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BEFORE THE INSURANCE COMMISSIONER
OF THE STATE OF CALIFORNIA

VIRGINIA SURETY COMPANY,)
)
Appellant,) FILE NO.: CIGA-07-1
)
v.)
)
CALIFORNIA INSURANCE)
GUARANTEE ASSOCIATION,)
)
Respondent.)
_____)

PROPOSED DECISION

I. Introduction

Appellant Virginia Surety (“Surety”) appeals¹ from the November 15, 2007 decision of Respondent California Insurance Guarantee Association (“CIGA”) refusing to refund credits Surety accumulated as a result of overpayment adjustments to its CIGA assessments for workers’ compensation insurance.

Surety’s claim arises under a 2007 amendment (“the Amendment” or “the 2007 Amendment”) to Insurance Code section 1063.5, which permits CIGA, in its discretion, to refund overpayment credits where the insurer has agreed with the California Insurance

¹ Pursuant to Insurance Code Section 1063.9(b), which provides: “(b) Any member insurer aggrieved by action or decision of the association may appeal to the commissioner within 30 days after the action or decision of the association and after exhaustion of administrative remedies may seek court relief as provided in Section 12940.”

Commissioner to cease writing the category of insurance that generated the credits.² In this case, Surety has agreed to cease writing workers' compensation insurance, a category in which it has accumulated approximately \$4.3 million in adjustment credits.

For the reasons discussed below, CIGA's decision to deny the requested refund is reversed.

II. Statement of Issue

Was CIGA's decision to deny Surety's refund request a reasonable exercise of its discretion within the meaning of the 2007 Amendment to Insurance Code section 1063.5?

III. Contentions of the Parties

A. Surety contends:

1. CIGA's refusal was not a reasonable exercise of discretion under the 2007 Amendment because:

(a) CIGA's board relied on egregiously misleading and erroneous management-generated financial information, and CIGA made no attempt to correct or clarify the information after its flaws were revealed.

(b) CIGA based its refusal on an invalid *ex post facto* "rule" it enacted at its November 15, 2007 meeting, creating and adding non-statutory requirements to the 2007 Amendment's conditions for obtaining a refund.

(c) CIGA's "rule" was an amendment to CIGA's Plan of Operations and was invalid because CIGA adopted it without the prior written approval of the Insurance Commissioner, violating Insurance Code section 1063, subdivision (c), and Article XI of the Plan of Operations.

(d) Exercise of reasonable discretion to refuse the requested refund would, at the very

² Section 1063.5 requires CIGA to make assessments to cover claims in three separate categories of accounts: (1) workers' compensation insurance; (2) homeowners' and automobile insurance; (3) all other property or casualty classes. This case involves only category 1, workers' compensation insurance.

least, have required CIGA to produce evidence that paying the refund would impair CIGA's ability to meet its statutory obligations, specifically its ability to pay covered claims. CIGA's chief financial officer was its sole witness in the case. He expressly acknowledged that paying the refund would not result in such impairment, and CIGA presented no contrary evidence.

B. CIGA contends:

1. CIGA's discretion in deciding to grant or refuse a requested refund is limited only by the "business judgment" rule, namely, to act in the best interests of CIGA "as if" it were a private corporation.

2. CIGA's refusing the requested refund was within the "business judgment" rule, and must therefore be granted deference.

3. The fact that the financial information on which CIGA's board relied was erroneous and misleading is not material, as the board acted within its "business judgment" in relying on the information presented to it.

4. The refund "rule" adopted at the November 15, 2007 meeting was not an amendment to the Plan of Operations. CIGA properly exercised its "business judgment" in adopting the rule without prior notice or hearing, and without the Insurance Commissioner's prior written approval.

5. The overall financial condition of CIGA is poor, and no prediction can be made as to when or whether it will ever be "good" enough to permit a discretionary refund under Insurance Code section 1063.5. Until such time as there has been significant improvement in CIGA's overall financial condition, CIGA's decision that it will not exercise its discretion to grant refunds except in the circumstances described in the new "rule" is a reasonable exercise of its discretion under the 2007 Amendment to section 1063.5.

IV. Procedural History

On September 17, 2007, Surety first filed this appeal from CIGA's August 17, 2007 refusal to refund \$2, 117,181 in overpayment adjustments to assessments paid by Surety in 2004 and 2006. The appeal also asked for deferral of Surety's 2007 CIGA premium assessment. The case was assigned to Administrative Law Judge David R. Harrison (the "ALJ").

CIGA filed its response on November 7, 2007, argued that the appeal was premature, and noted that the board of CIGA would be taking up the matter at its regular meeting on November 15, 2007.

By letter dated November 19, 2007, CIGA counsel advised that the board had made a decision at the November 15 meeting, but the decision had not been reduced to final written form. On December 10, 2007, CIGA filed documents including by reference a written statement of what the board had decided at its November 15, 2007 meeting. The written statement was a letter dated November 30, 2007 from Wayne Wilson, CIGA's Executive Director, to Brian Sullivan, Controller of FFG Insurance Company.³ The letter included certain "rules"⁴ CIGA had adopted at the board meeting.

The ALJ conducted a status conference on January 24, 2008, since CIGA had refused to recognize Surety's documentation as sufficient to cause the Board to exercise the refund discretion contemplated in the 2007 Amendment. At this status conference (1) CIGA cited Mr. Wilson's letter of November 30, 2007⁵ as a full itemization of what CIGA would require; and (2) Surety requested 90 days to complete needed discovery, and to determine an acceptable source in the Insurance Department for obtaining more precise documentation to satisfy the "agreement-with-the commissioner" condition of the 2007 Amendment.

³ Exhibit 25.

⁴ Exhibits 204 and 205.

⁵ Exhibit 25.

On March 6, 2008, the ALJ conducted a further status conference, to resolve certain discovery matters. At this status conference, the parties agreed on various dates for proceeding with discovery. Following the March 6, 2007 status conference, the ALJ issued an Order requiring the parties to meet and prepare (1) a joint statement of the factual and legal issues in the case; and (2) a stipulation as to undisputed factual matters, both to be filed by April 22, 2008.

On April 22, 2008, the parties filed their *Joint Statement of Undisputed Facts, Factual Issues and Legal Issues to be Determined in this Appeal*. The Joint Statement (“JS-1”)⁶ presented: (1) fifty numbered paragraphs of “undisputed facts,” (2) twelve numbered paragraphs of “factual issues to be determined,” and (3) eight numbered paragraphs of “legal issues to be determined.”

