

# THE PERFECT TEXAS INSURANCE STORM EMERGENCY ORDERS AND AD HOC RULEMAKING

Jay A. Thompson, Esq.  
(512) 708-8200

## *Introduction*

Texas is in the aftermath of a homeowner's insurance crisis. The crisis that hit Texas is much like a hurricane. A hurricane increases its intensity over water. The Texas homeowner's insurance crisis was intensified by water and mold damage claims. The ultimate destructive power of a hurricane for insurance companies is the catastrophic size of the losses it causes. This was certainly true in Texas, even though there was no hurricane.<sup>1</sup> The intensity of the Texas insurance storm was also fueled by the hot waters of election year politics. Much like the ship, the *Andrea Gail* in the "Perfect Storm," the Farmers Insurance Group ("Farmers") was caught in the eye of this Texas political, legal and economic storm.<sup>2</sup>

This article will discuss the facts and background surrounding the crisis, an emergency order issued against Farmers and the reliance by the Texas Department of Insurance ("TDI") on ad hoc rulemaking. The purpose of this article is to present a summary of the arguments for and against ad hoc rulemaking and whether ad hoc rules can or should be applied retroactively in an offensive manner by an insurance department.

## *Factual Background*

Much like a hurricane, the Texas insurance crisis took time to build. The seeds of the storm were planted beginning in the 1990s.

In 1995, on a certified question, the Texas Supreme Court overturned a decision of the Fifth Circuit<sup>3</sup> ruling that the slab foundation exclusion did not apply to the dwelling for damage claims caused by the accidental discharge of water.<sup>4</sup> This opinion cast doubt on the validity on several exclusions, including the mold exclusion for loss caused by accidental discharge. In 2001, a Texas jury awarded \$32 million to Melinda Ballard in a case against Farmers involving a mold claim.<sup>5</sup> The resulting publicity of this case led to a veritable flood of mold claims.

The Texas Department of Insurance, after hearings, approved endorsements to limit water damage and mold type coverage.<sup>6</sup> The TDI also approved policy forms and endorsements for State Farm, Farmers and ISO which more clearly limited mold and water damage coverage.<sup>7</sup>

Claims and losses escalated. Insurance companies, including Farmers, were left with no choice but to increase premiums. Even when restrictive forms were approved, some rates were not lowered. Increasing premiums and reducing coverage in an election year is bad business for politicians and it is easy to imagine the political reaction.

## *Legal Actions*

Beginning in October 2001, the state began an investigation of the Farmers Insurance Group. Specifically, the Office of the Attorney General sent a civil investigative demand to Farmers concerning its practices particularly relating to its use of credit scoring and its increase in rates.<sup>8</sup> In addition, in January 2002, the Texas Department of Insurance conducted a market conduct exam of Farmers Insurance Exchange and the Fire Insurance Exchange.<sup>9</sup> In April 2002, a draft market conduct report concluded that Farmers had not violated the law. This report was never finalized. Under Texas law, a reciprocal insurance exchange is exempt from all rate regulation for residential property insurance.<sup>10</sup>

Despite this, in August 2002, the Attorney General and Commissioner of Insurance filed suit against Farmers Insurance Exchange and Fire Insurance Exchange complaining of Farmers homeowner's insurance rating practices in Texas.<sup>11</sup> The suit alleged that Farmers failed to disclose information concerning its rates and further alleged that its use of credit violated certain insurance laws.<sup>12</sup> No other insurance company was singled out and subjected to the

same allegations.

