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## The Disaster After the Disaster: Insurance Companies' Post-Catastrophe Claims Handling Practices

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## COMMENT

### The Disaster After the Disaster: Insurance Companies' Post-Catastrophe Claims Handling Practices

#### *I. Introduction*

The recent surge of catastrophic events in the United States has unveiled the insurance industry's newly developed techniques for dealing with catastrophe claims.<sup>1</sup> In 2005, insurance companies in the United States and worldwide suffered the most costly catastrophe year in history.<sup>2</sup> Hurricanes Katrina, Rita, and Wilma—three of the ten most costly world insurance losses in history—occurred in the United States between August 2005 and October 2005.<sup>3</sup> Insured losses in the United States for the 2005 catastrophes totaled \$61.2 billion and more than doubled the record setting 2004 losses of \$27.3 billion.<sup>4</sup> Unfortunately, catastrophe losses are expected to double every ten years.<sup>5</sup>

Currently, a single incident, or series of closely related incidents, must cause insured property losses above \$25 million to be classified as a catastrophe.<sup>6</sup> In 2005, the Insurance Information Institute reported twenty-four catastrophic

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1. The Insurance Information Institute reported twenty-four catastrophic events in the United States in 2005. Press Release, Ins. Info. Inst., Insurers to Pay a Record \$56.8 Billion in 2005 Catastrophe Claims (Jan. 26, 2006), available at <http://www.iii.org/media/updates/press/749501/archive/press.749501/>.

2. Ins. Info. Inst., Catastrophes: U.S., <http://www.iii.org/media/facts/statsbyissue/catastrophes> (last visited June 13, 2008). The Munich Re Foundation, one of the world's top reinsurance companies, reported to the United Nations that preliminary estimates for world insured losses for 2005 exceeded \$70 billion. *Climate Talks: 2005 Weather Disasters Most Costly Ever*, ENV'T NEWS SERVICE, Dec. 7, 2005, <http://www.ens-newswire.com/ens/dec2005/2005-12-07-01.asp>.

3. Ins. Info. Inst., *supra* note 2. The Insurance Services Office ranked August 2005's Hurricane Katrina as the most costly insurance loss in history, with insured losses at \$45 billion. Hurricane Rita, September 2005, ranked sixth, with insured losses at \$10 billion. Hurricane Wilma, October 2005, ranked seventh, with insured losses at \$10 billion. *Id.*; see also Tom Ramstack, *Insurance Group Touts Storm Plan: Critics Urge Reliance on Catastrophe Fund*, WASH. TIMES, Aug. 23, 2006, at C12 (stating Hurricanes Katrina, Rita, and Wilma prompted \$61 billion in claims by 3.3 million policyholders).

4. Ins. Info. Inst., *supra* note 2.

5. Press Release, Ins. Info. Inst., Catastrophe Losses Will Double About Every 10 Years, Says Leading Catastrophe Modeling Expert at PCS Conference (Apr. 25, 2006), available at <http://www.iii.org/media/updates/press.753652/>.

6. Ins. Info. Inst., Glossary of Insurance Terms, <http://www.iii.org/media/glossary/> (search "Glossary" for the term "catastrophe") (last visited June 13, 2008).

events in the United States.<sup>7</sup> The leaders of major insurance companies suggest that unless the nation changes the way it handles major catastrophes, the insurance industry will suffer economic devastation in the event of another catastrophic year like 2005.<sup>8</sup> Major insurance companies claim Hurricane Katrina eliminated decades of profits and that the next major catastrophe may result in insolvency.<sup>9</sup> Nevertheless, the companies' balance sheets from 2005 indicate that this doomsday prediction may be poorly founded.<sup>10</sup> The insurance industry posted record profits in 2005, even though 2005 was the most expensive catastrophic year in history.<sup>11</sup>

Further, although premiums for homeowners insurance continue to increase steadily, coverage is decreasing dramatically.<sup>12</sup> The insurance industry claims that remedying the problems and risks associated with insuring individuals against catastrophes requires substantial premium hikes, scaling back commitments in disaster prone areas, and an increased role for the government in pre-disaster planning and post-disaster response.<sup>13</sup> This comment analyzes these suggestions as well as other techniques the industry used to reduce financial exposure during the most costly catastrophic period in history. While the recent catastrophes alone demonstrate the need for reform in the area of catastrophe management, it should not be the government's role, as suggested by many leading insurers, to compensate the insurance industry's shortcomings.<sup>14</sup> Rather, a close examination of recent catastrophes and their

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7. Press Release, Ins. Info. Inst., *supra* note 1.

8. Press Release, Ins. Info. Inst., Reforms Needed to Prepare for Major Catastrophes, Insurance CEOs Tell Forum (Jan. 10, 2006), available at <http://www.iii.org/media/updates/press.748575/>.

9. *Id.*; see also John Gibeaut, *Forces of Change*, A.B.A. J., Jan. 2007, at 40, 42 (discussing insurers' belief that another massive catastrophe or terrorist attack could financially devastate the insurance industry).

10. State Farm reported a \$3.5 billion pretax operating profit for 2005 solely for their property and casualty line of insurance. *Hurricanes Drive 39% Decline in Net Income for Giant State Farm, INS. J., Feb. 26, 2006*, <http://www.insurancejournal.com/news/national/2006/02/26/65934.htm> [hereinafter *State Farm Net Income*]. State Farm also reported a \$3.9 billion increase in their overall net worth, raising their net worth to \$50.2 billion in 2005. *Id.* Allstate reported a net income of \$1.8 billion for 2005. ALLSTATE CORP., 2005 SUMMARY ANNUAL REPORT 4 (2006), available at <http://www.allstate.com/investor/annual%5Freport/2005/pdf/2005AllstateSAR.pdf>.

11. Peter G. Gosselin, *Insurers Saw Record Gains in Year of Catastrophic Loss*, L.A. TIMES, Apr. 5, 2006, at A1 (reporting the United States insurance industry made record profits of \$44.8 billion in 2005, an 18.7% increase from 2004).

12. *Id.*

13. *Id.*

14. Kristina Herrndobler, *Insurance Industry Frets About Mega-Risks: Companies Lobby for Catastrophe Reinsurance*, BEAUMONT ENTER., Apr. 2, 2006, at E1 (stating that insurers

aftermath reveals that drastic changes in the conduct of responsible insurance companies will pave the way to more effective and ethical management of catastrophic events in the future.

Following a major catastrophe, millions of homeowners are desperate to resolve their insurance claims and return their homes to safe living conditions.<sup>15</sup> The difficulties claimants encounter during the claims process reveal the need for reform and increased regulation in the insurance industry. Imagine an elderly couple who just survived the traumatic experience of an F-5 tornado. Although they escaped unharmed, the tornado destroyed their home and all their belongings. Desperate to get their lives back in order as quickly as possible, they submit a claim to their insurance company, who has insured their home for the past fifty years. The couple patiently awaits a visit from a claims representative and expects an assessment of damages by an engineer, settlement negotiations, and an amicable resolution. Instead, the insurance company recognizes an opportunity to prey on an elderly couple in their most vulnerable state. The insurance company sends an ill-trained independent adjuster and a biased engineer with a pre-constructed report to inspect the damage and ultimately denies the couple's claim. After months of arguing on the phone and filing complaints, the insurance company agrees to send another engineer to assess the damage. The insurer concedes the damage may have resulted from the catastrophe and makes an embarrassingly low settlement offer. The couple is angry and shocked and has to decide if they can afford, both financially and psychologically, to keep fighting for their claim. The insurer, in a position of superior bargaining power, holds its ground, waiting to see if the couple is unwilling or unable to undertake the long and expensive process of litigation. This couple, like many policyholders, is experiencing the real disaster following a natural catastrophe—the insurance company's claims handling process. Although victims such as these consider themselves lucky to have survived the disaster unharmed, losing nothing more than their property, they are unaware they will be even luckier to survive unscathed the claims handling process that

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are asking for government help in the event of another Katrina-sized catastrophe); Larry Lipman, *Florida Representatives Formulate Plans on Catastrophes, Insurance*, PALM BEACH POST, Mar. 2, 2006, at 9A (discussing insurers lobbying for a national catastrophe fund); Ramstack, *supra* note 3, at C12 (discussing insurers asking state legislatures and Congress to establish more stringent building codes and tax incentives to encourage property owners to prepare for catastrophes).

15. ROBERT P. HARTWIG, INS. INFO. INST., 2004—YEAR END RESULTS (2004), <http://www.iii.org/media/industry/financials/2004yearend/> (reporting 2.2 million claims following a six week span of hurricanes on the southeast coast in 2004); INS. INFO. INST., HURRICANE KATRINA FACT FILE 1 (2006), [http://server.iii.org/yy\\_obj\\_data/binary/759496\\_1\\_0/Hurricane%20Katrina%20Fact%20File.pdf](http://server.iii.org/yy_obj_data/binary/759496_1_0/Hurricane%20Katrina%20Fact%20File.pdf) (reporting 1.7 million claims following Hurricane Katrina in 2005).

follows.<sup>16</sup> This type of vulnerability creates an environment in which insurance companies are able to take advantage of victims during the claims process.<sup>17</sup>

Stricter regulation of the insurance industry in Oklahoma is necessary to prevent insurance companies from taking advantage of catastrophe victims during the claims process. This can be accomplished through restructuring the Oklahoma Department of Insurance, making the Insurance Commissioner an advocate for policyholders, and utilizing the Oklahoma Attorney General's power to implement criminal charges as a means of regulation. The penalties enforceable by the Insurance Commissioner combined with the threat of criminal prosecution will internalize the costs of insurance companies' wrongdoings, thereby discouraging future violations. Ideally, increased regulation will bring the insurance industry's behavior into accord with existing Oklahoma insurance law. Part II of this comment examines Oklahoma's current laws and regulations that are designed to prevent fraud in insurance claims handling practices. Part II also examines insurance company practices that go unchecked in the catastrophe context, despite the current regulations. Parts III and IV provide a detailed analysis of ways in which these practices have and will continue to hurt Oklahomans if left unchecked. Specifically, part III argues that insurance companies use catastrophes as an opportunity to engage in bad faith and fraud by denying, delaying, and underpaying catastrophe claims. Part IV discusses the methods insurance companies use to avoid much of the burden of catastrophes by shifting the risk to policyholders, the government, and reinsurance companies. Finally, Part V identifies possible remedies for aligning the behavior of insurance companies with Oklahoma's

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16. This hypothetical was derived from an accumulation of sources. *See generally* Anita Lee, 'I Felt Like We Were Being Unfair': State Farm Stand Stuns Adjuster, SUN HERALD (Biloxi, Miss.), Sept. 23, 2006, at A1 (describing an 82-year-old man and his 79-year-old wife who "took the news hard" when their claim was denied following Hurricane Katrina, even though he carried \$800,000 in coverage and was told by his agent that he had "no worries"; during mediation, the mediator expressed embarrassment when conveying the insurer's \$50,000 offer for a house that required more than \$700,000 to be restored); State Farm Ins. Co., How Does the Catastrophe Claim Process Work?, [http://www.statefarm.com/insurance/claim\\_center/catinfo/catinfo.asp](http://www.statefarm.com/insurance/claim_center/catinfo/catinfo.asp) (last visited June 13, 2008) (describing the claims process in three easy steps: (1) report your claim, (2) damage assessment, and (3) settlement).