The ALJ conducted further telephone status conference on May 1, 2008, to clarify some items in the April 22, 2008 Joint Statement and to set the matter for evidentiary hearing. Following this status conference, the ALJ issued formal Notice of Hearing setting the evidentiary hearing to commence on July 16, 2008, and scheduling deadlines for various matters to be completed before the hearing.

By letter dated May 13, 2008, Surety’s counsel requested that the “formal hearing” procedures of Government Code sections 11500 et seq. govern the proceedings. On May 16, 2008, the ALJ issued an Order responsive to the governing procedures request. The Order agreed in part with using the formal hearing procedures, and also referred to the May 2, 2008 Notice of Hearing as a governing document on the issue.

On June 2, 2008, the ALJ issued a revised schedule for pre-hearing matters, without, however, changing the date for the evidentiary hearing.

⁶ This opinion refers to the April 22, 2008 joint statement as “JS-1,” and refers to a later joint statement, filed at the beginning of the evidentiary hearing on July 16, 2008, as “JS-2.”

On or about June 19, 2008, the parties requested a further status conference to discuss certain discovery matters. The ALJ held the requested conference on June 25, 2008, and ordered the parties to complete certain depositions before the start of the evidentiary hearing. Thereafter, in accordance with the Notice of Hearing and the modified schedules, the parties filed their pre-hearing documents, objections, and pre-hearing briefs.

The evidentiary hearing was held in the San Francisco hearing room of the Department of Insurance on July 16, 2008. Kent R. Keller and Stephen C. Klein of Barger & Wolen appeared as counsel for Surety. D. Guerry Collins and Conrad V. Sison of Locke, Lord, Bissell & Liddell appeared as counsel for CIGA.

Prior to the start of the evidentiary hearing, the parties presented a further *Joint Statement Re Additional Stipulated Facts, Revised Factual Issues to be Determined and Revised Legal Issues to be Determined*. (“JS-2”). JS-2 added four new factual stipulations, presented eight “Revised Factual Issues to be Determined,” and deleted one issue⁷ from the JS-1 list of legal issues, retaining the others.

At the evidentiary hearing, the parties presented documentary evidence and oral testimony. Each party presented only one witness. Documentary evidence in this case includes all exhibits listed in the parties’ exhibit lists, except those⁸ to which the ALJ had sustained objections; the parties’ Joint Statements of facts and issues (JS-1 and JS-2); and Exhibits ALJ-1 and ALJ-2.⁹

On July 17, 2008, the ALJ issued post-hearing orders requiring CIGA to file, by no later

⁷ The deleted issue was whether FFG Insurance Company had standing to seek the refund Surety claimed. JS-2 resolved the issue, recognizing FFG had legal standing, and agreeing any refund would be paid directly to Surety, not FFG. (JS-2, ¶53 of “Additional Undisputed Facts.”)

⁸ Exhibits 29, 67, 68 and 208.

⁹ CIGA lodged Exhibits ALJ-1 and ALJ-2 on July 18, 2008. On July 30 and August 11, CIGA filed subsequent explanatory and authenticating documentation, and the ALJ admitted the exhibits on August 12.

than July 21, 2008: (1) a complete copy of its Plan of Operations;¹⁰ and (2) an unredacted copy of the minutes of its November 15, 2007 board meeting.¹¹ The ALJ also ordered the parties to brief the issue of whether the CIGA “rules”¹² adopted at its November 15, 2007 meeting were valid, or whether one or both of them constituted an amendment to the Plan of Operations requiring prior written approval of the Insurance Commissioner pursuant to Insurance Code section 1063(c).¹³

CIGA filed its brief on the “amendment” issue on July 18, 2008; Surety filed reply on July 23, 2008. On the remaining issues, Surety filed its post-hearing brief on August 27, 2008, and CIGA filed its brief on September 11, 2008.

The ALJ closed the record by Order dated November 12, 2008.¹⁴

V. Findings of Fact

A. Historical and Statutory Context

As an aid to understanding the factual findings in this case, the following summarizes the relevant historical and statutory context:

The California Legislature established CIGA in 1969 to create a fund for paying “covered claims” under insurance policies issued by companies that become insolvent. CIGA is a compulsory association of all California insurance companies (“members”) writing insurance in one or more of three insurance categories, namely: (1) workers’ compensation

¹⁰ Subsequently lodged and admitted as Exhibit ALJ-1.

¹¹ Subsequently lodged and admitted as Exhibit ALJ-2. Originally, CIGA lodged a heavily redacted version of the November 15 minutes (Exhibit 203) asserting that the redacted sections were “non-responsive and irrelevant.”

¹² Exhibits 204 and 205.

¹³ The ALJ raised this issue at the beginning of the July 16, 2008 evidentiary hearing. Neither party had done so.

¹⁴ On September 9, 2008, the ALJ underwent surgery that unavoidably delayed closing the record and issuing this Proposed Decision.

insurance; (2) homeowners' and automobile insurance; and (3) all other property and casualty insurance.

Historically, CIGA has generated funds by assessing all companies writing insurance in one or more of the three covered categories.¹⁵ Assessments are a uniform percentage of net direct premiums written by an insurer in California in an applicable category during an applicable year. Maximum permitted assessment percentages have been 1% or 2% of annual net premiums written in a category, as determined by statute. For the years 2003 - 2007 the percentage maximum was 2%. As of January 1, 2008, it reverted to its current 1% level.

In addition to its basic insolvency premium assessments, CIGA generates substantial funds from the estates of insolvent insurers.¹⁶ It also derives funds from investment revenues, and, in recent years, proceeds of certain bond sales first authorized by the Legislature in 2003.¹⁷

The annual insolvency premium assessment is based on net direct premiums written by a member insurance company in a category in an applicable calendar year. Initial assessment is typically based on net premiums written in that category during the most recent prior year for which annual statements are available. After the end of the applicable year, when annual statements are available, CIGA adjusts the assessment amount to reflect the actual net premium written in that year. If the insurer experiences a decline in premium volume from the prior year, meaning the initial assessment amount paid is more than the adjusted amount later calculated based on actual written premium, the insurer receives a credit for the difference against future assessments. If premium volume has increased from the prior year, and the adjustment results in

¹⁵ Assessments are sometimes called "insolvency premiums," i.e. payment for the "insolvency insurance" CIGA provides.