On August 13, 2002, a week after filing the lawsuit in which TDI was a party, the Commissioner of Insurance approved an *ex parte* emergency cease and desist order against the Farmers Insurance Exchanges.<sup>13</sup> The order was aimed specifically at certain rating practices. The Commissioner found in the Order that TDI had no authority to regulate the rates of the Farmers Exchanges, but instead determined that Farmers' rating practices constituted unfair practices.<sup>14</sup> The order required the Exchanges to: (1) cease use of some data in calculating rates; (2) cease using an unfunded catastrophe load in calculating rates; (3) offer greater discounts to policyholders based on credit history; (4) offer greater discounts to policyholders based on the age of their home; (5) cease using certain trend factors in calculating rates; (6) use shorter trending periods for rate revisions; and (7) reduce the target rate of return in calculating rates.<sup>15</sup>

The day after the order was issued, the TDI instituted disciplinary action against Farmers seeking administrative penalties of up to \$25,000 for each alleged violation.<sup>16</sup>

In September 2002, Farmers filed a suit against the TDI alleging that the *ex parte* emergency cease and desist order was void as a matter of law.<sup>17</sup> On September 30, 2002, the TDI filed a Motion for Summary Judgment to the Farmers suit alleging, among other things, that the TDI can determine unfair acts through contested case proceedings and that the TDI can determine unfair acts by ad hoc rules determined in an *ex parte* emergency cease and desist order.<sup>18</sup> The TDI subsequently argued it had the authority to define new unfair acts in an *ex parte* order, and had the authority to apply such newly defined unfair acts retroactively and impose fines against Farmers.<sup>19</sup>

The Commissioner's authority to issue *ex parte* cease and desist order is limited to stopping unauthorized insurance or for the violations of unfair acts as defined in Art. 21.21, Insurance Code.<sup>20</sup> The Order did not cite any specific acts determined unfair in art. 21.21 § 4. The Order did not cite any formal rules that define unfair acts. The Order alleged only a violation of art. 21.21 § 3. Instead, the TDI argued it had the right to define new unfair acts.<sup>21</sup>

The TDI argued that its authority to make law through contested cases was established in the case of *SEC v. Chenery Corp.*<sup>22</sup> The TDI argued that the courts have adopted the *Chenery* analysis.<sup>23</sup> The TDI argued this was the type of case for which ad hoc adjudication is appropriate because "the problem of skyrocketing insurance premiums must be solved."<sup>24</sup>

### *Farmers' Response*

Farmers argued that the ad hoc adjudication does not substantiate the TDI's actions. In summary, the arguments were that: (1) "the TDI rules were legislative in nature and go beyond the scope of ad hoc adjudication"; (2) Policy decisions of the TDI should be through a formal administrative process; and, (3) the *Chenery* court cautions against precisely the type of action done by the TDI.<sup>25</sup> Farmers argued that while agencies cannot be straight jacketed into formal rulemaking, the Supreme Court recognized that use of ad hoc adjudication is a limited exception and stated a strong preference for formal procedures.<sup>26</sup>

### *Analysis*

Texas courts allow an even more limited use of ad hoc rulemaking.<sup>27</sup> Informally amending a rule or creating a rule through a contested case hearing results in the "issuance of a private opinion that will never be known by anyone except those few persons who have taken the time to research the files of an agency."<sup>28</sup> Ad hoc rulemaking may only be used when " (1) the agency may not have sufficient experience with a particular problem to warrant rigidifying its tentative judgment into a hard and fast rule or (2) where the problem is so specialized and varying in nature as to be impossible of capture within the boundaries of a general rule."<sup>29</sup>

No attempt was made in the *ex parte* order to justify either of these exceptions. It seems inconceivable the TDI could justify, on any basis, a lack of experience with underwriting practices that would prevent it from forming an opinion as to a particular underwriting or rating practice. The Order admits the Commissioner has no authority to regulate

Farmers' rating practices. Despite this finding, the state argued it had the right to regulate Farmers' rates through the *ex parte* order.

Even assuming that there was the requisite need for an ad hoc rule, very serious questions of due process and fairness exist as to whether an ad hoc rule can be created through an *ex parte* proceeding. By definition, an ad hoc rule did not exist before the issuance of the *ex parte* order. At all relevant times, Farmers was utilizing underwriting practices that were subsequently determined by the order to be a violation. Farmers had no right to be heard before the Order was issued, no right to defend itself against these newly created rules and no prior notice that its rating practices were unfair.