17. In a recent Oklahoma jury verdict, such predatory conduct by one insurance company was condemned. *Watkins v. State Farm Fire & Cas. Co.*, No. CJ-2000-303 (Okla. Dist. Ct. May 25, 2006), *appeal docketed*, No. DF-103756 (Okla. Civ. App. Sept. 13, 2006), *appeal dismissed per stipulation, verdict vacated and confidential settlement entered*, No. DF-103756 (Jan. 12, 2007). The jury unanimously found that State Farm not only recklessly disregarded its duty to deal fairly and act in good faith with policyholders by using a biased engineering firm and independent adjusters, but also intentionally and with malice breached its duty of good faith and fair dealing by using these entities. *Id.*

existing insurance laws, thereby encouraging insurers to fully, and in good faith, indemnify claimants following catastrophes.

## *II. General Insurance Claims Handling Practices*

Following a catastrophe, the victims' first step towards restoration is submitting a claim to the insurance company. To do this, the catastrophe victim makes a notification of claim, informing the insurer of the facts giving rise to the claim.<sup>18</sup> By notifying the insurance company, the victim becomes a first party claimant, an individual asserting a right to payment pursuant to the claimant's insurance policy.<sup>19</sup> Often, insurance companies establish catastrophe teams near the area of the catastrophe to provide access for victims to make the notification of claim. This, however, is just the beginning of the claims process.

After the insured makes a notification of claim, damage assessment begins.<sup>20</sup> During this crucial phase of the claim process, policyholders inventory personal belongings, contractors and engineers conduct investigations and generate reports regarding the damaged property, and adjusters prepare assessments of the covered losses and estimate the amount owed to the policyholder.<sup>21</sup> Once the claims adjusters determine the value of the loss, the settlement process begins.<sup>22</sup> During the settlement process, the insurance company, theoretically, pays the claimant the amount necessary to repair or replace the claimant's property in accordance with the terms and conditions of the policy.<sup>23</sup> In the event that a settlement of the claim cannot be reached, litigation often ensues. Although the above depiction of the claims process appears simplistic and easily administered, the process is often fraught with problems. These problems range from misinterpretation of policy language to deliberate denials or underpayment of claims.

Because insurance claim handling has great potential for misconduct, the Oklahoma legislature implemented strict regulations to ensure good faith conduct on the part of insurance companies. The Unfair Claims Settlement Practices Act regulates insurance companies' claims handling practices by identifying unacceptable conduct.<sup>24</sup> Common violations in catastrophe claims

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18. 36 OKLA. STAT. § 1250.2(8) (2001).

19. *Id.* § 1250.2(4).

20. State Farm Ins. Co., *The Catastrophe Claim Process Made Simple*, [http://www.statefarm.com/insurance/claim\\_center/catinfo/ins\\_claims\\_home\\_catas\\_process.asp](http://www.statefarm.com/insurance/claim_center/catinfo/ins_claims_home_catas_process.asp) (last visited June 13, 2008).

21. *Id.*

22. State Farm Ins. Co., *supra* note 16.

23. State Farm Ins. Co., *supra* note 20.

24. *See* 36 OKLA. STAT. § 1250.5.

include: failing to disclose pertinent benefits; failing to attempt a prompt, fair, and equitable settlement; misrepresenting pertinent facts or policy provisions; and failing to adopt reasonable standards for prompt investigation of claims.<sup>25</sup>

The Unfair Claims Settlement Practices Act states that the failure to disclose to a claimant benefits or coverage provided by the policy, when such benefits or coverage are pertinent to a claim, constitutes an unfair claims settlement practice.<sup>26</sup> For example, an insurance company's failure to disclose additional living expenses or overhead and profit benefits to a policyholder following a catastrophe violates the Unfair Claims Settlement Practices Act. Additionally, after liability has become reasonably clear, the Unfair Claims Settlement Practices Act provides that the insurance company commits a violation if the company fails to make a good faith attempt to effectuate "prompt, fair and equitable settlement" of claims.<sup>27</sup> Therefore, an insurance company that engages in conduct to delay or underpay claims violates the Unfair Claims Settlement Practices Act. Further, an insurance company commits a violation if the company knowingly misrepresents pertinent facts or policy provisions to the policyholder.<sup>28</sup> For example, replacement cost provisions are easily misrepresented to policyholders. An insurance company that exercises a two-step process for paying replacement cost benefits,<sup>29</sup> but represents the process as a one-step process through its agents and marketing materials, violates the Unfair Claims Settlement Practices Act when the company *knows* the policy is being misrepresented to the policyholder.<sup>30</sup> The Unfair Claims Settlement Practices Act also provides that "[f]ailing to adopt and implement reasonable standards for prompt investigations of claims" constitutes a violation.<sup>31</sup> For example, an insurance company that hires a biased engineering firm to conduct outcome-oriented "investigations" of damaged property following a catastrophe violates the reasonable standard set forth in the Unfair Claims Settlement Practices Act. Although these provisions are not the only laws regulating unfair claims settlement practices, they represent the regulations that pertain to the insurance companies' conduct discussed in this comment.

The Oklahoma Insurance Commissioner is charged with implementation and administration of the Unfair Claims Settlement Practices Act.<sup>32</sup> The

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25. *Id.*

26. *Id.* § 1250.5(1).

27. *Id.* § 1250.5(4).

28. *Id.* § 1250.5(2).

29. *See infra* Parts III.A.2 & IV.A (discussing replacement cost coverage and the process for paying replacement cost benefits).

30. 36 OKLA. STAT. § 1250.5(2).

31. *Id.* § 1250.5(3).

32. *Id.* § 1250.16.

investigative authority vested in the Insurance Commissioner provides an additional protection for the claims process.<sup>33</sup> The Oklahoma Insurance Code provides that insurance companies' claim files must contain sufficiently detailed notes and paperwork and are subject to examination by the Insurance Commissioner.<sup>34</sup> This broad authority gives the Insurance Commissioner the ability to investigate the claims practices of insurers and enforce appropriate remedies that range from requiring insurers to file periodic reports to issuing cease and desist orders.<sup>35</sup>

The Oklahoma Insurance Code mandates that the Insurance Commissioner issue a cease and desist order when an insurance company is found to be in violation of any provision of the Unfair Claims Settlement Practices Act.<sup>36</sup> The Oklahoma Insurance Code further provides that the Insurance Commissioner "shall have the authority to revoke or suspend the insurer's certificate of authority" if the insurer fails to comply with the order.<sup>37</sup> Furthermore, the Insurance Commissioner has the power to limit, regulate, and control an insurance company's line of business and volume of business, as well as the power to seek the assistance of the Attorney General to enforce the Insurance Commissioner's order.<sup>38</sup> Under existing laws, Oklahoma appears to be sufficiently equipped with the tools necessary to bring the insurance industry's claims handling behavior into accord with Oklahoma's Insurance Code—it is the enforcement of existing laws that is lacking. Failure to adequately enforce the existing laws creates an environment in which insurance companies engage in wrongful and illegal claims settlement practices.

### *III. Catastrophes Create Opportunities for Insurance Companies to Engage in Bad Faith and Fraud*

#### *A. First Party Bad Faith*

An insurance company commits bad faith when it unreasonably and unfoundedly refuses to provide coverage in violation of its duties of good faith and fair dealing.<sup>39</sup> First party bad faith occurs when the insurance company refuses to settle a policyholder's individual claim in accordance with duties of good faith and fair dealing that is brought by a policyholder asserting a claim.<sup>40</sup>

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33. *Id.* § 1250.4.

34. *Id.*

35. *Id.* §§ 1250, 1250.13.

36. *Id.* § 1250.13.

37. *Id.*

38. *Id.*

39. BLACK'S LAW DICTIONARY 149 (8th ed. 2004).

40. CHARLES L. KNAPP ET AL., PROBLEMS IN CONTRACT LAW 400-01 (5th ed. 2003)



Catastrophe victims have alleged bad faith against insurance companies for intentionally denying, delaying, and underpaying claims.<sup>41</sup>

*1. The Squeaky Wheel Gets the Oil: The Policy of Standard Denial*

Following catastrophes, insurance companies often implement a policy of standard denial, which requires insurance adjusters to deny a policyholder's first claim as a means of gauging the policyholder's willingness to haggle with the insurance company.<sup>42</sup> If the policyholder accepts the denial, the insurance company retains all of the money owed to the policyholder. In essence, an insurance company can eliminate claims by issuing sweeping denials under the presumption that some policyholders will accept the denial without question. Policyholders who refuse the denial and choose to pursue their claim through litigation, however, may face "mad dog defense tactics" that keep the policyholders preoccupied with court motions, thereby frustrating policyholders' ability to pursue their claims.<sup>43</sup> In addition, litigating insurance bad faith claims has become so expensive and time consuming, policyholders—as well as attorneys—are becoming increasingly unwilling to fight insurance

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(distinguishing between a first party claim and a third party claim). A first party bad faith claim is when the insured seeks to recover damages due to the insurance company's bad faith refusal to settle a claim brought by the insured. A third party bad faith claim is when the insured seeks to recover damages due to the insurance company's bad faith refusal to settle a claim brought by a third party against the insured. *Id.*; see also 36 OKLA. STAT. § 1250.2(4) (defining "first party claimant" as an "individual . . . asserting a right to payment pursuant to an insurance policy").

41. Anita Lee, *Top Execs of State Farm are Targeted: Judge Broadens Wind-Water Suit*, SUN HERALD (Biloxi, Miss.), Jan. 11, 2007, at A1 (discussing 200 lawsuits and 640 claims pending settlement resulting from claims denied based on a wind-water protocol issued by State Farm); see also Amended Complaint, *Watkins v. State Farm Fire & Cas. Co.*, No. CJ-2000-303 (Okla. Dist. Ct. May 25, 2006) (alleging defendants engaged in a scheme to delay, deny, or underpay claims by repeatedly engaging the engineering services of Haag Engineering while knowing Haag Engineering was predetermined to disagree with the policyholders), *appeal docketed*, No. DF-103756 (Okla. Civ. App. Sept. 13, 2006), *appeal dismissed per stipulation, verdict vacated and confidential settlement entered*, No. DF-103756 (Jan. 12, 2007).

42. See Michael Kunzelman, *State Farm Contractors Testify in Probe*, TULSA WORLD, Jan. 19, 2007, at E3 (discussing internal documents turned over by two whistleblowers showing that State Farm manipulated documents so that claims could be denied).

43. Guy Kornblum, Remarks at the 1986 Divisional Claim Superintendents Conference 17 (Nov. 18, 1986) (transcript on file with author) (describing a strategy of keeping plaintiffs tied up in law and motions for months and referring to it as "mad dog defense tactics").

companies.<sup>44</sup> Nevertheless, in the aftermath of Hurricane Katrina, several policyholders joined forces to collectively fight for their claims.<sup>45</sup>

Within weeks of Hurricane Katrina, State Farm implemented a protocol, drafted by a claims consultant and edited by in-house attorneys, shifting the burden of proving the cause of loss to policyholders.<sup>46</sup> By shifting the burden of proof, State Farm effectively issued a standard denial to policyholders faced with the impossible burden of proving whether their property was destroyed by Hurricane Katrina's wind, which was covered under the policy, or water, which was excluded.<sup>47</sup> Although the insurance policy provided that the insurance company carries the burden of proving the cause of loss, by shifting the burden, State Farm was able to deny claims simply because policyholders could not prove water was not the cause of the damage.<sup>48</sup> Fortunately for policyholders, a Mississippi court recently held that it was unacceptable for insurance companies to deny claims under this burden shifting protocol.<sup>49</sup> In an order granting a policyholder judgment as a matter of law, the court held that the burden of proof remains on the insurance company to establish that the portion of the loss sought to be excluded was attributable to flooding and rising water, thereby making State Farm's protocol unenforceable.<sup>50</sup>

A policy of standard denial constitutes first party bad faith by unreasonably and unfoundedly refusing to provide coverage to policyholders.<sup>51</sup> In an order awarding punitive damages against State Farm, a Utah judge stated that State Farm

is able to pressure its adjusters to deny consumers insurance benefits with impunity, knowing: (1) that few of its victims will even realize that they have been wronged; (2) that fewer still will ever be able to sue; (3) that only a small fraction of those who do sue will be able to weather the years of litigation needed to reach trial; and (4) that any victims who do actually reach trial will have great difficulty

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44. *Anderson Cooper 360 Degrees: Insurance Surprises* (CNN television broadcast Feb. 7, 2007), transcript available at <http://transcripts.cnn.com/TRANSCRIPTS/0702/07/acd.02.html> (quoting former Allstate attorney describing Allstate's strategy to make fighting the company "so expensive and so time-consuming that lawyers would start refusing to help clients").

