

DEPARTMENT OF INSURANCE

Recent Settlement and Enforcement Practices Raise Serious Concerns About Its Regulation of Insurance Companies

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Audit Highlights . . .

Our review of the settlement practices at the Department of Insurance (department) revealed that:

- The former commissioner abused his authority by requiring companies to make "off-the-book" payments directly to third parties that were unrelated to the enforcement activities that led to the payments.*
- Other settlement payments made directly to third parties, while apparently legal, were imprudent because they were not subject to state purchasing and expenditure controls.*
- Many settlements failed to include any monetary penalties against insurance companies that violated the law.*

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The Joint Legislative Audit Committee (audit committee) asked us to determine the number of settlement agreements the Department of Insurance (department) reached with insurers between January 1996 and the end of May 2000. The audit committee also asked us to track payments ordered by the settlement agreements to determine if and when insurers made such payments. Finally, we evaluated the department's record keeping to determine whether it is adequate to ensure appropriate and prompt payment of settlement agreements.

Finding #1: The former insurance commissioner abused his discretionary authority in the settlement of enforcement actions.

Between January 1, 1996, and May 31, 2000, the former commissioner entered into 96 settlement agreements requiring some form of monetary payment on the part of the insurance companies for various violations of the insurance code. However, the former insurance commissioner abused his authority by requiring insurance companies to make \$12.3 million in outreach payments directly to vendors and nonprofit organizations when such payments did not relate to the regulatory activities that gave rise to them. These funds were not subject to the State's system of fiscal controls and were outside the Legislature's oversight. According to an attorney general's opinion, to be legal, an outreach payment to a third party must be related to the enforcement responsibilities of the department that led to the settlement agreement.

The department also omitted critical enforcement provisions from settlement agreements—such as the levying of fines and issuance of cease and desist orders when insurance companies engaged in unfair or deceptive business practices. Failure to assess penalties or ordering insurers to cease unfair or deceptive practices misleads the public and gives the appearance that no improper conduct occurred while precluding the department from using stronger

☑ *The department deprived consumers of important information regarding insurance companies because settlement agreements omitted details of the insurers' illegal activities.*

☑ *Insurers that violate the law may go unpunished because the department does not effectively manage its enforcement activities.*

sanctions in the future if the insurer violated the same sections of law. In lieu of assessing penalties, the department required insurers to make outreach payments directly to third parties. In fact, the amount of outreach payments required of insurers generally increased in proportion to the amount of fines and penalties assessed to insurers during the 4.5-year period we examined.

Even when the department does impose a fine or penalty on an insurance company that violates the Insurance Code, it fails to consistently report such actions to the National Association of Insurance Commissioners (NAIC)—a voluntary association created to coordinate the regulation of multistate insurers. Between January 1, 1996, and May 31, 2000, we identified 78 settlement agreements that included fines or penalties. However, the department reported just four such cases to the NAIC. By failing to consistently report the fines and penalties it does impose, the department removes an effective deterrent against future violations.

Additionally, the department sometimes masked the purpose of outreach payments by omitting specific information from public settlement agreements. For example, settlement agreements that included an outreach component did not always stipulate the exact amount that was to be paid to the nonprofit organization or vendor. In these cases, the payment amount was specified in a separate letter, which the department agreed to keep confidential.

We recommended that the Legislature consider a change to the Insurance Code forbidding the insurance commissioner from requiring that payments be made to nonprofit organizations, foundations, or vendors as a part of a settlement agreement. We also recommended that the department make penalties a public component of the settlement in all instances involving egregious violations in which a penalty is justified. In addition, the department should include as part of any public settlement agreement the date each type of payment is due, provisions listing the alleged violations, an order to cease and desist from such activities, and any other pertinent terms of the agreement. Finally, we recommended that the department report all penalties assessed against insurers to the NAIC. These actions would ensure the appropriate public disclosure of the nature of the violations and provide the department with more enforcement power should repeat violations occur.

Legislative Action: Corrective action taken.

Chapter 1091, Statutes of 2000 (SB 2107), prohibits the commissioner from ordering an insurer, agent, or broker to make settlement payments to a nonprofit entity, or direct funds outside the state treasury system.

Department Action: Corrective action taken.

The department reported it has implemented a policy whereby standardized language will be used in settlement agreements. Specifically, the language will include the terms of settlements, including monetary amounts to be paid and the time frame within which payment is due. Settlement agreements will also specify the code or regulatory provisions said to have been violated and include, where applicable, cease and desist orders.

The department also stated it has implemented a policy whereby all penalties assessed against insurers will be reported to the NAIC.

Finding #2: The purposes of outreach payments made to entities outside state control were often questionable.

Based on the attorney general's criteria, the settlement terms directing a total of \$16.5 million in outreach payments to third parties appear to be legal. However, we believe this practice is imprudent because such payments fall outside the State's fiscal controls. As a result, the subsequent use of these funds can be for questionable purposes.