There is no Texas case that expressly allows *ex parte* orders to be used to create ad hoc rules. Two Texas opinions set aside the use of ad hoc rulemaking even though hearings were held in both cases, because the agency did not formulate the rule until the "*issuance of the final order.*"<sup>31</sup> In both decisions, the failure to apprise the parties of the law prior to the hearing was an abuse of the ad hoc rulemaking process, and the court held that the agency actions were fundamentally unfair. Farmers was given notice of the ad hoc rule when it was served with a copy of the *ex parte* order. Before it could present any arguments on the validity of the rule or the immediate effect of the rule, they were subject to the *ex parte* order without notice and any right to be heard.

The draconian effects of ad hoc rulemaking in an *ex parte* order is further demonstrated by Texas law requiring that a respondent (Farmers), not the Commissioner or the TDI, bear the burden of proof to show why the *ex parte* order should not be affirmed.<sup>32</sup> Therefore, Farmers would be forced to disprove an ad hoc rule that has never been justified by the agency, never subjected to public comment or other proceeding. Such a procedure would be a farce of the limited use accorded ad hoc rulemaking within the confines of both the Texas Administrative Procedure Act and as authorized by the United States Supreme Court.<sup>33</sup>

The Austin Court of Appeals has unequivocally held that the burden is not upon the party to disprove the validity of an ad hoc rule, but that the burden is upon the agency, within the contested case hearing, to demonstrate that such rulemaking has a rational basis and it is not arbitrary and capricious.<sup>34</sup>

### ***Retroactivity***

Even more incredible is the fact that the TDI not only sought to create an ad hoc rule through the *ex parte* order, but they argued its new rule can be applied retroactively in order to seek penalties against Farmers.<sup>35</sup> The TDI argued that its choice of ad hoc adjudication lies within its informed discretion; the legislature had given it the authority to proceed through either ad hoc adjudication or formal rulemaking; and it was simply applying a new interpretation of a statute that has been in effect for decades.<sup>36</sup>

The Texas Supreme Court has held that laws may not operate retroactively to impose new duties in respect to transactions or consideration past.<sup>37</sup> This principle has been applied to ad hoc adjudication, which is not immune from consideration of fairness, including retroactivity, in its exercise.<sup>38</sup> The Austin Court held that it is not permissible to adopt new rules through ad hoc adjudication where fines or damages are involved.<sup>39</sup> Indeed, the primary deleterious effect of ad hoc adjudication is the problem of retroactivity.<sup>40</sup>

The due process clause of the United States requires that a party must have prior notice both that the activity to be punished has been proscribed and that a hearing will be held in order to comport with the dictates of due process.<sup>41</sup> Exemplary damages, like administrative sanctions, are punitive in nature and warrant similar considerations.

### ***Conclusions***

Farmers' ship did not sink like the *Andrea Gail* because the case is likely to settle. Texas was engaged in a hotly debated election where the homeowners' insurance crisis was at the center of the debate. Thousands of consumers were receiving rate increases. Hundreds of consumers were making complaints. The TDI was approving forms that reduced coverage and yet there was little decrease in rates. It is understandable that the TDI chose to react. It is

unfortunate, however, that the TDI sought to clothe itself with the authority to promulgate new rules on unfair practices in an *ex parte* proceeding and apply them retroactively.

In conclusion, the hurricane has passed but the damage that has been wrought by the insurance storm that ripped through Texas still exists. The potential damage to the rule of law is one of many victims. It is hoped, that as with hurricanes when the storm passes, the time for healing and rethinking begins. It is hoped that the rebuilding of the homeowners' insurance market will be founded upon sound principles of constitutional and statutory law and the need for ad hoc rulemaking of this type never happens again.