45. *See* Lee, *supra* note 41, at A1.

46. *Id.*

47. *Id.*

48. *Id.*

49. Opinion on Rule 50 Motions for Judgment as a Matter of Law, *Broussard v. State Farm Fire & Cas. Co.*, No. 1:06CV6 LTS-RHW, 2007 WL 113942 (S.D. Miss. Jan. 11, 2007).

50. *Id.*

51. BLACK'S LAW DICTIONARY 149 (8th ed. 2004).

establishing the basis for punitive damages when met with claims that only an “honest mistake” was made . . . .<sup>52</sup>

The standard denial of claims following catastrophe is just the beginning of the fraudulent claims practices. Insurance companies have created an “impenetrable wall of defense,” through which the odds are overwhelmingly against policyholders attempting to recover for wrongful claims handling procedures and practices.<sup>53</sup>

## 2. *Time Is Money: The Policy of Delay*

When dealing with large amounts of money, time is of the essence. Part of the present value of money is the ability to invest it, earning a rate of return proportional to the risk of the investment. Insurance companies that control billions of dollars are able to earn substantial interest on the company’s assets. Because the potential for generating profit by retaining money for a period of time exists, insurance companies have an incentive to delay paying claims to policyholders.<sup>54</sup> The longer an insurance company extends the process of settling claims, the more interest is accrued on policyholders’ money.

To delay payment, insurance companies first delay appraisal of the damage. Often, after a catastrophe, policyholders’ homes are subjected to multiple structural engineering inspections.<sup>55</sup> Whether because the insurance company waits for an agreeable report,<sup>56</sup> or because the policyholder is forced to insist on a fair assessment by a public appraiser,<sup>57</sup> multiple inspections result in delayed payment. Even though failing to implement prompt investigations of

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52. *Campbell v. State Farm Mut. Auto. Ins. Co.*, Civ. No. 890905231, slip op. ¶ 47 (Utah Dist. Ct. Aug. 3, 1998), available at <http://graham.main.nc.us/~bhammel/CASES/CvSF.pdf>.

53. *Id.*

54. See Press Release, Miss. Att’y Gen. Jim Hood, Katrina Insurance Case Remanded to State Courts (Mar. 13, 2006) [hereinafter Katrina Case Press Release], available at [http://www.ago.state.ms.us/index.php/press/releases/katrina\\_insurance\\_case\\_remanded\\_to\\_state\\_courts/](http://www.ago.state.ms.us/index.php/press/releases/katrina_insurance_case_remanded_to_state_courts/) (discussing the Mississippi Attorney General’s interest in knowing how much money insurance companies save by retaining policyholders’ money).

55. *Case Preparation for Insurance Coverage Disputes*, ON THE SCENE: CED ELECTRONIC NEWS BULL., Feb. 5, 2007, [http://www.ced-aa.com/onthescene\\_disp.asp?rk=34](http://www.ced-aa.com/onthescene_disp.asp?rk=34) [hereinafter *Case Preparation*] (discussing the requirement that an insurance company’s decision to deny a claim must be based on a thorough investigation surrounding the claim, warning of the potential for bias when using an in-house insurance company’s engineer, and suggesting the use of an impartial inquiry based on all the facts).

56. See *infra* Part III.B.1 (discussing insurance companies hiring biased structural engineering firms to create outcome-oriented reports).

57. See *infra* Part III.B.2 (discussing policyholders having to pay to retain their own engineering firm or rely on a public adjuster to assure a fair investigation).

claims violates Oklahoma's Unfair Claims Settlement Practices Act<sup>58</sup> and similar legislation in other states,<sup>59</sup> insurance companies continue to delay investigations because of their ability to leverage assets, earning tremendous profit from the delay.

Other techniques used by insurance companies to delay claim settlement include withholding "overhead and profit," a benefit that pays an additional amount beyond the claim to cover the costs of a general contractor to coordinate the repairs, and "additional living expenses," a benefit providing coverage when temporary shelter is necessary; both of which are discussed in detail below.<sup>60</sup> Another profitable delay tactic is the withholding of replacement cost coverage which is intended to provide a sum of money sufficient to replace damaged property "without deducting for depreciation."<sup>61</sup> Insurance companies across the nation have switched to a two-step process for paying replacement cost coverage.<sup>62</sup> First, after liability for the claim arises, the insurance company pays the policyholder the actual cash value of the damaged property, which is the value of the property in its existing, damaged condition.<sup>63</sup> Second, after the policyholder incurs and documents the full costs of repairs by spending his or her own money, the insurance company pays the remaining benefits, referred to as "holdback" money, to the policyholder.<sup>64</sup> Although the purpose of a replacement cost policy is to avoid depreciation and ensure policyholders sufficient coverage to repair or replace their property, under the two-step process of paying replacement cost benefits, the property is depreciated because policyholders initially only receive actual cash value.<sup>65</sup> Through this method of

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58. 36 OKLA. STAT. § 1250.5(3) (2001).

59. *See, e.g.*, N.M. STAT. ANN. § 59A-16-20(C) (West 1978); TEX. INS. CODE ANN. § 542.003(4) (Vernon 2005).

60. *See infra* Part III.A.3.

61. *Ins. Info. Inst., supra* note 6 (search "Glossary" for the term "replacement cost").

62. *See* JOHN A. BISHOP, SR. & TIM SPEIGHT, HOMEOWNER POLICY COVERAGE A: BENEFITS PAID UPFRONT 1 (2000) ("In the majority of states and provinces structural damage claims are settled by initially issuing an Actual Cash Value payment (the cost of covered repairs less applicable depreciation) until the policyholder has actually incurred the full cost of the covered repairs. Once these replacement costs have been incurred and documented by the policyholder, the difference between the initial payment(s) and the necessary cost to repair covered damages is paid to the policyholder.").

63. *See id.*; *see also* *Ins. Info. Inst., supra* note 6 (search "Glossary" for the term "actual cash value").

64. *See* BISHOP & SPEIGHT, *supra* note 62, at 1.

65. A sample homeowners policy, produced by the Insurance Services Office (ISO), provides a guideline of the terms and conditions generally included in fire and property insurance policies. KENNETH S. ABRAHAM, INSURANCE LAW AND REGULATION 175 (4th ed. 2005). The ISO sample policy contains a Loss Settlement section describing the criteria for receiving replacement cost coverage and includes a provision, like most homeowners policies,

paying replacement cost benefits, insurance companies have effectively revoked the benefits of the replacement cost policy. If policy holders are unaware of the two-step process, do not have funds to undertake the necessary repairs, or miss the limited window in which they must make repairs to take advantage of the policy, the policy holders lose their opportunity to claim the full replacement cost benefits. This two-step process of indemnifying policyholders is a windfall for the insurance company. In the event the policyholder never repairs or replaces the damaged property, the insurance company retains the higher premiums it received from the replacement cost policy but only pays actual cash value for the loss because the insurance company never makes the holdback payment. Further, even if the insurance company makes the holdback payment, the two-step process allows the insurance company to earn significant interest on the holdback money between the time of the claim and the actual repair or replacement of the damaged property.

Insurance companies also engage in delay tactics after the claim escalates to litigation. For example, insurance companies—including State Farm, Allstate, Farm Bureau, USAA, and Nationwide—attempted to delay litigation regarding Hurricane Katrina claims by removing the cases to federal court.<sup>66</sup> In recent press releases, Mississippi Attorney General Jim Hood stated that insurance companies “were wrong in trying to delay the case in federal court”<sup>67</sup> and stated that he would be interested “to know how much money they’ve saved themselves [by] holding on to these people’s money.”<sup>68</sup> Even after cases are remanded, insurers continue their delay tactics in state court. For example, insurance companies refuse to produce discovery after being ordered by the court to do so and instruct witnesses not to answer questions during depositions.<sup>69</sup> Delay tactics during the claims settlement process and during

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stating that the insurance company “will pay no more than actual cash value of the damage until actual repair or replacement is complete.” *Id.* at 188.

66. Press Release, Miss. Att’y Gen. Jim Hood, Statement on Ruling to Remand Insurance Lawsuit (Dec. 27, 2006) [hereinafter Insurance Lawsuit Press Release], available at [http://www.ago.state.ms.us/index.php/press/releases/statement\\_on\\_ruling\\_to\\_remand\\_insurance\\_lawsuit/](http://www.ago.state.ms.us/index.php/press/releases/statement_on_ruling_to_remand_insurance_lawsuit/).

67. *Id.*

68. Katrina Case Press Release, *supra* note 54.

69. State Farm was recently sanctioned and held in contempt by an Oklahoma judge for discovery abuses, including failing to comply with a court order and refusing to answer questions during depositions. Order Sustaining Plaintiff’s Motion for Contempt and for Sanctions Against Defendant, State Farm Fire & Casualty Company, Watkins v. State Farm Fire & Cas. Co., No. CJ-2000-303 (Okla. Dist. Ct. May 25, 2006), appeal docketed, No. DF-103756 (Okla. Civ. App. Sept. 13, 2006), appeal dismissed per stipulation, verdict vacated and confidential settlement entered, No. DF-103756 (Jan. 12, 2007). The court found that State Farm’s obstructionist behavior willful, deliberate, and in bad faith and ordered State Farm to immediately produce the documents, respond to interrogatories, re-produce several

litigation allow insurance companies to earn substantial interest on large sums of money which rightfully belong to policyholders.<sup>70</sup>

Although earning interest on business assets is not illegal, it becomes problematic when insurance companies engage in delay tactics at the expense of policyholders. The Oklahoma Insurance Code provides that the failure to make a good faith effort to promptly settle claims when liability has become reasonably clear constitutes an unfair claim settlement practice.<sup>71</sup> By intentionally engaging in delay tactics, insurance companies have violated their duty to deal fairly and act in good faith, thereby committing first party bad faith.<sup>72</sup> Nevertheless, insurance companies continue to use techniques to delay payment of policyholders' claims because the benefits of the earned interest outweigh the repercussions for engaging in such practices. Therefore, insurance companies have no incentive to promptly satisfy policyholders' claims until the punishment for delay tactics sufficiently affects insurance companies' cost-benefit analysis and delay tactics are no longer deemed financially viable.