¹⁶ See, for example, CIGA annual statements for 2005-2007 (Surety Exhibits 16 and 17), item designated as "advances from liquidators." For advances limited to the workers' compensation category, see Exhibit 16, pages 20-21; Exhibit 17, pages 21-22.

¹⁷ Workers' Compensation Bond Fund, Ins. Code §§1063.70 - 1063.77.

an increased assessment, the increase must be promptly charged to the insurer.¹⁸

Insurance Code section 1063.14 requires insurers to recoup their assessments by surcharging their policyholders over the course of the applicable year. The surcharge is a uniform percentage of the amount billed for the underlying insurance coverage. If an insurer's collected surcharges come up short of its actual adjusted assessment for the applicable year, the deficiency is a credit against future assessments. If the collected surcharges exceed the adjusted assessment, the insurer must pay the excess to CIGA, and it then becomes a credit against future assessments of that insurer.

In 2003, to help CIGA meet its cash flow needs in the workers' compensation category, the legislature authorized the California Infrastructure and Economic Development Bank to issue bonds, upon CIGA's request, in an aggregate principal amount not to exceed \$1.5 billion at any one time.¹⁹ The bonds, when issued, become a debt obligation of CIGA. In addition to the historical insolvency premium assessments, Insurance Code section 1063.74 authorizes CIGA to assess workers' compensation insurers a uniform percentage of their workers' compensation premiums to defray the costs of serving the bonded indebtedness. The statute provides no maximum percentage-of-premium limit for this assessment.²⁰

CIGA determines the percentage amount for the bond assessment and notifies its member insurers. The insurers must recoup the bond assessment by an additional surcharge on policyholders during the applicable year, the percentage amount of the surcharge being as CIGA determines.²¹

¹⁸ Ins. Code §1063.5.

¹⁹ Ins. Code, Article 14.26, sections §§1063.70 ff., "Workers' Compensation Insurance Bond Fund." The Development Bank initially issued \$750 million in bonds in 2004. No subsequent issues have occurred.

²⁰ Section 1063.74 starts with the phrase "Notwithstanding any other limits on assessments" and provides that CIGA may levy "special bond assessments in the amount necessary to pay the principal and interest on the bonds..."

²¹ Ins. Code §1063.74(a).

Prior to a 1986 amendment, Insurance Code section 1063.5 required CIGA to refund insolvency premium overpayments calculated as a result of assessment adjustments (sometimes referred to as “true-up” adjustments). In practice, however, some companies elected to have overpayments credited against future assessments, and CIGA allowed this.

The 1986 amendment to section 1063.5, effective January 1, 1987, changed the statutory language relating to the difference between the initial premium charge and the adjusted premium charge by stating the difference must be “charged or credited” to the insurer, rather than “refunded or charged” as had been the case prior to the amendment.

In 2006, section 1063.5 was further amended, effective January 1, 2007 (“the 2007 Amendment”) to allow CIGA “at the discretion of the association” to refund credits due in a category resulting from adjusted premium calculations where the member insurer “has agreed with the commissioner to no longer write insurance in that category but has not withdrawn from the state and surrendered its certificate of authority.”

In this proceeding, the parties have stipulated Surety has achieved the required agreement “with the commissioner” to cease writing workers’ compensation insurance.²² Surety has not withdrawn from California nor has it surrendered its certificate of authority.²³

B. Findings of Fact²⁴

1. Surety is an Illinois-domiciled insurance company, admitted as an insurer in California since 1982, and authorized to write all lines of traditional property and casualty insurance, and workers’ compensation insurance. Surety is a member of CIGA and has timely paid all premium

²² JS-2 Undisputed Facts, ¶51. The “agreement” is a letter dated June 10, 2008 from Department of Insurance Senior Staff Counsel, Legal Division, Corporate Affairs Bureau (Exhibit 65).

²³ JS-1 Undisputed Facts, ¶48.

²⁴ This opinion cites various “Undisputed Facts” asserted in the Joint Statements, omitting irrelevant portions. JS-1 is the Joint Statement filed in April 2008. JS-2 is the Joint Statement filed at the evidentiary hearing on July 16, 2008. Numbers are those used in the numbered paragraphs of the Joint Statements.

assessments billed by CIGA, except the 2007 initial assessment, which Surety asked CIGA to defer or excuse. The deferral/exemption request was resolved and is no longer in dispute.²⁵

2. Until November 30, 2006, Surety was a subsidiary of AON Corporation. On June 30, 2006, AON agreed to sell AON Warranty Group to Warrior Acquisition Corp., an affiliate of Onex Corporation. Surety, as a provider of warranty coverage, was one of the companies AON sold. As part of the arrangements, AON agreed that Surety would limit its business to writing extended warranty insurance, and would cease writing workers' compensation and other property/casualty lines in all states. Concurrent with the sale, Surety entered into a loss portfolio transfer and asset transfer agreement with FFG Insurance Company ("FFG"), a wholly-owned AON subsidiary, transferring all net property/casualty reserves and other operating balances to FFG. The agreements also appointed FFG as administrator of Surety's non-warranty business, making FFG Surety's legal agent.²⁶ FFG has standing, as agent and attorney in fact for Surety, to pursue Surety's claim against CIGA for refund of net adjusted premium credits to Surety's CIGA account.²⁷ FFG was domiciled in Texas and had made certain financial commitments to Texas regulators as part of the approval process for AON's disposition and runoff of Surety's non-warranty business.²⁸ These commitments were such, however, that AON would be responsible for providing financing to see that they were met.²⁹

3. On July 21, 2006, AON notified the Insurance Department that Surety would not be renewing any non-warranty coverages in California, and that it would not place any new non-

²⁵ JS-1, Undisputed Facts, ¶¶1-5.

²⁶ JS-1, Undisputed Facts, ¶¶12-14

²⁷ JS-2, Undisputed Facts ¶56. See also footnote 7, *supra*, at page 6.

²⁸ Transcript, pages 76 – 81.