#### *Endnotes*

1. TDI data shows between 2000 and the end of 2001 a 1306% increase in frequency and 152% increase in severity of mold claims. III Briefing, Mold & Insurance, March 2003. Farmers lost \$1.2 billion in two years and \$400 million in 2002 in Texas.
2. The parties entered into a Memorandum of Understanding settling all claims on November 30, 2002. Essentially, Farmers agreed to refund premiums and change its rating procedures.
3. *Sharp v. State Farm Fire & Cas. Ins. Co.*, 115 F.3d 1258 (5<sup>th</sup> Cir. 1997).
4. *Balandran v. Safeco*, 972 S.W.2d 738 (Tex. 1998).
5. *Allison v. Fire Insurance Exchange*, 98 S.W.3d 227 (Tex.App.—Austin, 2002); The appellate court reduced the judgment to \$4 million.
6. Commissioner's Order No. 01-1105, dated October 2001.
7. Farmers filed amendatory endorsements to limit coverage in 2001; State Farm form approved in Order No. 02-0208, March 2002; the ISO form approved in Order No. 02-0741, July 2002.
8. Based on facts established in Cause No. GV202501, *State of Texas, et. al. v. Farmers Group, Inc., et. al.*, in the 261<sup>st</sup> District Court, Travis County, Texas.
9. *Supra*. The April 2002 Draft Report concluded that Farmers did not violate the law. This report was never finalized.
10. Tex. Ins. Code, art. 19.12. This fact was also admitted in subsequent pleadings and orders of the State.
11. *See* Endnote 8.
12. *Supra*, Tex. Ins. Code at 21.21-8
13. Order No. 02-0844.
14. *Supra*.
15. *Supra*.
16. A report was filed August 14, 2002 and Notice of Hearing, September 18, 2002 in Docket No. 454-03-0193.D.
17. Cause No. GN203156, *Farmers Insurance Exchange, et. al. v. Commissioner of Insurance*, in the 353<sup>rd</sup> District Court, Travis County, Texas.

18. TDI's Motion for Summary Judgment filed September 30, 2002.
19. TDI's Response to Farmers Motion for Summary Judgment filed in Cause No. GN203156.
20. Tex. Ins. Code § 83.051.
21. *See* note 19, *supra*. The TDI argument seems contradictory to *Allstate v. Watson*, 876 S.W.2d 145 (Tex. 1994), holding that art. 21.21 § 4 is an *exclusive* list of unfair practices.
22. 332 U.S. 194, 775 S.Ct. 1575 (1974), where the court saw a need to address unforeseen problems.
23. *Citing R.R. Comm'r v. Lone Star Gas*, 844 S.W.2d 679 (Tex. 1992); *Brinkley v. Tex. Lottery Comm'n.*, 986 S.W.2d 764 (Tex.App.—Austin 1999, no pet.)
24. *See* Endnote 18.
25. Farmers Cross Motion and Reply to TDI Summary Judgment filed in Cause No. GN203156.
26. *SEC v. Chenery, supra*. 322 U.S. at 203.
27. *Rodriguez v. Service Lloyds Ins. Co.*, 997 S.W.2d 248, 255 (Tex. 1999); Beal, "Ad Hoc Rulemaking: Texas Style," 41 Baylor L.Rev. 101 (1989).
28. *Id.* at 255, 256; Beal, *supra* at 120.
29. Rodriguez, *supra* at 254.
30. Emergency Order, *supra*.
31. *Texas State Board of Pharmacy v. Seely*, 764 S.W.2d 806 (Tex.App.—Austin 1988, writ denied); *Madden v. Tx. State Board of Chiropractic Examiners*, 663 S.W.2d 622, 626-27 (Tex.App.—Austin 1983, writ ref'd n.r.e.).
32. Tex. Ins. Code § 83.054.
33. Tex. Govt. Code § 2001, *et. seq.*; *SEC v. Chenery, supra*.
34. *West Texas Utilities Co. v. PUC*, 896 S.W.2d 261, 272 (Tex.App.—1995).
35. TDI Response to Farmers' Motion for Summary Judgment.
36. *Supra*.
37. *Ex Parte Abell*, 613 S.W.2d 255, 260 (Tex. 1981).
38. *S.W.Bell Tel. Co. v. PUC*, 745 S.W.2d 918, 926-27 (Tex.App.—Austin 1988, writ denied).
39. *Supra*.
40. *Meno v. Amarillo I.S.D.*, 854 S.W.2d 950, 998 (Tex.App.—Austin 1993, writ denied).
41. *B.M.W. of N.America v. Gore*, 116 S.Ct. 1589 (1996). 