### *3. Settle on the Spot: The Policy of Underpayment*

The Oklahoma Insurance Code provides that an insurance company engages in unfair claim settlement practices when the company does not attempt "in good faith to effectuate prompt, *fair* and *equitable* settlement of claims submitted in which liability has become reasonably clear."<sup>73</sup> After major catastrophes, insurance companies often encourage claim adjusters to "settle on the spot."<sup>74</sup> At first glance, settling on the spot seems favorable to policyholders because it provides immediate monetary relief, but the practice raises questions of fairness. Although insurance companies recognize policyholders' urgent

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deponents, and pay the costs and attorney's fees associated with the violations. *Id.* In addition, the court adopted a proposed jury instruction, pursuant to 12 OKLA. STAT. § 3237(B)(2)(a) (2001), advising the jury that State Farm had been found guilty of litigation misconduct "in obstructing or refusing to answer appropriate deposition questions" and allowed the jury to presume the answers would have been detrimental to State Farm's interests. *Id.* The order, however, was later rescinded, although the judge noted he may require further hearings on the matter or reissue the order without prior notice. Order Sustaining Plaintiff's Motion for Contempt and for Sanctions Against Defendant, State Farm Fire & Casualty Company, *Watkins*, No. CJ-2000-303.

70. The year of the May 3, 1999, tornados, withholding replacement cost coverage owed to policyholders—referred to as "holdback"—allowed State Farm to retain \$10 million in the Oklahoma and Kansas region alone. Trial Transcript at 27, *Watkins*, No. CJ-2000-303. Nationally, State Farm retained \$104 million in holdback. *Id.*

71. 36 OKLA. STAT. § 1250.5(4).

72. BLACK'S LAW DICTIONARY 149 (8th ed. 2004).

73. 36 OKLA. STAT. § 1250.5(4) (emphasis added).

74. STATE FARM FIRE & CAS. CO., FIRE ASSIST TRAINING/CLAIM SERVICE STUDENT'S MANUAL: TRICKS OF THE TRADE 19 (1996).

need to restore their homes to a liveable condition after a catastrophe, the insurance companies' anxiousness to settle claims preys upon the policyholders' vulnerabilities and presents the opportunity for insurance companies to underpay claims. For example, State Farm's Claim Service Student's Manual instructs claim representatives about "tricks of the trade" for handling catastrophe claims and encourages claims representatives to "negotiate settlements."<sup>75</sup> Furthermore, the manual states that "it is not necessary to tell a policyholder your experience level or give them the impression you are unfamiliar [with] the Fire Company adjusting practices."<sup>76</sup> Certainly, these "tricks of the trade" should qualify as unfair settlement practices under the Oklahoma Insurance Code. By implementing a policy of settling claims so soon after catastrophes, insurance companies engage in bad faith by disregarding their duties of good faith and fair dealing and failing to make a good faith effort to *properly* settle policyholders' claims.

In addition, settling claims "on the spot" decreases a policyholder's likelihood of receiving all of the benefits the policy affords the policyholder. By settling claims quickly, insurers avoid paying additional benefits, such as additional living expenses<sup>77</sup> and overhead and profit.<sup>78</sup> Often, policyholders are unaware of their entitlement to these benefits or are uncertain about the procedure for obtaining such benefits.<sup>79</sup> Immediate settlement without full disclosure of policy benefits is unfair. If policyholders knew that the policy

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75. *Id.*

76. *Id.*

77. Additional living expenses (ALE) is a benefit that provides additional coverage when an insured requires temporary shelter because the dwelling is rendered temporarily uninhabitable. Ins. Info. Inst., *supra* note 6 (search "Glossary" for the term "additional living expense").

78. Overhead and profit is a benefit available to policyholders that provides an additional twenty percent above the amount of the claim to pay for a general contractor to coordinate repairs. *Gilderman v. State Farm Ins. Co.*, 649 A.2d 941, 943 (Pa. Super. Ct. 1994). A Pennsylvania court held that general contractor overhead and profit is included in the actual cash value payment. *Id.* Therefore, the insurance company cannot withhold overhead and profit as part of the holdback under a two-step process for paying replacement cost benefits. *Id.* According to the *Gilderman* court's decision, policyholders are entitled to overhead and profit whether they actually hire a general contractor or coordinate the repairs themselves. *See id.*

79. Steve Strezelec, a former employee of State Farm who now testifies as an expert witness on behalf of policyholders, testified that general contractor overhead and profit was often not clearly explained and was frequently concealed from policyholders. Trial Transcript, *supra* note 70, at 2304. Strezelec testified that State Farm retained a lot of money as a result of State Farm's concealing and failing to explain overhead and profit. *Id.* In addition, class members testified they were unaware of their entitlement to general contractor overhead and profit. *Id.* at 1258.

provided additional living expenses for temporary shelter until the home returned to livable conditions, the urgency of recovering the insurance claim would be reduced, allowing the policyholder, as well as the insurance company, to fully evaluate the claim.

In some circumstances, insurance companies have faced criminal charges for rapidly settling claims without fully disclosing policy benefits to policyholders.<sup>80</sup> Because of the underpayment that occurred in Mississippi following Hurricane Katrina, Mississippi Attorney General Jim Hood has criminally charged five insurance companies with persuading victims of Hurricane Katrina to sign forms acknowledging that they sustained flood damage—damage not covered by the victims' policies—in order to receive an immediate payment for living expenses.<sup>81</sup>

Similarly, insurance companies withhold overhead and profit by settling claims quickly after catastrophes. Although insurance companies previously required policyholders to show a specified number of trades were necessary to repair the damaged property before policyholders could recover overhead and profit, it is now within the discretion of the insurance company to determine whether overhead and profit is reasonable and necessary.<sup>82</sup> Policyholders who settle too quickly following a catastrophe are more likely to be denied this benefit. When policyholders are aware of the procedure for obtaining overhead and profit benefits, they will likely be more hesitant to settle their claims before obtaining sufficient information to show general contractor overhead and profit is a reasonable and necessary expense.

Failing to fully disclose all of the benefits and coverage available under an insurance policy when such benefits and coverage are pertinent to the claim violates Oklahoma's Unfair Claims Settlement Practices Act.<sup>83</sup> An insurance

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80. *Miss. AG Accuses Five Carriers of Attempting to Cheat Katrina Survivors*, INS. J., Sept. 15, 2005, <http://www.insurancejournal.com/news/southeast/2005/09/15/59672.htm> [hereinafter *Miss. AG Accuses*].

81. Mississippi Attorney General Jim Hood has criminally charged insurance companies—including Nationwide Mutual Insurance Co., State Farm Fire and Casualty Co., Allstate Property and Casualty Co., and United Services Automobile Association—for attempting to cheat Hurricane Katrina survivors out of millions of dollars regarding their homeowners insurance claims. *Id.* However, Hood has expressed willingness to drop the criminal investigation against State Farm in the event of an agreeable settlement with policyholders. Anita Lee, *Damaging Opinions: Attorney Claims Consultants' Findings Convenient for Insurance Companies*, SUN HERALD (Biloxi, Miss.), July 30, 2006, at A1.

82. State Farm's expert witness, a former employee at the Oklahoma Department of Insurance in the claims division, testified that the insurance company determines whether it is reasonable and necessary to pay general contractor overhead and profit. Trial Transcript, *supra* note 70, at 3589, 3663.

83. 36 OKLA. STAT. § 1250.5(1) (2001).



company that attempts to settle claims quickly in order to avoid disclosing the range of benefits available under the policy engages in bad faith by failing to comply with the duties of good faith and fair dealing. Quick settlement of claims is desirable to both the policyholder and the insurance company so long as integrity and fairness do not suffer as a result. Nevertheless, fairness and integrity suffer when insurance companies take advantage of policyholders' vulnerabilities following a catastrophe in an effort to underpay claims.

#### *4. Programs Implemented to Facilitate Bad Faith Payment of Claims*

Insurance companies, like other major corporations, often hire third-party consulting firms to analyze components of their business and recommend policies and procedures to benefit the company.<sup>84</sup> Unfortunately, several insurance companies, including State Farm, USAA, Allstate, and Nationwide, have used recommendations from consulting firms to implement wrongful claims practices and profit-making schemes specifically designed to underpay policyholders; thereby limiting their losses during catastrophes.<sup>85</sup>

For example, State Farm hired McKinsey & Company to develop a corporate methodology to improve company profits by reducing indemnity payout on claims;<sup>86</sup> the resulting program was known as ACE. Upon recognizing the program's incredible potential for cost savings in claims handling,<sup>87</sup> several other insurance companies adopted variations of ACE.<sup>88</sup> Through

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84. Hager v. Allstate Ins. Co., No. 98-CI-2482, 2002 WL 34360512 (Ky. Cir. Ct. June 25, 2002).

85. Watkins v. State Farm Fire & Cas. Co., No. CJ-2000-303 (Okla. Dist. Ct. May 25, 2006), *appeal docketed*, No. DF-103756 (Okla. Civ. App. Sept. 13, 2006), *appeal dismissed per stipulation, verdict vacated and confidential settlement entered*, No. DF-103756 (Jan. 12, 2007); *see also* H.R. 60-ESSB 5726, 2007 Reg. Sess., at 4 (Wash. 2007), *available at* <http://apps.leg.wa.gov/documents/billdocs/2007-08/Pdf/Bill%20Reports/House/5726-S.HBR.pdf> (noting that insurance companies are hiring consulting firms to depress claims payments).

86. Trial Transcript, *supra* note 70, at 2365-66.

87. An internal State Farm publication referred to ACE as "an extraordinary example of changing the way we operate to save really significant costs." State Farm Mut. Auto. Ins. Co., *A Stitch in Time, Costs Saving Solutions for the 90's*, ACTION, Jan. 1996 (on file with the author). State Farm's Senior Vice President stated, "ACE has the potential of taking a billion dollars of cost out of our system every year!" *Id.* "At State Farm the ratio [of claims paid to premiums collected since ACE was implemented] dropped from 77.5% in 1994 to 66.6% in 2005 . . . ." Walter Updegrave & Kate Ashford, *Think You're Insured? Maybe Not.*, MONEY, Mar. 2007, at 110, *available at* [http://money.aol.com/cnnmoney/insurance/canvas3/\\_a/insurance-coverageclaim-disputes/20070308143809990002](http://money.aol.com/cnnmoney/insurance/canvas3/_a/insurance-coverageclaim-disputes/20070308143809990002).

88. Through McKinsey & Company's recommendations, State Farm and Nationwide implemented programs called "Advancing Claims Excellence" (ACE), USAA implemented "Professionalism and Claims Excellence" (PACE), and Allstate implemented "Claim Core Process Redesign" (CCPR). *See The McCarran-Ferguson Act and Antitrust Immunity: Good*

implementation of ACE, State Farm developed incentives, such as promotions for keeping costs down, that resulted in policyholders being paid less than they were owed.<sup>89</sup> According to a former State Farm employee, ACE created pressure for profit-making that manifested itself in underpayment of claims.<sup>90</sup> State Farm alleges the purpose of ACE was to identify and remove shortfall—the difference between the amount paid on a claim and the amount State Farm thought should have been paid—by conducting closed file reviews.<sup>91</sup> State Farm documents, however, revealed that State Farm had evidence during the development of ACE that it would result in underpaying policyholders' claims.<sup>92</sup> In addition, a State Farm internal memorandum regarding a focus group analysis of ACE revealed that State Farm knew ACE was “nothing more than a program for increased profits.”<sup>93</sup> The memorandum recounts the focus group's comments in response to ACE, stating that State Farm “is involved in a national conspiracy to cheat policyholders out of money that they are entitled to,” and State Farm “prey[s] on the poor, elderly, uneducated, and non-English speaking policyholders.”<sup>94</sup>

Implementing a company-wide scheme to adopt methods for reducing indemnity payments owed to policyholders is illegal under Oklahoma law.<sup>95</sup> The Unfair Claims Settlement Practices Act provides that an insurer's failure to make a good faith attempt “to effectuate prompt, fair and equitable settlement of claims submitted in which liability has become reasonably clear” constitutes an unfair claim settlement practice.<sup>96</sup> By disregarding their duties of good faith and fair dealing, insurance companies have committed bad faith through the implementation of corporate schemes designed to reduce indemnity payments to policyholders.