²⁹ Transcript, page 89.

warranty business.³⁰

4. On July 9, 2007, CIGA billed Surety \$3,446,667 for the 2007 Initial Premiums Assessment. CIGA also billed a special bond assessment at the same time for \$492,831. These assessments were based on Surety's 2006 workers' compensation premiums of \$196,952,372. By letter dated July 9, 2007,³¹ FFG, as agent for Surety, requested an exemption from the 2007 assessments and a refund of the 2005 adjusted assessment (\$2,117,181) in light of Surety's ceasing its workers' compensation placements and renewals, which would result in expected credits larger than the initial assessment and the already paid 2005 adjusted assessment.

5. By letter dated July 27, 2007³² CIGA's Director of Finance, Richard Hurd, advised Surety that its request for refund of the 2005 adjusted premium assessment required additional documentation in order to "meet the statutory definition which would trigger the right to receive a refunded adjusted premium assessment..." The letter characterized the 2007 Amendment to section 1063.5 as providing "that any credit due in a specific category to a member insurer as a result of the adjusted premium calculation may be refunded to the member insurer at CIGA's discretion if the member insurer has agreed with the Commissioner to no longer write insurance in that category *and surrendered its certificate of authority.*" (Exhibit 20-1, emphasis added.). The letter further requested that "you provide to CIGA Virginia Surety's agreement to no longer write Workers' Compensation business in the state of California from the California Department of Insurance Commissioner *and the surrendered Certificate of Authority*" (Exhibit 20-2, emphasis added.).³³ The letter also advised that the special bond assessment

³⁰ Exhibit 4. Letter of Pamela Hanner, AON Senior Counsel, to Commissioner Garamendi.

³¹ Exhibit 19.

³² Exhibit 20.

³³ The italicized language is an incorrect statement of what the 2007 Amendment requires. The Amendment specifically applies to a member that "has *not* withdrawn from the state and surrendered its certificate of authority." The same error appeared at footnote (9) of CIGA's 2005-2006 audited financial statements, and in Exhibit 22, discussed *infra* at footnote 34.

(.24%, or \$492,831) in the July 9, 2007 billing was due on August 10, 2007. Surety subsequently paid the special bond assessment.

6. By letter dated August 17, 2007,³⁴ CIGA advised that it would not refund the 2005 assessment credits, and Surety appealed.

7. After first notifying the Department of Insurance in July 2006 that it would not be writing any new or renewal workers' compensation business, Surety wrote a series of letters to the California Department of Insurance, seeking appropriate confirmation to comply with the 2007 Amendment's requirement that a party seeking a refund of assessment credits must have "agreed with the commissioner" to cease writing insurance in the category that generated the credits.

8. The Department had no procedures or forms for compliance with the 2007 Amendment's agreement requirements, but eventually, on June 10, 2008, Senior Staff Counsel for the Department wrote a letter to Surety counsel confirming that Surety had agreed to cease writing workers' compensation and other categories of insurance. The parties stipulated that this letter complied with the "agreement with the commissioner" condition of the 2007 Amendment.³⁵

9. Prior to a 1986 amendment, Insurance Code section 1063.5 required CIGA to refund assessment credits to its members. The 1986 amendment, effective January 1, 1987, changed the statutory language relating to the difference between initial assessment charges and adjusted assessment charges by stating the difference must be "charged or credited" to the insurer, rather than "refunded or charged" as had been the case prior to the amendment.

From 1987 until the summer of 2005, however, when adjusted premium assessments

³⁴ Exhibit 22. The letter alludes, inter alia, to Surety's failure to "surrender its certificate of authority" as a defect in the request for refund. As noted, the 2007 Amendment has no such requirement. See footnote 33, *supra*.

³⁵ JS-2 Undisputed Facts ¶51.

charged to a member were less than the member's initial premium assessments, CIGA routinely refunded the difference. It was not until the 2005 adjusted premium assessments were billed that CIGA began advising its members that credit balances would be credited against future premium assessments, not refunded. CIGA announced this new position based on its being advised by (unidentified) legal counsel that "the California Insurance Code only allows CIGA to issue credits, not refunds" of calculated overpayment adjustments.³⁶

10. In or about the summer of 2006, CIGA sought and obtained the 2007 Amendment to section 1063.5, allowing CIGA to refund a member's assessment credits where the member has agreed with the Insurance Commissioner to cease writing the category of insurance that generated the credits. The 2007 Amendment is the statutory basis for Surety's refund request.

11. CIGA first implemented the 2007 Amendment on February 14, 2007, when it approved refunding \$16,457,933 in assessment credits to the Kemper companies. As part of the approving resolutions, the minutes stated the board "has determined that refunding the adjusted premium credits to the Kemper Companies will not have any adverse effect on the Association's cash flow needs, or its ability to timely pay covered claims."³⁷ At that time, the board had no general "rules" relating to how it would exercise its discretion under the 2007 Amendment.

12. Surety's refund request was the only refund request presented to CIGA after the 2007 Amendment went into effect.³⁸ CIGA management placed Surety's request on the agenda for the board's regular quarterly meeting held on November 15, 2007.

13. At the November 15, 2007 meeting, CIGA's Board of Governors adopted a formal set

³⁶ Letter of December 20, 2005 from Richard Hurd, CIGA Director of Finance, re 2004 Adjusted Premium Charge for California Indemnity Insurance Company, etc, Page 68 of Exhibit 2 to Deposition of Wayne Wilson. (Surety Exhibit 71.) CIGA has had the same legal counsel since 1991 or 1992.

³⁷ Exhibit 218.

³⁸ The Kemper request antedated the 2007 Amendment's effective date. The Amendment, however, made settlement of Kemper's request possible.

of rules: (1) delegating authority to the Executive Director to exercise CIGA's discretion to grant refunds of adjusted premium credits; and (2) prohibiting the Executive Director from approving any refunds unless the following conditions are met:

- (i) the member insurer requesting the refund has agreed with the California Commissioner of Insurance not to write any workers' compensation insurance business in California;
- (ii) the member insurer is in run-off under the supervision, oversight or control of the regulatory authority in the member insurer's state of domicile; and
- (iii) failure to approve the refund could jeopardize the run-off plan and risk having the member insurer placed into liquidation.^{39,40}

14. Surety was not in runoff under the supervision, oversight, or control of the insurance regulatory authority in its domiciliary state (Illinois).⁴¹

15. The "criteria for refunds and deferral of premium assessments utilized by CIGA as adopted in the November 15, 2007 resolutions had their origin in CIGA's concerns"⁴² that:

(1) it faced cash flow problems brought about by the reduction in California gross workers' compensation premiums; (2) it had bonded indebtedness of \$750 million that must be repaid by 2023 out of premium assessments (and any distributions from liquidated companies); (3) the "possibility" that it would have to return to the bond market; and (4) the deficit in the workers'

³⁹ Exhibit 204. Condition (i) is required by the 2007 Amendment. Conditions (ii) and (iii) are CIGA's inventions, not part of the statute. CIGA management was aware that Surety could not meet condition (ii) or (iii), and Surety made no attempt to do so. The rules are negative conditions precedent to the Director's exercising any discretion in response to a refund request. If any condition is not met, discretion may not be exercised. If, however, all conditions are met, the rule provides no assurance the Director will grant the requested refund.

