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MARKET CONDUCT SETTLEMENT IN CALIFORNIA - BEWARE OF PITFALLS

by
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The California Department of Insurance ("DOI") maintains a Market Conduct Bureau ("Bureau") which conducts market conduct examinations of insurers focusing on their claims, underwriting and marketing practices. The purpose of claims and marketing examinations is to determine if the insurer is engaged in any unfair method of competition or unfair or deceptive act or practice prohibited by Section 790.03 of the California Insurance Code ("Code"). Because of the shortage of examiners, not all insurers are examined.

Generally, the Bureau examines insurers with a large number of consumer complaints or those that necessitate a follow-up exam due to problems discovered in an earlier examination. In conducting examinations, the examiners follow the NAIC Market Conduct Examiner's Handbook. They review a sampling of claims files both paid and unpaid which the exam report separates by type of coverage. The Report provides a summary in the comment portion of the evaluation and generally will provide an error ratio based on a ratio of errors to files reviewed. The Report also has a "Recommendation" section in which the examiner lists specific practices the insurer is requested to change.

The Report may also require follow-up documentation from the insurer and require the insurer to correct errors on claims by making payments to insureds. Finally, the examiner may also make a recommendation on whether enforcement action is necessary to change the behavior of the insurer on a case-by-case basis. Enforcement actions have traditionally been initiated through Order to Show Cause Hearings. Recently, the Bureau has initiated an Alternative Resolution Program to facilitate insurer settlements. This paper explores the Alternative Resolution Program ("ARP") and several of the issues that confront insurers in these settlements.

Alternative Resolution Program

The purpose of ARP is to allow the Bureau to directly negotiate fines with the insurer instead of referring the matter to the Legal Division for formal action. The stated benefit for these settlements is that there is no public record since there is no hearing plus the monetary penalty is not disclosable in the annual statement, to the NAIC or any state. The Department benefits by the easy resolution and collection of a penalty which encourages the insurer into future compliance.

Applicable Code Provisions

Section 790.03 of the California Insurance Code ("Code") defines a group of eight unfair or deceptive acts or practices in the business of insurance. These include misrepresentations, untruthful and deceptive statements, restraint of trade and unfair rate discrimination. The key provision is 790.03(h), which covers the unfair claims settlement practices. Under this subsection, listed are 16 separate claim settlement practices which are considered unfair claims settlement practices.

Section 790.035(a) is the penalty provision for engaging in unfair methods of competition. This statute is very favorable to the Commissioner. It provides that any person engaging in any unfair method of competition or unfair or deceptive act or practice may be liable up to \$5,000 for *each act* if not willful and \$10,000 if willful. Further, the Commissioner is given the authority to determine what constitutes a single act.

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Section 790.10 permits the Commissioner to adopt regulations to administer the Unfair Claims Practices Act. In 1992, the Unfair Claims Settlement Practices Regulations were promulgated by former Insurance Commissioner Garamendi. All insurers were required to be in full compliance with the regulations by April, 1993. The regulations were revised and renamed, The Fair Claims Settlement Practices Regulations in January of this year. These regulations establish specific standards or acts which constitute unfair claim settlement practices under Section 790.03. It establishes the disclosure provisions applicable to the policy and its benefits, precise timelines for responses to communications, training certification requirements, as well as standards for settlement of claims. The significance of these regulations is made clear by the magnitude of the penalties for their violation and also that a violation of the regulations is treated with the same severity as a violation of the statute. Therefore, in settlement discussions, each individual act will be determined by the Bureau to be a violation which includes such mundane things such as late payments or late responses to correspondence.

Section 790.05 sets forth the procedure under which the Commissioner may institute a proceeding against a person engaging in an unfair method of competition. This proceeding is an order to show cause hearing under the Administrative Procedure Act. This provision further provides that the purpose is to determine whether the Commissioner should issue an order for the insurer to pay the penalty imposed by Section 790.035 and to "cease and desist" its unlawful practices. Section 790.07 sets forth the procedure in the event that a person violates the cease and desist order issued pursuant to Section 790.05. Subsequent violations of the cease and desist order authorizes the Commissioner to suspend or revoke the certificate of authority for up to one year and to increase the amount of fines.

ARP Settlements

In an effort to maintain nondisclosure of ARP Settlements, the settlement amount is referred to as a "forfeiture" as opposed to a monetary fine or penalty. However, with that concession there still remains controversial terms in these settlements which raise the issue of disclosure to other states. To date, the legal division in working with the Bureau has insisted that the cease and desist language of Section 790.05 be contained in ARP settlement documents. As noted above, under Section 790.05, the Commissioner has discretion to issue and serve an Order to Show Cause containing a statement of the charges in order to determine whether the Commissioner should issue an order to the insurer to pay the penalty imposed by Section 790.035 and to "cease and desist those methods, acts or practices or any of them." Thereupon, under this section if any of the charges are found to be justified, the Commissioner must issue an order requiring that the person pay the penalty and cease and desist from engaging from those methods.

Obviously, the inclusion of a cease and desist order undermines the whole purpose of the ARP since once a cease and desist is issued against an insurer, then that becomes a disclosable item for the insurer. Moreover, in recent ARP settlements, the cease and desist orders preclude insurers from violating specific regulations as opposed to restricting the specific factual conduct which served as basis for the action in the first place. Since the regulations are generally broader in scope than each factual situation, the insurer would be held to a greater standard of conduct pursuant to the cease and desist order. This has severe consequences in light of Section 790.07 of the Code. Under this section, if the Commissioner finds that a person has violated a cease and desist order, the Commissioner after a hearing may order the insurer to forfeit an additional \$5,000 for each act if nonwillful and up to \$55,000 if the violation is found to be willful. The Commissioner also has the ability to suspend or revoke the license or certificate of authority for a period of one year.

In order to ensure the viability of ARP settlements, the Department will need to reevaluate the use of cease and desist orders in these settlements. Presently, the inclusion of cease and desist orders undermines the nondisclosable aspect of the ARP which is the incentive for insurers to enter into the settlements in the first place. Furthermore, such settlements should be simplistic aimed at the insurer changing its practices through monetary penalties. The controversial terms relating to cease and desist orders should be left to more severe matters which do not warrant settlement under the ARP.

This also brings into question the penalty provision in Section 790.035(a) which establishes a penalty of \$5,000 for each act and gives the Commissioner the authority to determine what constitutes an act. In fact, the Department has argued that every instance in which there is a noncompliance with any of the Unfair Claims Practices Regulations constitutes a separate act, which raises the possibility of extraordinary fines. There should be a maximum fine under this section.

CONCLUSION

The ARP is beneficial to the Department of Insurance since it is an easy vehicle to change insurer behavior through a monetary penalty process which is not disclosable. More egregious behavior can be dealt with through the order to show cause hearing process. The inclusion of cease and desist orders in ARP settlements which has the same effect as if an order to show cause hearing was held and therefore subjects the insurer to the 790.07 (violation of cease and desist orders) procedure in the event any further violation occurs, will cause insurers to question the true benefit of this program.