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*for Consumers?: Hearing Before the S. Comm. on the Judiciary*, 110th Cong. 66 (2007) (prepared statement of J. Robert Hunter, Director of Insurance, Consumer Federation of America), available at [http://frwebgate.access.gpo.gov/cgi-bin/getdoc.cgi?dbname=110\\_senate\\_hearings&docid=f:35166.pdf](http://frwebgate.access.gpo.gov/cgi-bin/getdoc.cgi?dbname=110_senate_hearings&docid=f:35166.pdf).

89. Trial Transcript, *supra* note 70, at 2363, 2295-97 (discussing claim representatives' salary being determined on how well shortfall is reduced and noting that claim representatives' financial future is being driven on reducing shortfall).

90. *Id.* at 2394.

91. *Id.* at 136-37.

92. *Id.* at 2366.

93. Memorandum from Frank Comella, *Watkins v. State Farm Fire & Cas. Co.*, No. CJ-2000-303 (Okla. Dist. Ct. May 25, 2006), *appeal docketed*, No. DF-103756 (Okla. Civ. App. Sept. 13, 2006), *appeal dismissed per stipulation, verdict vacated and confidential settlement entered*, No. DF-103756 (Jan. 12, 2007).

94. *Id.*

95. 36 OKLA. STAT. § 1250.5(4) (2001).

96. *Id.*

### *B. Fraud*

An insurance company commits fraud when it knowingly misrepresents or conceals a material fact to induce a policyholder to act to his or her detriment.<sup>97</sup> To meet the prima facie elements of fraud, the plaintiff must show: (1) there was a false material misrepresentation; (2) which was either known to be false or made recklessly without knowledge of the truth; (3) with the intention that it be acted upon; and (4) which was detrimentally relied upon.<sup>98</sup> Insurance companies have been held liable for committing fraudulent claims handling practices in Oklahoma, as well as on the Gulf Coast, for hiring biased engineering firms to produce predetermined reports against the interest of policyholders and hiring ill-trained independent adjusters and falsely representing that the adjusters are employees of the insurance company.<sup>99</sup>

#### *1. Biased Engineering Firms Producing Outcome-Oriented Reports*

Often, insurance companies rely on reports produced by professional engineers who survey the damaged property to determine the insurance companies' liability for claims.<sup>100</sup> Following a catastrophe, insurance companies hire structural engineering firms to assess the damage in the affected area and determine the extent to which the natural disaster directly caused the damage.<sup>101</sup> In recent years, courts have found insurance companies to have acted fraudulently by hiring biased engineering firms to produce outcome-oriented reports.<sup>102</sup> In *Watkins v. State Farm Fire & Casualty Co.*, an Oklahoma jury unanimously found that State Farm Fire and Casualty Company (State Farm) hired Haag Engineering, a Texas structural engineering firm, to survey damage in Oklahoma and produce biased reports in favor of State Farm following the May 3, 1999, tornados.<sup>103</sup> The jury found that Haag Engineering surveyed the damage in Oklahoma with a pretextual basis for denying claims and wrote "cookie cutter" reports concluding that the tornados produced no structural damage.<sup>104</sup> Instead, the reports concluded that poor construction

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97. BLACK'S LAW DICTIONARY 685 (8th ed. 2004).

98. *Gay v. Akin*, 1988 OK 150, ¶ 7, 766 P.2d 985, 989.

99. Opinion on Rule 50 Motions for Judgment as a Matter of Law, *Broussard v. State Farm Fire & Cas. Co.*, No. 1:06CV6 LTS-RHW, 2007 WL 113942 (S.D. Miss. Jan. 11, 2007); *Watkins*, No. CJ-2000-303; see also Tom Wilemon, *State Farm Critics Not Surprised by Today's Ruling*, SUN HERALD (Biloxi, Miss.), Jan. 11, 2007, at A1.

100. See *Case Preparation*, *supra* note 55.

101. *Id.*

102. *Watkins*, No. CJ-2000-303; *State Farm Fire & Cas. Co. v. Simmons*, 963 S.W.2d 42, 45 (Tex. 1998); *State Farm Lloyds v. Nicolau*, 951 S.W.2d 444, 448 (Tex. 1997).

103. *Watkins*, No. CJ-2000-303.

104. *Id.*

caused the cracked foundations and moving bricks.<sup>105</sup> Because the jury found State Farm's conduct willful and malicious, the jury awarded the plaintiffs actual and punitive damages.<sup>106</sup>

In a previous Texas case, the Texas Supreme Court held State Farm liable for hiring a biased engineering firm—again, Haag Engineering—to evaluate a homeowner's claim regarding a plumbing leak.<sup>107</sup> The court held that reliance on an expert report did not shield an insurer from fraud and bad faith liability if the plaintiff presents evidence that the report was not prepared objectively.<sup>108</sup> The well-settled law in Texas is that an insurance company cannot “insulate itself from bad faith liability by investigating a claim in a manner calculated to construct a pretextual basis for denial.”<sup>109</sup> Even after the Texas Supreme Court's ruling that State Farm's use of Haag Engineering was fraudulent and bad faith conduct, State Farm nevertheless subsequently used Haag Engineering in Oklahoma.<sup>110</sup> The unanimous verdict in *Watkins* against State Farm regarding its use of Haag Engineering was Oklahoma's first opportunity to examine insurance companies use of biased engineering firms to adjust claims.<sup>111</sup>

Even though Oklahoma and Texas courts held State Farm liable for hiring Haag Engineering as a biased engineering firm, State Farm again contracted with Haag Engineering to survey damage on the Gulf Coast following Hurricane Katrina in 2005.<sup>112</sup> In addition to the numerous civil suits that have been filed against insurers for fraudulently using biased engineers following Katrina,<sup>113</sup> the Mississippi Attorney General has instituted a criminal investigation as well.<sup>114</sup> The Mississippi Attorney General has looked to the *Watkins* case and its unanimous verdict regarding State Farm's conduct in Oklahoma to facilitate the investigation.<sup>115</sup> Insurers' use of biased engineering

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105. *Id.*

106. Verdict Form at 1, *Watkins*, No. CJ-2000-303.

107. *Nicolau*, 951 S.W.2d at 448.

108. *Id.* (citing *Lyons v. Millers Cas. Ins. Co. of Tex.*, 866 S.W.2d 597, 601 (Tex. 1993)).

109. *Douglas v. State Farm Lloyds*, 37 F. Supp. 2d 532, 541 (S.D. Tex. 1999) (citing *State Farm Fire & Cas. Co. v. Simmons*, 963 S.W.2d 42, 43 (Tex. 1998); *Nicolau*, 951 S.W.2d at 448; *Lyons*, 866 S.W.2d at 601).

110. *Watkins*, No. CJ-2000-303.

111. *Id.*

112. *700 Katrina Victims Sue Insurance Firm*, USA TODAY, May 10, 2006, at 3A [hereinafter *700 Katrina Victims Sue*].

113. During the Oklahoma trial, almost 700 Gulf Coast homeowners filed suit against State Farm for using “a biased, ‘one-size-fits-all’ engineering report as the basis for denying claims from Hurricane Katrina.” *Id.* The report, produced by Haag Engineering, concluded that the storm surge, rather than the wind, caused the homeowners' damage. *Id.*

114. *Miss. AG Accuses*, *supra* note 80.

115. A federal grand jury in Mississippi subpoenaed a transcript from *Watkins*,

companies will rise to the level of criminal fraud if the misrepresentations are determined to be willful.<sup>116</sup> In support of the Mississippi Attorney General's theory that the misrepresentations were willful, two whistleblowers have come forward to report that an insurance company "pressured engineers to change conclusions so claims could be denied" following Hurricane Katrina.<sup>117</sup> The whistleblowers also reported that if the insurance company did not like the reports submitted, the insurance company pressured the engineer to alter the reports' conclusions or risk nonpayment and the loss of future business.<sup>118</sup>

Engineering reports in the Gulf Coast played a critical role in determining whether Katrina victims' claims were to be paid by their insurer or by the National Flood Insurance Program—if the policyholder was to be paid at all. That determination depended upon whether Hurricane Katrina's wind or water caused the property damage.<sup>119</sup> If the engineering report determined that the storm surge and its resulting flooding caused the damage, the insurance company was not liable, as most policies do not insure against flood damage.<sup>120</sup> As a result of insurance companies falsely blaming property damage on water rather than wind, the National Flood Insurance Program was forced to pay for much of Hurricane Katrina's damage.<sup>121</sup> Numerous Katrina victims have brought suit against insurance companies claiming that Haag Engineering's reports erroneously indicated that flooding caused damage to their property.<sup>122</sup> The victims allege that the insurance companies, specifically Nationwide Insurance Company and State Farm, purchased reports from Haag Engineering that concluded Hurricane Katrina's storm surge preceded the wind for the

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policyholders' claim files, Haag Engineering reports, and the sworn testimony of twenty-six individuals that range from top executives to claims adjusters. *Lee, supra* note 16, at A1. Currently, the criminal investigation is being used as leverage to facilitate settlement of civil suits of policyholders in Mississippi and elsewhere. *Lee, supra* note 81, at A1.

116. BLACK'S LAW DICTIONARY 685 (8th ed. 2004).

117. Michael Kunzelman, *Lawyer: Whistleblower Helping Build Case Against Insurer in Hurricane Katrina Lawsuit*, ASSOCIATED PRESS WORLDSTREAM, Mar. 17, 2006, available at Westlaw, 3/17/06 AP Worldstream 04:55:11.

118. *Id.*

119. A manual, created by Tim Marshall, Professional Engineer and meteorologist for Haag Engineering Co., was provided to Nationwide Insurance Co. to help them determine if damage was caused by wind or wave. TIM MARSHALL, WIND OR WAVE: AN EXERCISE IN DAMAGE ANALYSIS (2005).

120. ABRAHAM, *supra* note 65, at 186 (providing an ISO sample policy excluding water damage, defined as "[f]lood, surface water, waves, tidal water, overflow of a body of water, or spray from any of these, whether or not driven by wind").

121. Opinion on Rule 50 Motions for Judgment as a Matter of Law, *Broussard v. State Farm Fire & Cas. Co.*, No. 1:06CV6 LTS-RHW, 2007 WL 113942 (S.D. Miss. Jan. 11, 2007).

122. *700 Katrina Victims Sue*, *supra* note 112.

purpose of denying policyholders' claims.<sup>123</sup> Policyholders allege the insurance companies committed fraud by hiring Haag Engineering to make false representations about the cause of their damaged property, knowing that the reports were false, and relying on the reports to the detriment of policyholders.<sup>124</sup> Relying on and encouraging clearly objectionable reports constitutes fraud and violates the Unfair Claims Settlement Practices Act.<sup>125</sup> To change this fraudulent behavior, courts must inflict a punishment sufficiently harsh to outweigh the millions of dollars insurance companies save by engaging in fraudulent conduct.