⁴⁰ At the November 15, 2007 meeting, CIGA's Board also passed and adopted formal rules setting forth criteria to be met by a member insurer seeking deferral or exemption from paying an assessment. Surety's earlier exemption request is no longer a part of these proceedings, and the ALJ does not, therefore, comment on the related rules..

⁴¹ Surety Annual Statements for 2006 and 2007 (CIGA Exhibits 201 and 202)

⁴² JS-1, Undisputed Facts, ¶44.

compensation account exceeded \$1.6 billion.⁴³ Substantially these same “facts,” or worse, were known to CIGA when it “sought and obtained” the 2007 Amendment to section 1063.5.⁴⁴

16. The pre-conditions set in CIGA’s rules for exercising its discretion to refund (or not) assessment credits were to “remain in effect until there has been significant improvement in the factors cited ... relating to the overall financial condition of CIGA’s workers’ compensation claim account.”⁴⁵ However, there is no way of predicting when, if ever, such a “significant improvement” might occur, nor how large it would have to be.⁴⁶

17. The rules adopted at the November 15, 2007 meeting relating to refunds of assessment credits were adopted after the fact, without prior notice or hearing, specifically in response to Surety’s refund request.⁴⁷ CIGA never presented these rules to the Insurance Commissioner for approval.

18. The financial information presented to the Board at its November 15, 2007 meeting consisted of certain general financial information presented and discussed by CIGA’s executive director, and a single document,⁴⁸ prepared by CIGA’s chief financial officer, purporting to show CIGA’s financial condition and projections. The document (1) omitted

⁴³ *Ibid.*

⁴⁴ The bonded indebtedness of \$750 million was incurred in 2004. According to CIGA’s annual statements (Exhibits 16 and 17), the deficit condition in the workers’ compensation fund had improved from (\$2.63 billion) as of June 30, 2006, to (\$2.26 billion) as of June 30, 2007. The “more than \$1.6 billion” deficit referred to at the November 15, 2007 board meeting was an improvement from the June 30, 2007 deficit position. The reduction to 1% in the assessment rate was part of the 2003 legislation that temporarily raised the assessment rate to 2%.

⁴⁵ Exhibit 204, Section 2.

⁴⁶ Deposition of Wayne Wilson, Executive Director, pages 70-71. (Surety Exhibit 71). The parties stipulated that Mr. Wilson’s deposition could be used instead of requiring him to testify in person. Each party presented selected excerpts from the deposition to the ALJ. Both parties selected pages 70-71.

⁴⁷ The unredacted minutes (Exhibit ALJ-2) of the meeting show that Surety, and only Surety, was identified, and the “rules” were adopted immediately before Surety’s requests were presented for the board to reject. The minutes do not evidence discussion or consideration of any other requests, and, indeed, suggest that the new rules precluded any consideration of Surety’s request, other than to decide it did not comply with the new rules.

⁴⁸ Exhibit 207.

substantial estate recoveries that CIGA's chief financial officer "did not have time" to determine in preparation for the meeting or for the evidentiary hearing;⁴⁹ (2) ignored available WCIRB information in projecting assessment revenues because the witness "had not had time" to review the third quarter reports of the WCIRB;⁵⁰ (3) presented estimates of future premiums for assessment purposes that had no basis other than the "guess" of the Chief Financial Officer;⁵¹ and (4) presented projected losses and loss adjustment expenses that were allegedly based on what an actuary had "told" the Chief Financial Officer, with no written actuarial report.⁵² CIGA made no attempt to correct or update any of this information for the evidentiary hearing.⁵³

19. At the November 15, 2007 meeting, the CIGA board did not discuss or consider the actual refund amount Surety sought.⁵⁴

20. After Surety filed this appeal, and while the appeal was pending, the amount of Surety's refund request changed due to additional adjusted assessment credits that resulted from further assessment billings and payments. By the time the matter came to evidentiary hearing, Surety's total adjustment credits were \$4,292, 029.04.⁵⁵ If the Surety refund request is granted, this is the amount CIGA should pay.

21. Paying Surety's requested refund will not impair CIGA's ability to perform its statutory duties in any significant way. CIGA's financial condition in November 2007 was at least as good as when CIGA approved Kemper's \$16 million refund in February of 2007 and

⁴⁹ Transcript, pages 157-162.

⁵⁰ Transcript, page 164.

⁵¹ Transcript pages 143-144.

⁵² Transcript pages 141-143.

⁵³ Transcript, pages 161-162.

⁵⁴ Exhibit ALJ-2, Unredacted Minutes of November 15, 2007 Meeting, all pages. The minutes do not mention any consideration of the actual amount or range of amounts for the Surety refund claim.

⁵⁵ The amount is not in dispute; see Exhibit 69-5, CIGA Invoice dated 6/24/2008.

found that doing so “would not have any adverse effect on the Association’s cash flow needs, or its ability to timely pay covered claims.”⁵⁶

22. CIGA’s financial condition in November 2007 was also significantly better than when CIGA had “sought and obtained” the 2007 Amendment.⁵⁷

23. By letter dated November 30, 2007⁵⁸ to Brian Sullivan, Controller of FFG, Wayne Wilson, CIGA’s Executive Director, quoted the “rules” the Board adopted at the November 15, 2007 meeting, and advised “...the Board found that Virginia Surety had not met the conditions under which ... a refund of an adjusted premium credit would meet the policies established by the Board and directed the association to deny Virginia Surety’s request...”⁵⁹

24. Section 1 of Article XI “Amendment” of CIGA’s Plan of Operation⁶⁰ states:

Section 1. It is the intent of the Association that this Plan of Operation and the insolvency policy issued to the members of the Association shall fully comply with the provisions of Articles 14.2, 14.25, and 14.26^[61] of the Code and all other applicable provisions of the Insurance Code of the State of California pertaining to this Association as the same now stand or may hereafter be amended, and with any applicable rules, regulations or orders lawfully promulgated by the Commissioner. Should there be any change in the rights, duties or obligations of the Association, whether by limitation, modification or addition, and whether by statutory addition or amendment or through promulgation of rules, regulations or orders by the Commissioner, *such changes shall automatically be incorporated into this Plan of Operations* and the insolvency policy issued by the Association to its members, and it shall not be necessary for the Association to formally amend said Plan or policy. *However, the Association may from time to time issue clarifying amendments thereto or a restated Plan of Operations or insolvency policy, subject to the written approval of the Commissioner.* (Emphasis added.)

