawal to begin in 60 days.²¹ The plan must be filed over the signature of an elected officer of the insurer,²² and the insurer must notify its Maryland producers, in writing, of the filing of the plan at the time the plan is filed.²³

Generally the statute provides little in the way of standards for withdrawal plans, and the Commissioner is merely instructed to review the plan for compliance with Sections 27-501 and 27-603.²⁴ Rather, the statutory requirements deal primarily with content of the plan. In practice, the Commissioner can delay matters by seeking additional information, which will start the clock over on the 60-day waiting period when the requested information is provided.²⁵ An explicit approval is not required as there is a 60-day deemer provision that provides a plan is approved if it is not disapproved within 60 days.²⁶

In some instances, insurers have chosen to take the halfway step of placing a moratorium on the writing of new business rather than withdrawing from a line of business. Insofar as personal lines coverages, such as homeowners' and private passenger automobile insurance, are concerned, the Insurance Commissioner has adopted a Bulletin which requires the filing of an appropriate rating rule "excluding new business from eligibility under the insurer's applicable rating plans" and requiring a comprehensive explanation of the economic and business purposes supporting the insurer's decision, including, where applicable, statistical support.²⁷

Conclusion

The Maryland legislature has created an arcane scheme for regulating the underwriting efforts of insurers. The rules are not insurmountable, but they do require close attention by insurers well in advance of the implementation of underwriting decisions. It is clearly a situation where "an ounce of prevention is worth a pound of cure."

Endnotes

1. Those regulatory attorneys who have been through several hard and soft insurance market cycles can recall the insurers' soft market mantra: "We know we lose money on each policy, but we'll make it up on the volume!"
2. The Maryland Insurance Code is the Insurance Article of the Maryland Code Annotated. All statutory references herein will refer to the Maryland Insurance code unless otherwise designated.
3. Surety insurance is exempted from most of the requirements of Subtitle 6 of Article 27. However, Section 27-502 provides an explicit and detailed scheme for restricting unfair discrimination in connection with surety underwriting. This statutory scheme for concerning surety discrimination will not be dealt with in this paper.
4. The legislature's treatment of "private passenger motor vehicle insurance" is somewhat obscure. Rather than utilize that generally understood expression, the legislature has adopted the expression "automobile liability insurance policy issued in the State to a resident of a household". Thus, statutory underwriting requirements that apply to motor vehicle insurance policies but do not contain the "resident of a household" limitation are applicable to both commercial automobile and private passenger automobile. This paper will deal with the generic issues concerning cancellation and nonrenewal of insurance policies and will not focus on the more specialized and detailed restrictions applicable to private passenger motor vehicle insurance policies issued to Maryland insureds.

5. Section 27-601(c).
6. Section 27-601(b).
7. Section 27-601(c)(2) and (3).
8. Section 27-601(d).
9. Section 27-602(c).
10. Section 27-602(d).
11. *See, e.g., MIA v. Medical Mutual (Ex rel: John Kijak, Jr., M.D.)*, Case No. MIA-96-2/01, June 12, 2002, slip opinion at 29-30.
12. Section 27-609(a)(1).
13. *MIA v. Medical Mutual (Ex rel: John Kijak, Jr., M.D.)*, Case No. MIA-96-2/01, slip opinion at 38 (June 12, 2002).
14. *Insurance Commissioner for the State of Maryland v. Royal Insurance Company of America (Ex Rel. Maryland State Treasurer)*, Case No. MIA-217-5/02, slip opinion at 45 (August 26, 2002). Royal appealed the Commissioner's ruling, and the matter was affirmed by a decision of the Circuit Court for Baltimore City; that court's decisions are unreported.
15. *Id.*, at 48 and 49.
16. *Id.*, at 49.
17. Much of the detail found in the extensive provisions of Section 27-501 deals with motor vehicle and homeowners insurance underwriting. These specialized requirements are beyond the limited and introductory scope of this paper.
18. *See*, Sections 2-210 and 2-212.
19. The Insurance Commissioner has recently issued Bulletin 02-8 (April 19, 2002) which clarifies the requirements of Section 27-604. The Bulletin provides in pertinent part:

It is the position of the Maryland Insurance Administration that in order to be in compliance with § 27-604 of the Insurance Article, insurers should indicate on the notice the premium charged for the expiring policy, the premium to be charged for the renewal, and the difference, which is the amount of the increase. In addition, all premium increases must be in accordance with the insurer's filed rating plan. (*See* §§ 11-230, 11-341 and 27-216 of the Insurance Article.)
20. Generally the provision applies to all kinds of insurance except life insurance, health insurance and annuities, but there are specific requirements for health insurance found in Section 27-603(a)(3).
21. Section 27-603(a)(2).
22. Section 27-603(b)(1).
23. Section 27-603(d).
24. Section 27-603(e).

25. Section 27-603(c).
26. Section 27-603(f)(2).
27. Bulletin 02-22 (October 30, 2002).