The Insurance Code requires that the fines and reimbursements the commissioner receives through settlement agreements or by order of an administrative law judge be deposited in the General Fund and Insurance Fund of the state treasury system. Such requirements enable the department to better track insurers' adherence to settlement provisions. In addition, funds deposited in this manner are subject to state purchasing and expenditure controls, and their disbursement must be reviewed and approved according to state laws and regulations. The funds must also be included in the department's budget process, which allows for legislative oversight and public disclosure. Absent these fiscal controls, more than \$1.4 million in settlement funds directed to one nonprofit organization were spent for purposes wholly unrelated to the department's regulatory responsibilities.

To ensure that all activities and expenditures funded by settlement payments relate to the department's regulatory responsibilities that prompted the payments and adhere to the State's fiscal controls, we recommended that the department:

- Require insurers to direct all settlement payments to the department.
- Deposit these funds in the state treasury system.
- After depositing such funds, the department could either conduct outreach activities itself or contract for these activities so as to increase its direct control over the expenditures made for outreach and ensure that they clearly relate to the regulatory responsibilities that initiated the payments.

Department Action: Corrective action taken.

The department stated it has instituted a policy that prohibits outreach provisions in settlements with insurers and other regulated entities. The department also reported it has implemented procedures pursuant to SB 2107 that requires the commissioner's approval of settlement terms.

Additionally, the department indicated it has implemented procedures whereby all settlement funds are invoiced by and remitted directly to its accounting bureau. Standardized language has been included in settlement documents that inform licensees that they will be invoiced for penalties and reimbursements and directs them to wait for the invoice before remitting payment. The department's legal branch will provide information to the accounting bureau as to the proper characterization of the monies, and whether the funds should be deposited into the Insurance Fund or General Fund.

The department did not specifically address our recommendation concerning conducting outreach activities itself or contracting out for these activities. However, the changes it addressed in its response sufficiently address our concern over the direct control of expenditures.

Finding #3: The department does not effectively manage its enforcement activities.

Insurers that have committed Insurance Code violations may go unpunished because the department does not effectively manage its enforcement activities. Specifically, the department is unable

to compel insurance companies to correct identified violations promptly because of significant delays by the legal division in resolving cases. For example, according to the legal division's tracking system, as of April 2000, 183 (33 percent) of the 554 open cases in the legal division's compliance bureau have yet to be assigned to an attorney for resolution. Thirty-seven of these cases have been open for more than one year, even though several are designated as high priority. Additionally, bureaus that have initiated enforcement actions cannot quickly determine the status of cases referred to the legal division because the department's systems for monitoring cases are not integrated. We identified at least five separate systems used by the department to track the status of enforcement actions, none of which are capable of sharing information. Finally, poor controls over the remittance of fines, reimbursements for the costs of enforcement activity, and outreach payments do not ensure the prompt receipt and deposit of funds or the appropriate use of settlement payments.

To improve the effectiveness of its enforcement activities, we recommended that the department:

- Develop an integrated system for tracking enforcement activities and establish protocols for the consistent recording of key information.
- Periodically review open enforcement cases and determine why the legal division is taking so long to resolve cases referred to it and correct the situation.
- Instruct insurance companies to remit settlement payments directly to the accounting division or establish cashiering units in the bureaus initiating enforcement actions and the legal division to better safeguard these funds.
- Communicate settlement terms to the accounting division upon approval of settlement agreements so that appropriate accounts receivable can be established to track and monitor payments.
- Strengthen controls in the accounting division to ensure that all settlement payments are collected promptly and deposited in the appropriate state funds.

Department Action: Partial corrective action taken.

The department stated its E-Government and Technology Solution Branch has begun to integrate all enforcement tracking databases within the department. Specifically, it has developed a plan to consolidate its case management systems into one Web-based system. Additionally, the department intends to develop a core information system that will provide case information tracking by pulling data from the consumer services, financial surveillance, and company/criminal investigations management systems. The department's legal branch is also continuing to work toward full implementation of its case tracking system.

Additionally, the legal branch has established a permanent compliance office in Los Angeles. Attorneys are available to the consumer services and market conduct branch and the criminal investigations branch for the purpose of discussing ongoing and proposed investigations and other matters that are currently the subject of administrative proceedings. The department stated it has also instituted monthly meetings of all compliance attorneys to discuss both specific cases and matters of mutual concern regarding consistency and efficiency in the enforcement program.

As previously stated, the department indicated it has implemented new procedures to improve controls over the collection and accounting of proceeds of settlements. Specifically, all settlement funds will be invoiced by and remitted directly to the accounting bureau. Additionally, language will be included in the commissioner's orders informing insurers that they will be invoiced and instructing them to wait for the invoice before remitting payment.

The department has developed a new standard form to be completed by the legal branch, attached to a copy of the settlement agreement, and forwarded to the accounting bureau. The form will characterize any payments to be received as either a fine or cost reimbursement. The form will also indicate whether the funds should be allocated to the General Fund or the Insurance Fund. Finally, the legal branch's database has been modified to provide for the tracking of settlement funds from invoice through final disposition.