### *2. Independent Adjusters Participating in a Masquerade*

In addition to insurance companies commission of fraud through hiring biased engineering companies as a pretextual basis for denying policyholders' claims, insurance companies further commit fraud by hiring independent adjusters and misrepresenting them to be employees of the insurance company.<sup>126</sup> Insurance companies use independent adjusters to create a layer of insulation between themselves and the insured designed to shield the companies from bad faith liability.<sup>127</sup> Although the use of independent adjusters is permissible, a problem arises when the insurance company masquerades independent adjusters as employees of the insurance company.<sup>128</sup> For example,

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123. Lee, *supra* note 81, at A1; Lee, *supra* note 16, at A1.

124. The CEO and Chairman of State Farm, Edward B. Rust, Jr., testified during a deposition in the *Watkins* case regarding the Oklahoma May 3, 1999, tornados that if State Farm had it to do over again, State Farm would not have used Haag Engineering to assess Hurricane Katrina damage. Anita Lee, *State Farm to Probe Haag Firm: Policyholders' Lawyer Calls It Just a Spin Tactic*, SUN HERALD (Biloxi, Miss.), Sept. 21, 2006, at A1. Rust also discussed an independent investigation, conducted by a team of State Farm employees and outside legal counsel, regarding State Farm's use of Haag Engineering and stated that a moratorium had been placed on State Farm's use of Haag Engineering as a result of the Oklahoma jury's findings in *Watkins*. *Id.* Although Rust testified that he did not consider State Farm's use of biased engineers to represent a pattern, he acknowledged the Texas Supreme Court's decision, as well as similar findings in a medical malpractice case by an Idaho court. *Id.* (discussing a 1998 Idaho case where the judge found that State Farm, "beginning with its claims adjuster and running up through its management, participated in the egregious process of manufacturing fictitious reports and obtaining biased opinions").

125. An insurance company's failure to adopt and implement reasonable standards of investigation constitutes an unfair claim settlement practice. 36 OKLA. STAT. § 1250.5(3) (2001).

126. Trial Transcript, *supra* note 70, at 7.

127. *Id.* at 37.

128. Plaintiff's expert witness, a former employee of State Farm, testified that it was appropriate for State Farm to use independent adjusters following the catastrophe. *Id.* at 2306. The witness stated that State Farm erred, however, by not identifying the adjusters as independents, noting that an independent adjuster's training does not compare to the training

an Oklahoma court has held State Farm liable for willfully and maliciously hiring independent adjusters and masquerading the independent adjusters as State Farm employees.<sup>129</sup> Following the May 3, 1999, tornados in Oklahoma, State Farm hired independent adjusters and provided them with State Farm shirts, badges, and stickers for their cars.<sup>130</sup> State Farm then dispatched these independent adjusters to adjust claims on behalf of State Farm, instructing the adjusters not to inform policyholders about their independent status.<sup>131</sup> At trial, State Farm justified this nondisclosure as a means of protecting policyholders by stating that the policyholders did not need any additional worries in the midst of the catastrophe.<sup>132</sup>

Although the use of independent adjusters is permissible during a state of emergency, disguising independent adjusters as employees of the insurance company and misrepresenting their qualifications constitutes fraud.<sup>133</sup> Insurance companies make a material misrepresentation by giving independent adjusters the appearance of employees of the insurance company<sup>134</sup> and instructing the independent adjusters not to inform policyholders of their status nor their qualifications.<sup>135</sup> Insurance companies knowingly make these false representations because the companies are responsible for hiring the independent adjusters and have documentation stating independents are not as well qualified as adjusters employed by the insurance companies.<sup>136</sup> In addition, insurance companies hire independent adjusters for the purpose, and with the intention, of acting upon the adjusters' determinations. Policyholders, unaware of the adjusters' independent status and training level, detrimentally rely upon

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of a State Farm employee. *Id.*

129. Verdict Form, *supra* note 106, at 1.

130. Trial Transcript, *supra* note 70, at 75 (discussing independent adjusters that were issued State Farm credentials and received State Farm jackets, shirts, and signs in the aftermath of the May 3, 1999, Oklahoma tornados. State Farm adjusters and independent adjusters had the same duties and authority to pay claims).

131. *Id.* at 76 (discussing State Farm advising independent adjusters not to disclose their status as independent adjusters unless asked by the policyholder).

132. *Id.*

133. State Farm's expert witness, a former employee of the Oklahoma Insurance Department, testified that the Insurance Commissioner must declare a state of emergency before independent adjusters can be used. *Id.* at 3616. The witness further testified that the Insurance Commissioner has jurisdiction over complaints regarding independent adjusters. *Id.* at 3593. Of the eighty independent adjusters hired by State Farm in the aftermath of the May 3, 1999, tornados, twenty-five were involved in complaints. *Id.* at 3672.

134. *Id.* at 75.

135. *Id.* at 76.

136. *Id.* at 3711 (discussing State Farm internal documents noting that independent adjusters are less qualified than State Farm adjusters).

the determinations of the independent adjusters. The policyholders' detriment results from independent adjusters' incentive to underpay claims.

Insurance companies create an environment that encourages independent adjusters to underpay claims while contractually shielding themselves from bad faith liability.<sup>137</sup> By tracking the average amount paid on claims for each adjuster, insurance companies are able to determine which adjusters are keeping costs down.<sup>138</sup> Independent adjusters are therefore rewarded by receiving additional business by minimizing the insurance company's indemnity payout on claims. Although claims adjusters are intended to be neutral, disinterested third parties, this policy of tracking adjusters' payout has resulted in conflicting interests between independent adjusters and policyholders by incentivizing independent adjusters to underpay and deny claims.<sup>139</sup> Two former independent adjusters, hired to adjust claims in the aftermath of Hurricane Katrina, testified before a grand jury that they were hired by the insurance company to defraud policyholders by denying claims.<sup>140</sup> The adjusters testified that they refused to cover at least two billion dollars in damages caused by Hurricane Katrina.<sup>141</sup> Insurance companies have engaged in fraudulent claims handling practices by creating an environment that fosters underpayment of claims through the use of independent adjusters, misrepresenting the independent status of the adjusters to policyholders, and allowing policyholders to detrimentally rely on the independent adjusters' determinations.

#### *IV. Shifting the Risk to Policyholders, the Government, and Reinsurance Companies*

Insurers often develop methods, beyond hiring biased engineers and independent adjusters, to insulate themselves from the extreme financial consequences of catastrophes by adopting risk-limiting strategies. Insurance companies are reducing financial exposure by shifting much of the risk associated with insurance to policyholders, the government, and reinsurance companies. Insurance companies are implementing strategies that require policyholders in disaster-prone areas like Oklahoma to bear much more of the risk of potential catastrophic loss.<sup>142</sup> Increasingly, major insurers attempt to avoid high catastrophe areas by refusing to issue new policies<sup>143</sup> and refusing

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137. *Id.* at 37.

138. *Id.* at 2297-98.

139. *Id.*

140. Kunzelman, *supra* note 42, at E3.

141. *Id.*

142. See Ins. Info. Inst., *supra* note 2 (showing that Oklahoma ranked among the top ten states in total catastrophe losses for 2007).

143. Gosselin, *supra* note 11, at A18 (reporting that major insurance companies, such as



to renew existing policies in these areas.<sup>144</sup> In addition, insurers reduce coverage in these areas by diluting the terms and conditions of the policies to limit the insurance company's risk.<sup>145</sup> The state and federal governments must also bear much of the risk insurance companies have escaped,<sup>146</sup> as major insurance companies have lobbied successfully for the creation of state and federal catastrophe funds to serve as a limit on the insurance companies' liability for catastrophic losses.<sup>147</sup> Also, insurance companies are reducing their presence in the most risky lines of business, such as flood insurance, due to the federal government's increased responsibility with respect to these areas of insurance.<sup>148</sup> George K. Bernstein, the first administrator of the government's flood, riot, and crime insurance programs, warned, "[t]here's not going to be much left that [the insurance companies] do insure by the time it's all over."<sup>149</sup> Unfortunately, if the insurance companies continue to shift the assumption of risk to the government, Bernstein's statement will come to fruition. Insurers further insulate themselves by purchasing reinsurance policies.<sup>150</sup> Although reinsurance provides much needed protection to insurers, reinsurance allows insurers to become overly insulated from liability and overextend themselves in the number of policies issued. The added protection provided by reinsurance allows insurers to engage in risky business ventures that may prove detrimental to policyholders.

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Allstate, are "approving no new policies along substantial stretches of the nation's East and Gulf coasts"); Aldo Svaldi, *Federal Backup Sought to Pay Claims: Insurance Pool Pushed Again—Some Argue that Those Living in Low-Risk Areas Shouldn't Have to Fund Catastrophe Coverage*, DENVER POST, Jan. 8, 2006, at K1 (reporting that Allstate is looking to do business in "safer" states like Colorado).

144. Trial Transcript, *supra* note 70, at 2144 (discussing an insured that was not renewed due to difficulty in claims settlement; noting that non-renewal will stand as an underwriting decision).

145. Gosselin, *supra* note 11, at A18.

146. *Id.*

147. Herrndobler, *supra* note 14, at E1.

148. Gosselin, *supra* note 11, at A18.

149. *Id.*

150. *Id.*

*A. Shifting the Risk to Policyholders*

California's Insurance Commissioner described the insurance industry as "running away from risk, and leaving policyholders holding the bag."<sup>151</sup> By running away, insurance companies defeat policyholders' purpose in purchasing insurance. Homeowners acquire insurance to mitigate the potentially devastating financial consequences of a natural catastrophe or other significant loss.<sup>152</sup> The policyholder assumes that by making regular premium payments to the insurance company, the policyholder will not be faced with the cost of rebuilding in the event of a major loss as the insurance company will cover the cost of rebuilding. Because insurers have shifted so much of the risk to policyholders, policyholders now bear the burden of their regular premiums and the risk of great financial loss in the event of a catastrophe. Insurance companies have shifted the risk to policyholders by increasing premiums, increasing deductibles, reducing coverage, refusing to issue policies in high risk areas, and refusing to renew high risk policyholders.<sup>153</sup>

Homeowners insurance premiums continue to rise.<sup>154</sup> By increasing premiums, insurance companies decrease the amount of each premium dollar spent on claims and expenses, known as the combined ratio.<sup>155</sup> A lowered combined ratio equates to less risk for the insurer.<sup>156</sup> Insurers, however, provide an alternate explanation for rising premiums. Insurers claim that the deficit they experienced after the devastating 2004 and 2005 hurricane seasons necessitates the increase in premiums.<sup>157</sup> For example, insurance companies have added an annual 1% charge to Florida citizens' premiums.<sup>158</sup> According to the insurance companies, over the next ten years this annual increase will pay off \$1.5 billion in deficits that resulted from the 2004 and 2005 storm losses.<sup>159</sup> The insurance companies' deficit claim, however, is difficult to reconcile with

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151. *Id.*

152. ABRAHAM, *supra* note 65, at 3 (stating that "the function of insurance is to protect the policyholder in the event of a future loss").

153. Gosselin, *supra* note 11, at A18.

154. *Id.* (stating that premiums for homeowners insurance have increased over fifty percent since the early 1990s).

155. The combined ratio is the percentage of each premium dollar that the insurance company spends on claims and expenses. Ins. Info. Inst., *supra* note 6 (search "Glossary" for the term "combined ratio"). When the combined ratio decreases, it means financial results for the insurance company are improving. *Id.*

156. *Id.*

157. Gosselin, *supra* note 11, at A18.

158. Paul Flemming, *Cabinet Oks 1 Percent Insurance Charge: Add-on to Pay Bonds for Catastrophe Fund*, NEWS-PRESS (Fort Myers, Fla.), June 1, 2006, at B5.