⁵⁶ Transcript pages 182-183.

⁵⁷ See footnote 44, *supra*, at page 16.

⁵⁸ Exhibit 25.

⁵⁹ See also Exhibit ALJ-2, Unredacted Minutes of Meeting of November 15, 2007, page 5, noting the Board adopted a motion to deny Surety’s request “for the reasons sets forth and consistent with the policy set forth in the resolutions that had previously been adopted.”

⁶⁰ Exhibit ALJ-1, page 17.

⁶¹ Articles 14.2, 14.25, and 14.26 include Insurance Code sections 1063-1063.16, 1063.50-1063.68, and 1063.70-1063-77.

DISCUSSION

The Financial Context

The principal issue in the case is whether CIGA properly exercised its discretion under the 2007 Amendment to section 1063.5 in denying CIGA's refund request. The statute sets no guidelines for exercising the discretion, but the parties agree, and the ALJ finds, the financial impact of granting or refusing the refund request is a relevant consideration. The two witnesses who testified at the evidentiary hearing both discussed the financial context.

Brian Sullivan, Controller of FFG Insurance Company, the company designated to act as Surety's agent in running off its workers' compensation business, described generally the arrangements with AON Corporation and pointed out certain problems with Texas regulators that might occur if Surety did not receive its refund.⁶² These related to commitments AON had made in order to obtain regulatory approval for the arrangements. Mr. Sullivan stated his understanding, however, that AON had committed to provide necessary financing if any problems occurred.⁶³

Mr. Hurd, chief financial officer of CIGA testified he had prepared the financial projections⁶⁴ presented to the CIGA board at its November 15, 2007 meeting. On cross-examination, he stated he had "not had time" to prepare current data for the meeting, and acknowledged various flaws in his materials.⁶⁵ The numbers he presented to the CIGA board at the November 15, 2007 meeting appear to the ALJ to have been "culled" to present a skewed scenario to the board attempting to justify decisions management wanted the board to make.

⁶² Transcript, pages 78-81. Exhibits 1 through 3.

⁶³ Transcript, pages 74-75.

⁶⁴ Exhibit 207.

⁶⁵ Finding of Fact 18, *supra*, pages 16-17.

CIGA's Executive Director, Wayne Wilson, and unidentified "counsel" pre-drafted the "rules" adopted at the meeting, without notice or hearing, and, as planned, the board adopted them without change.

Ultimately, and most importantly, however, Mr. Hurd testified that paying the Surety refund would have no significant adverse effect on CIGA's financial condition.⁶⁶

A. The Credit Refund Rules CIGA Adopted at its November 15, 2007 Board Meeting were Invalid

A threshold issue is whether the credit refund rules CIGA adopted at its November 15, 2007 board meeting were valid.⁶⁷ They were not. They did not have the Insurance Commissioner's prior written approval, as required by Insurance Code section 1063, subdivision (c) and by Article XI of CIGA's Plan of Operation.

Insurance Code section 1063, subdivision (c) requires the Commissioner's prior written approval for any amendments to CIGA's Plan of Operations.⁶⁸ CIGA argues that section 1063, subdivision (c), does "not specify its contents or reach, except to state the plan may not contradict statutory provisions."⁶⁹ CIGA argues the "reach" of the statute enumerates matters the Plan must provide for. These matters include only (1) designating servicing facilities (Ins. Code §1063 subd. (e)), and (2) addressing the manner and mode of recoupment of assessments by surcharging policyholders. (Ins. Code §1063.14 subd. (a).) CIGA "detects no other statutory sections specifying areas of concern or operation of the Plan of Operation."⁷⁰

⁶⁶ Transcript, pages 182-183.

⁶⁷ Exhibit 204. The Exhibit 205 rules, relating to deferrals or exemptions, are no longer relevant to determine the refund issue, and the ALJ refrains from ruling on their validity.

⁶⁸ "The plan of operations and any amendments thereto shall be subject to prior written approval by the commissioner." (Ins. Code §1063 subd. (3).)

⁶⁹ This decision refers to the *Brief of California Insurance Guarantee Association on Plan of Operation Issue*, filed July 18, 2008 as the "CIGA Brief." The quote is from page 2, lines 8-9 of the CIGA Brief.

⁷⁰ CIGA Brief, page 2, lines 15-20.

From this narrow view of the statutory scheme, CIGA argues that since the cited statutes enumerate the specific things the Plan must provide for, anything not enumerated is outside the scope of the Plan⁷¹ and cannot, therefore, be regarded as an amendment to it requiring the Commissioner's prior written approval.

CIGA asserts the Plan of Operation "confirms the power of the board of governors to exercise its statutory discretion regarding refunds"⁷² --- even though CIGA also argued that credits and refunds are not enumerated in the CIGA legislation as a subject for the Plan of Operation and are therefore precluded from being the subject of an amendment requiring Commissioner approval.

CIGA's argument entirely ignores Article XI ("Amendments") of the CIGA Plan of Operation. (Exhibit ALJ-1).

Article XI of the Plan states:

...Should there be any change in the rights, duties or obligations of the Association, whether by limitation, modification or addition, and whether by statutory addition or amendment or through promulgation of rules, regulations or orders by the Commissioner, *such changes shall automatically be incorporated into this Plan of Operations* and it shall not be necessary for the Association to formally amend said Plan... However, the Association may from time to time issue clarifying amendments thereto, *subject to the written approval of the Commissioner.*

(Plan of Operation, page 17, Article XI, Exhibit ALJ-1, Emphasis added.)