159. *Id.*

the insurance industry's record profits in 2004 and 2005.<sup>160</sup> Following Hurricanes Katrina, Rita, and Wilma, insurance premiums in the Gulf Coast rose as much as 500%.<sup>161</sup> This sky-rocketing increase may force many Gulf Coast residents to relocate.<sup>162</sup>

While some insurers in catastrophe-prone areas increase premiums, others exit the market entirely.<sup>163</sup> For example, Allstate Insurance Company has announced that it will no longer issue new homeowners policies for homes located along the East and Gulf coasts.<sup>164</sup> By exiting the market, insurance companies shift all of the risk of loss to homeowners, thus making homeowners unwilling, or unable, to continue residing near the coasts.<sup>165</sup> Homeowners who continue residing in areas where insurers have pulled out of the market will either reside with no insurance, bearing one-hundred percent of the risk associated with potential loss, or be forced to pay a colossal amount in premiums due to the lack of market competition. In response to the shrinking insurance market in some states, Colorado and other states have argued for the creation of catastrophe funds on a state-by-state basis to prevent homeowners living in low risk states like Colorado from paying higher premiums to compensate for those living in high risk states like Oklahoma.<sup>166</sup> A state-by-state scheme for catastrophe funds, as proposed by Colorado, could potentially prevent the sky-rocketing increases in premiums that follow catastrophes like Hurricane Katrina and prevent the repercussions of increases from spilling over into other states.<sup>167</sup>

In addition, insurers increasingly refuse to renew policies in high risk areas following a catastrophe.<sup>168</sup> After the 1999 tornados near Oklahoma City, State

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160. Gosselin, *supra* note 11, at A18.

161. Ramstack, *supra* note 3, at C12.

162. Thomas Lee, *Counting the COST: Insurers Have Never Seen the Likes of Hurricane Katrina*, STAR TRIB. (Minneapolis, Minn.), Oct. 24, 2005, at 1D (suggesting insurance premiums in Louisiana might become unaffordable for businesses and homeowners, thereby forcing policyholders to consider relocation).

163. Svaldi, *supra* note 143, at K1.

164. Gosselin, *supra* note 11, at A18.

165. *See* Lee, *supra* note 162, at 1D.

166. Svaldi, *supra* note 143, at K1; *see also* Lee, *supra* note 162, at 1D (suggesting insurance companies might seek to spread the risk of catastrophes to policyholders throughout the country).

167. Svaldi, *supra* note 143, at K1.

168. Trial Transcript, *supra* note 70, at 2144; *see also* Anita Lee, *State Farm Drops Wind Coverage: New Customers Won't Be Covered*, SUN HERALD (Biloxi, Miss.), Dec. 16, 2006, at A1 (discussing State Farm's decision to no longer provide wind coverage for new policyholders in Mississippi and State Farm's considerations regarding whether to extend wind coverage on renewals of existing policies).

Farm denied renewal of policies held by homeowners in the area.<sup>169</sup> State Farm justified their refusal to renew the policies by claiming the policyholders were difficult during the claims process.<sup>170</sup> When an insurance company refuses to renew a policy, policyholders must find an insurance company willing to insure already damaged property—often at unnecessarily high premiums—or be left with no coverage.

Insurers have also shifted the risk of loss to policyholders by reducing coverage. The Insurance Information Institute reports that, historically, insurers covered more than sixty percent of total losses caused by a natural disaster.<sup>171</sup> Following the 2004 hurricanes in Florida, however, insurers covered less than fifty percent of the total losses caused by the hurricane.<sup>172</sup> Coverage decreased even further in 2005, when insurers covered only thirty percent of the total losses resulting from Hurricane Katrina.<sup>173</sup> As the losses covered by insurers decreases, the risk born by policyholders increases because homeowners not only have to pay premiums for insurance, but are also compelled to be financially responsible for an uncovered loss.

Insurers also reduce coverage by tightening policy language.<sup>174</sup> For example, insurance companies have relied on the intricacies of policy language to deny post-Hurricane Katrina claims on the basis that wind damage is not covered when water contributes to the damage.<sup>175</sup> Mississippi Attorney General Jim Hood commented that, “sneaky companies have tried to use these provisions to even deny wind damage if any water touched the house. This just shows how overreaching the insurance industry has become in using their ‘fine print.’”<sup>176</sup> Fortunately for policyholders, a U.S. district judge ruled that the language was ambiguous and could not be enforced.<sup>177</sup> Although insurers are increasingly relying on the fine print of policy language to deny claims, courts are recognizing the ambiguity and interpreting the policy against the drafter consistent with the universal law of contracts.<sup>178</sup>

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169. Trial Transcript, *supra* note 70, at 2144.

170. *Id.* (describing a policyholder whose homeowners policy was not renewed, after forty-five years of being insured with State Farm, due to difficulty in the settlement of her claim; policyholder testified she was not being difficult, but simply standing up for her rights).

171. Gosselin, *supra* note 11, A18.

172. *Id.*

173. *Id.* (noting that the low percentage is partially due to the large amount of flood damage).

174. *Id.*

175. Anita Lee, *Settlement Near?: State Farm May Reopen Claims*, SUN HERALD (Biloxi, Miss.), Jan. 9, 2007, at A1; *see also supra* Part III.A.1.

176. Insurance Lawsuit Press Release, *supra* note 66.

177. Lee, *supra* note 175, at A1.

178. Katrina Case Press Release, *supra* note 54.

In addition to tightening policy language regarding the hotly contested water damage provision, insurers have narrowed the definition of “replacement cost coverage” to change the procedure for paying replacement cost benefits, thereby denying full coverage to policyholders. Replacement cost coverage is intended to be the best policy available to homeowners. The Insurance Information Institute defines replacement cost coverage as “[i]nsurance that pays the dollar amount needed to replace . . . personal . . . or dwelling property without deducting for depreciation.”<sup>179</sup> Insurance companies, however, have tightened the language in their policies to restrict coverage to the actual cash value.<sup>180</sup> Actual cash value represents the replacement cost value of the damaged property less the damaged property’s depreciation value.<sup>181</sup> Only after the policyholder provides documentation that the property has actually been repaired or replaced will the insurance company pay the difference.<sup>182</sup> This two-step process for paying replacement cost coverage claims greatly reduces coverage because policyholders often do not possess the money, time, or energy to repair or replace damaged property after a natural disaster.

In addition, insurance companies impose time limitations within which policyholders must claim their replacement cost benefits after the insurance companies make the actual cash value payment for the policyholder’s damaged property.<sup>183</sup> The money that the insurance companies retains—the difference between the replacement cost and the actual cash value—is referred to as “holdback benefits.”<sup>184</sup> Holdback benefits are money owed to the policyholders but held back by the insurance company until the policyholder meets certain conditions.<sup>185</sup> Because many policyholders do not understand the replacement cost provision of the policy, insurance companies retain millions of dollars nationwide in holdback benefits.<sup>186</sup>

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179. Ins. Info. Inst., *supra* note 6 (search “Glossary” for the term “replacement cost”).

180. ABRAHAM, *supra* note 65, at 188.

181. Ins. Info. Inst., *supra* note 6 (search “Glossary” for the term “actual cash value”).

182. ABRAHAM, *supra* note 65, at 188 (providing an ISO sample policy containing a replacement cost provision stating that the insurance company will pay the cost to repair or replace the property once actual repair or replacement is complete).

183. *Id.* (describing a provision in the ISO sample policy informing policyholders that if they accept actual cash value at the time of loss, they must inform the insurance company of their intent to make a claim for additional replacement cost benefits within 180 days of the date of loss).

184. Trial Transcript, *supra* note 70, at 472 (describing the process of holding back replacement cost benefits until actual repair or replacement is complete. The witness testified that if the policyholder cannot afford to get the property repaired or replaced, the insurance company keeps the benefits that were held back).

185. *Id.*

186. Following the May 3, 1999, tornados, State Farm retained \$10 million in holdback benefits never paid to policyholders in Oklahoma and Kansas through the two-step caveat in

Insurers are aware that policyholders do not understand the procedure for obtaining replacement cost benefits when they purchase policies.<sup>187</sup> The most frequently asked question by policyholders following a catastrophe is, “My agent told me my policy provided replacement cost coverage for my house. Why was I not paid the full cost to repair the damage to my home?”<sup>188</sup> Policyholders do not understand the procedure for obtaining replacement cost benefits because most insurance companies do not explain the two-step process in their marketing materials, nor do the agents explain the procedure when selling the policy.<sup>189</sup> Because insurers know the two-step process is confusing to policyholders and expensive for the insurance company to implement, some insurers, such as State Farm, have considered switching to a one-step process.<sup>190</sup> Nevertheless, realizing the increase in claims expenditures that resulted from paying policyholders the full amount owed on claims, State Farm decided to return to a two-step process, claiming it was necessary to remain competitive.<sup>191</sup> Even though the insurance industry has toggled between a one-step process for paying replacement cost benefits outright and a two-step process of holding back replacement cost benefits, the marketing materials used by insurance companies regarding the replacement cost policies have not changed.<sup>192</sup>

Some courts have held that replacement cost provisions that limit the insurer’s liability to actual cash value unless the policyholder repairs or replaces the property are void as unconscionable.<sup>193</sup> In Pennsylvania, one such provision

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the replacement cost provision of the policies. *Id.* at 27. Furthermore, State Farm retained \$104 million nationwide throughout that year. *Id.* at 10.

187. *See* STATE FARM INS. CO., FIRE ASSIST TRAINING/CLAIM SERVICE STUDENT’S MANUAL: TEN QUESTIONS MOST COMMONLY ASKED ABOUT CATASTROPHE CLAIMS 13 (1996).

188. *Id.*

189. A State Farm employee testified that there is nothing in State Farm’s marketing materials that informs a lay person how replacement cost benefits are paid, specifically, that replacement cost benefits are not going to be paid until the policyholder makes the repairs themselves. Trial Transcript, *supra* note 70, at 43, 436, 3706. In addition, State Farm’s expert witness, a former employee of the Department of Insurance, testified that although State Farm changed the process for paying replacement cost benefits, marketing materials remained the same. *Id.* at 3706. Fraudulent marketing was one of the several claims brought against State Farm in the aftermath of the 1999 tornados. *See* Amended Complaint, *supra* note 41.

190. *See* BISHOP & SPEIGHT, *supra* note 62, at 2 (stating in an internal State Farm study that “the purpose of this research was to examine what effect a change in policy language and claims settlement procedures regarding up-front payment of Coverage A—Replacement Cost Benefits would have on overall claim severity, production efficiency, expense savings, and customer service”).

191. Trial Transcript, *supra* note 70, at 472-73.

192. *Id.* at 3706.