Pursuant to Article XI, the 2007 Amendment to section 1063.5 "automatically" became part of the Plan of Operation. The ALJ finds that CIGA's refund "rules" adopted at the November 15, 2007 meeting were "clarifying amendments" detailing the precise conditions CIGA was imposing before it would consider exercising the discretion granted in the 2007 Amendment. CIGA could not therefore lawfully adopt or implement these rules without

⁷¹ *Idem.*, page 2, lines 21-25.

⁷² *Idem.*, page 3, lines 1-2.

“prior written approval by the commissioner.”⁷³

Moreover, CIGA’s new refund rules did more than merely “clarify” the 2007 Amendment --- they created new, non-statutory obstacles to CIGA’s even considering a refund request.⁷⁴ In this respect, it was particularly important that CIGA submit the rules to the Commissioner for prior evaluation and approval (or disapproval) pursuant to section 1063, subdivision (c). CIGA intentionally failed and refused to do so.⁷⁵

Continuing to ignore Article XI and citing various examples where CIGA’s board normally exercises discretion pursuant to statutory authority, CIGA repeats its argument that the authorizing statutes and the cited examples are outside the scope of the Plan of Operation.⁷⁶ The argument has no merit. Article X specifically provides that any “change in the rights, duties or obligations of the Association” is “automatically” incorporated into the Plan of Operation. The 2007 Amendment clearly changed the rights, duties and obligations of CIGA, giving it a new right to grant refunds, and a duty to exercise its discretion in considering a refund request meeting the Amendment’s requirements. General “rules” or “clarifying amendments” affecting or limiting how or whether CIGA will exercise its statutory discretion must necessarily have the Commissioner’s prior written approval.⁷⁷ To hold otherwise would be to empower this non-regulatory organization, without oversight, to adopt policies and engage in practices affecting the entire property/casualty and workers’ compensation insurance industry.

⁷³ Ins. Code §1063, subd.(c).

⁷⁴ To the extent the rules preclude CIGA’s even exercising the discretion contemplated in the statutory language, they are arguably “inconsistent with” the statute and thus violate the substance of §1063, subd. (c), as well as its “prior written approval” requirement.

⁷⁵ Transcript, pages 39-40, 100-101. CIGA intentionally did not seek the Commissioner’s approval, actively maintaining that it was not required to do so.

⁷⁶ CIGA Brief, pages 5-7.

⁷⁷ Ins. Code §1063 subd. (c); Exhibit ALJ-1, Plan of Operation, Page 17, Article XI.

The sole communicated basis⁷⁸ for denying Surety's refund request was Surety's failure to comply with the "rules"⁷⁹ adopted at the November 15, 2007 meeting. These rules were themselves after-the-fact creations, enacted with no notice or hearing, never communicated to Surety until after CIGA had invented them as a reason to reject Surety's refund request. Adherence to these rules resulted in CIGA's *failure to exercise its statutory discretion* in reviewing Surety's refund request. Instead, CIGA relied on these "rules," adopted after the fact and without notice, to create an artificial barrier against its having to exercise any discretion at all in responding to the refund request. It did not even have to examine how much money the requested refund involved, since its new rules barred granting the request, no matter how small.⁸⁰ The "standard of discretion" issue does not arise because the case presents a failure to exercise the statutory discretion. This failure is *per se* an abuse of discretion.⁸¹

The ALJ finds the rules passed at the November 15, 2007 meeting have no legal force or effect. Decisions based on failure of Surety to comply with those rules, as announced in CIGA's letter of November 30, 2007 to the FFG's Controller are similarly invalid.

B. CIGA Failed to Exercise its Discretion in Conformity with the Spirit and Purpose of the 2007 Amendment to Insurance Code Section 1063.5

Even if the rules adopted at the November 16, 2007 board meeting had been validly adopted, they would not constitute a reasonable exercise of the discretion granted to CIGA by the 2007 Amendments to section 1063.5.

Surety's post-hearing brief (at pages 9-11) discusses and cites authorities outlining

⁷⁸ Exhibit 25, CIGA letter of November 30, 2008 to FFC's Controller.

⁷⁹ Exhibit 204.

⁸⁰ Finding of Fact 19, page 17, *supra*.

⁸¹ *Woodbury v. Brown-Dempsey* (2003) 108 Cal.App.4th 421, 437-438, cited by CIGA at page 8 of its Post-Hearing Brief.

general guidelines that must govern the exercise of discretion granted by statute. Most eloquent and persuasive is the quote from the ancient *Bailey* case (*Bailey v. Taffee* (1866) 29 Cal.422, 424), frequently repeated in subsequent decisions:

‘The discretion intended, however, is not a capricious or arbitrary discretion, but an impartial discretion, guided and controlled in its exercise by strict legal principles. It is not a mental discretion, to be exercised *ex gratia*, but a legal discretion, to be exercised *in conformity with the spirit of the law and in a manner to subserve and not to impede or defeat the ends of substantial justice.*’ (*Bailey, supra*, as quoted in *Harris v Alcoholic Control Appeals Board* (1965) 62 Cal.2d 589, 594-595. Emphasis added.)

After CIGA first began to assert, in late 2005, that it would comply with the anti-refund mandate of the 1986 amendments to section 1063.5, it became clear to the Legislature and to CIGA itself that those mandates, if strictly obeyed, could lead to unfair results in cases where “credits” for assessment premium adjustments would be valueless because there would be no future premiums and hence no assessments against which to offset them. In particular, the issue became an obvious problem at about the time Kemper sought refunds of its adjusted assessment credits in 2006.

Accordingly, while the Kemper refund request was pending in 2006, CIGA sought and obtained the 2007 Amendment,⁸² recognizing that if a company had formally agreed with the insurance commissioner to cease writing a category of insurance, it would never be able to recover value from the credits it had earned, since there would be no future assessments against which it could use the credits. This was unfair, resulting in a *de facto* forfeiture of assessment credits a member had earned by timely paying its assessments as CIGA called for them. The 2007 Amendment was, on its face, designed to remedy this unfairness.

In 2006, when CIGA sought and obtained the 2007 Amendment: (1) CIGA’s financial condition was significantly worse than it was in November 2007, when it considered Surety’s

⁸² Finding of Fact 10, *supra*, page 14..

refund request; and (2) CIGA had full knowledge of the anticipated events it later cited as “concerns” to support its new rules when it turned down Surety’s refund request.⁸³

The workers’ compensation fund deficit had been \$3.52 billion as of June 30, 2005, \$2.63 billion as of June 30, 2006, and, by June 30, 2007, \$2.26 billion.⁸⁴ When the board considered Surety’s request in November 2007, the deficit was “more than \$1.6 billion,”⁸⁵ significantly lower than in the three prior years.

The financial context for the 2007 Amendment was a deep deficit, with no predictable end in sight. A continuing, but smaller, deficit was the context for Surety’s refund request in November 2007.

Given the surrounding circumstances, the ALJ finds that CIGA’s generalizations about its “overall financial condition” were not a sufficient basis for denying a refund request that met the statutory “agreement-with-the-commissioner” requirement of the 2007 Amendment and was not financially threatening to CIGA’s performing its insolvency duties. The “overall financial condition” approach CIGA suggested⁸⁶ would mean the 2007 Amendment was never intended to allow CIGA to pay a refund unless and until some miraculous leap to a “substantially improved” financial condition occurred, an event which all witnesses agreed was unpredictable in time, and uncertain in amount.⁸⁷ The vagueness and uncertainty of CIGA’s “overall financial condition” position, if adopted, would simply perpetuate the unfairness the 2007 Amendment was designed to remedy.

⁸³ Findings of Fact 15, *supra*, pages 15-16.

⁸⁴ *Ibid.*

⁸⁵ Finding of Fact 17, *supra*.

⁸⁶ *Ibid.*

⁸⁷ CIGA’s Executive Director, Wayne Wilson, testified (Wilson deposition, pages 70-71) that financial conditions were ongoing and there was no way of guessing when they would be sufficiently “improved” to allow CIGA to change the rules adopted at the November 15, 2007 meeting.

Looked at in this light, i.e. as a remedy to avoid a manifestly unfair result, the ALJ finds that the 2007 Amendment dictates a course of action and an exercise of discretion designed to carry out the Amendment's purpose *in conformity with the spirit of the law and in a manner to subserve and not to impede or defeat the ends of substantial justice.*⁸⁸ Unless, therefore, the circumstances are such that allowing the refund would have "an adverse effect on CIGA's cash flow needs or its ability to timely pay covered claims"⁸⁹ the burden of justifying denial should properly be on CIGA. CIGA's own financial witness testified that if CIGA paid Surety's refund request, no such adverse effect would occur.⁹⁰

Moreover, CIGA did not assert its "concerns" regarding its overall financial condition as the reason for denying Surety's refund request. Rather, CIGA cited these "concerns" as the "origin" of the "criteria for refunds and deferral of premium assessments utilized by CIGA as adopted in the November 15, 2007 resolutions."⁹¹ Whether or not the described financial concerns might be a reasonable basis for proposing rules to the commissioner for approval, the plain fact is such approval was never sought. The rules were never validly adopted, as CIGA failed to comply with Article XI of the Plan of Operations and section 1063, subdivision (c) of the Insurance Code.

The ALJ finds that CIGA has failed to establish a reasonable basis for its actions consistent with the purposes of the 2007 Amendment.

⁸⁸ *Bailey v. Taffee* (1866) 29 Cal.422, 424, quoted *supra*.

⁸⁹ Standard CIGA used in granting Kemper's refund request. Finding of Fact 21, pages 17-18.

⁹⁰ Transcript, pages 182-183.

⁹¹ Finding of Fact 15, *supra*. JS-1, ¶44.

CONCLUSION AND DETERMINATION OF ISSUE

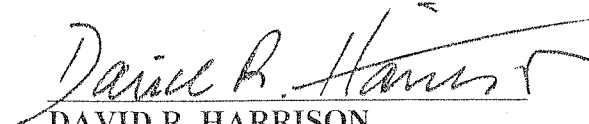
For the foregoing reasons, the ALJ concludes that CIGA, in refusing Surety's request for refund, did not reasonably exercise its statutory discretion under the 2007 Amendment to Insurance Code section 1063.5.

ORDER

1. CIGA's decision to refuse Surety's refund request is reversed.
2. Within 90 days after the Commissioner's Order adopting this Proposed Decision becomes final, CIGA shall pay \$4,292,029 to Surety as a full refund of accumulated credits resulting from assessment adjustments in Surety's workers' compensation account.
3. Surety shall not begin or resume writing workers' compensation insurance in California without first applying for and obtaining the prior written permission of the California Insurance Commissioner and meeting such other conditions as the Commissioner may impose. Surety shall give CIGA prior notice of any such application.

I submit this Proposed Decision based on the evidentiary hearing, records and files in this matter and recommend its adoption as the decision of the Insurance Commissioner of the State of California.

Dated: 24 December 2008


DAVID R. HARRISON
Administrative Law Judge
Administrative Hearing Bureau
California Department of Insurance

DECLARATION OF SERVICE BY MAIL (AND FAX)

Case Name/No.: In the Matter of the Appeal of
VIRGINIA SURETY COMPANY
FILE NO. CIGA-07-1

I, JEAN T. AGPOON, declare that:

I am employed in the County of San Francisco, California.
I am over the age of 18 years and not a party to this action. My
business address is State of California, Department of Insurance,
Administrative Hearing Bureau, 45 Fremont Street, 22nd Floor, San
Francisco, California, 94105.

I am readily familiar with the business practices of the
San Francisco Office of the California Department of Insurance for
collection and processing of correspondence for mailing with the
United States Postal Service. Said ordinary business practice is
that correspondence is deposited with the United States Postal
Service that same day in San Francisco, California.

On January 13, 2009, following ordinary business
practices, I caused a true and correct copy of the following
document(s):

ORDER ADOPTING PROPOSED DECISION AND
DESIGNATING PORTION OF DECISION AS PRECEDENTIAL

to be placed for collection and mailing at the office of the
California Department of Insurance at 45 Fremont Street, San
Francisco, California, with proper postage prepaid, in a sealed
envelope(s) addressed as follows:

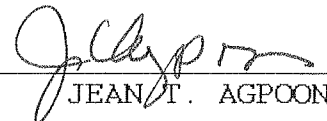
(SEE ATTACHED SERVICE LIST)

In addition, on _____, I also FAX'ed a copy of
said document to all parties where indicated to the FAX number
which is printed under each address on this Declaration.

I declare under penalty of perjury that the foregoing is
true and correct, and that this declaration was executed at San
Francisco, California, on January 13, 2009.

January 13, 2009

DATE


JEAN T. AGPOON

PARTY SERVICE LIST
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