193. *Ferguson v. Lakeland Mut. Ins. Co.*, 596 A.2d 883, 885 (Pa. Super. Ct. 1991) (holding

violated public policy because it required the insured to “procure from their own funds, which they may not have, replacement property prior to receipt of full replacement cost.”<sup>194</sup> Although Oklahoma courts initially appeared to accept this position as well,<sup>195</sup> Oklahoma courts have since rejected the argument.<sup>196</sup> In *Bratcher v. State Farm*, the Oklahoma Supreme Court held that the two-step replacement cost provision was not void as unconscionable because the provision was clear and unambiguous and, therefore, had to be given its plain and ordinary meaning.<sup>197</sup> Importantly, the court noted the plaintiff admitted that he read and understood the policy, including the replacement cost provision.<sup>198</sup> Because the plaintiff admittedly understood the replacement cost provision of the policy, fraud was not a potential allegation.<sup>199</sup> In addition, this admission foreclosed the use of the doctrine of reasonable expectations—the avenue that proved successful for plaintiff class members in *Watkins* regarding the replacement cost provision.<sup>200</sup>

Although Oklahoma courts have declined to use the equitable doctrine of unconscionability to hold replacement cost provisions void, plaintiffs in Oklahoma may obtain relief under the doctrine of reasonable expectations.<sup>201</sup> Under the doctrine of reasonable expectations, an ambiguous insurance policy is to be resolved in favor of the insured’s expectations under the policy.<sup>202</sup> Because insurers fail to explain the admittedly confusing two-step replacement cost provision, policyholders expect insurance companies to pay the full cost of replacing the policyholders’ property when that property is damaged.<sup>203</sup> In 1996, the Oklahoma Supreme Court held that the doctrine of reasonable

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the replacement requirement is unconscionable despite the clear and unambiguous language of the policy).

194. *Gilderman v. State Farm Ins. Co.*, 649 A.2d 941, 944 (Pa. Super. Ct. 1994).

195. *Coblentz v. Okla. Farm Bureau Mut. Ins. Co.*, 1995 OK CIV APP 126, ¶ 10, 915 P.2d 938, 940 (holding the replacement requirement contained in a policy unconscionable), *overruled by Bratcher v. State Farm Fire & Cas. Co.*, 1998 OK 63, ¶ 10, 961 P.2d 828, 831.

196. *Truesdell v. State Farm Fire & Cas. Co.*, 960 F. Supp. 1511, 1517 (N.D. Okla. 1997) (holding that a replacement cost provision is not void as unconscionable in this instance); *Bratcher*, ¶ 10, 961 P.2d at 831, *overruling Coblentz*, 1995 OK CIV APP 126, 915 P.2d 938.

197. *Bratcher*, ¶ 11, 961 P.2d at 831.

198. *Id.* ¶ 5, 961 P.2d at 830.

199. *Id.*

200. *Watkins v. State Farm Fire & Cas. Co.*, No. CJ-2000-303 (Okla. Dist. Ct. May 25, 2006), *appeal docketed*, No. DF-103756 (Okla. Civ. App. Sept. 13, 2006), *appeal dismissed per stipulation, verdict vacated and confidential settlement entered*, No. DF-103756 (Jan. 12, 2007).

201. *Max True Plastering Co. v. U.S. Fid. & Guar. Co.*, 1996 OK 28, ¶ 23, 912 P.2d 861, 870.

202. BLACK’S LAW DICTIONARY 1294 (8th ed. 2004).

203. *See STATE FARM INS. CO.*, *supra* note 187, at 13.

expectations applies to the interpretation of insurance contracts and can apply to ambiguous language or to exclusions either masked by technical language or hidden in the policy's provisions.<sup>204</sup> The court stated, "[I]f the insurer or its agent creates a reasonable expectation of coverage in the insured which is not supported by policy language, the expectation will prevail over the language of the policy."<sup>205</sup> Because insurers knowingly provide policyholders with the expectation that the policyholder will receive the full replacement cost value of damaged property, the insurance companies should be obligated to conform to those expectations.<sup>206</sup> When purchasing a replacement cost policy rather than an actual cash value policy, policyholders have the reasonable expectation of total coverage in the event of a loss, thereby justifying the higher premium. Arguably, policyholders would not have spent the additional money to purchase the replacement cost coverage if the policyholder knew that, upon a loss, the coverage required the policyholders to spend his or her own money to repair or replace their property before receiving the full benefits of the replacement cost policy. To remedy the situation, the Oklahoma Supreme Court has held that "reformation of an insurance contract is allowed if the insurer has reason to believe that the insured would not have signed the contract if the inclusion of certain limitations had been known."<sup>207</sup> Therefore, if the insurance company has reason to believe that the policyholder would not have purchased replacement cost coverage if he or she had known of the two-step provision, then reformation of the policy would be allowed and the policyholder could recover full replacement cost benefits.<sup>208</sup>

Oklahoma courts are increasingly making remedies available for policyholders who have found themselves victims to the insurance industry's tactics to evade liability for claims. Insurance companies, nonetheless, continue to avoid much of the risk necessarily associated with the insurance industry by increasing premiums, diluting coverage, and pulling out of disaster prone areas.<sup>209</sup> Unfortunately, the remaining risks the insurance industry is unable to push off on policyholders are often shifted to the government, leaving the insurance industry in an increasingly safe and profitable position.<sup>210</sup>

### *B. Shifting the Risk to the Government*

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204. *Max True Plastering Co.*, ¶ 24, 912 P.2d at 870.

205. *Id.* ¶ 7, 912 P.2d at 864.

206. *See STATE FARM INS. CO.*, *supra* note 187, at 13.

207. *Max True Plastering Co.*, ¶ 14, 912 P.2d at 867.

208. *Id.*

209. *Gosselin*, *supra* note 11, at A18.

210. *See id.*



Following the catastrophic years of 2004 and 2005, major insurers have claimed that without government assistance insurance companies have little incentive to provide coverage in high risk areas.<sup>211</sup> Although the government debates the insurance companies' claim, especially in light of the insurance companies' extraordinary profits,<sup>212</sup> the insurance companies threat of entirely withdrawing from the market is concerning. As an alternative, insurance companies are seeking assistance from the government in the most risky areas of insurance, such as catastrophe coverage. To ensure insurance companies remain in the market, the government is increasingly accepting many of the risks associated with private insurance.<sup>213</sup>

For example, following the 9/11 attacks on the World Trade Center, Congress passed the 2002 Terrorism Risk Insurance Act (TRIA).<sup>214</sup> In the event of another major terrorist attack, TRIA will provide federal money to assist private insurance companies by paying ninety percent of insured losses.<sup>215</sup> TRIA provides up to \$100 billion of federal assistance to insurance companies.<sup>216</sup> Under the original TRIA, damages from the terrorist attack had to exceed \$5 million before the federal government was obligated to contribute.<sup>217</sup> Although the trigger mark for damages increased to \$50 million in 2006, and will increase again in 2007, TRIA has nonetheless been criticized as being a gift to the insurance industry.<sup>218</sup> The government has expressed reluctance to back terrorism coverage, but Congress nonetheless continues to extend TRIA.<sup>219</sup>

Insurance companies are further shifting risks to the government by refusing to cover risky lines of insurance, such as flood insurance.<sup>220</sup> Federal money

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211. *Id.*

212. Allstate's CEO, Edward M. Liddy, described how a set of storms can wipe out an insurer's profits and destroy their financial stability. *Id.* Liddy stated offering insurance in such storm-prone areas is "not a viable economic proposition for a company," nor an industry. *Id.* However, it is hard to accept the notion that it is not a viable market when Allstate made \$6.6 billion in premium earnings in Florida alone between the mid-1990s and the end of 2005. *Id.*

213. John Gibeaut, *Forces of Change*, A.B.A. J., Jan. 2007, at 41, 46 (discussing the 2002 Terrorism Risk Insurance Act assisting insurance companies in the event of a major terrorist attack); Lee, *supra* note 41, at A1 (discussing the National Flood Insurance Program covering damage for those who had flood policies); Lipman, *supra* note 14, at 9A (discussing Congress' consideration of a federal catastrophe fund).

214. Gibeaut, *supra* note 213, at 46.

215. *Id.*

216. *Id.*

217. *Id.*

218. *Id.*

219. *Id.*

220. ABRAHAM, *supra* note 65, at 186 (providing an ISO sample policy excluding flood

paid for much of the damage resulting from Hurricane Katrina under the National Flood Insurance Program.<sup>221</sup> In addition to refusing to insure against flood damage, insurance companies further attempted, though unsuccessfully, to avoid liability by putting the burden on policyholders to prove their losses were not caused by Hurricane Katrina's water.<sup>222</sup> In preparation of a Congressional hearing investigating the insurance industry, Mississippi Attorney General Jim Hood expressed confidence that the House Homeland Security Chairman would look into the insurance companies' shifting the costs of Hurricane Katrina's damage to tax payers through the National Flood Insurance Program and FEMA.<sup>223</sup>

In addition, several major insurers are attempting to shift the risk of loss to the government by urging Congress to approve pending legislation that would establish state and federal catastrophe funds.<sup>224</sup> If enacted, this legislation would establish a safety fund for insurance companies faced with great losses resulting from natural disasters.<sup>225</sup> The legislation requires insurance companies to deposit a portion of policyholders' premium payments into the state funds, and the state funds would, in turn, contribute to the federal fund.<sup>226</sup> The state funds would act as "tax-free piles of money" that secure insurance companies during huge losses by allowing insurance companies to extract money from the fund after paying a specified amount of money in satisfaction of claims.<sup>227</sup> When a catastrophe depletes a state fund, the insurance companies can recover from the federal fund.<sup>228</sup>

Ironically, the legislation that would create state and federal funds speaks only to the threat of insufficient funds for insurance companies to pay policyholders even though the insurance industry recently recorded record profits.<sup>229</sup> Also, the national catastrophe fund would provide no additional protection to policyholders, the funds merely redirect a portion of policyholders' premium payments to state and federal funds designed to ensure the satisfaction of claims after catastrophe.<sup>230</sup> This is the assurance that the insurance contract itself supposedly provides.

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coverage).

221. Lee, *supra* note 41, at A1.

222. *Id.*; see also *supra* Part III.A.1.

223. Insurance Lawsuit Press Release, *supra* note 66.

224. Lipman, *supra* note 14, at 9A.

225. Herrndobler, *supra* note 14, at E1.

226. *Id.*

227. Flemming, *supra* note 158, at B5.

228. Herrndobler, *supra* note 14, at E1.

229. Gosselin, *supra* note 11, at A1.

230. Herrndobler, *supra* note 14, at E1.

Insurers, on the other hand, benefit greatly from the catastrophe funds. Among the proposed legislation before Congress is a bill that encourages states to establish state catastrophe funds that would be secured by a new national catastrophe fund,<sup>231</sup> a bill that allows insurance companies to set aside pre-tax money into disaster protection funds for payment of claims for future catastrophes reducing their tax liabilities,<sup>232</sup> and a bill that allows policyholders to set aside twice the amount of their insurance deductible in a tax-free investment account.<sup>233</sup> Congressional approval of these measures would enable insurance companies to place money in tax-free funds and draw on these funds to satisfy claims as an alternative to purchasing expensive reinsurance.<sup>234</sup> In addition, the bill allowing policyholders to set aside twice the amount of their deductible in a tax free account essentially encourages policyholders to prepare for their claims to be denied.<sup>235</sup> In light of their recent behavior following Hurricane Katrina, it is no surprise that the bills are supported by insurance companies.<sup>236</sup> Although the pending legislation would theoretically benefit both insurance companies and policyholders by avoiding the high costs of reinsurance, the legislation does little to address the real problems policyholders face following catastrophes. The pending legislation proposes a solution for insufficient funds which, as evidenced by record profits, is not an existing problem.<sup>237</sup> The real problem, however, lies in how insurers handle claims. Allowing insurers to further avoid responsibility for policyholders through state and federal assistance does not solve the problems presented in claims handling practices.

Rather than establishing government funds to further protect the insurer, the government's response should be directed at protecting policyholders by strictly enforcing current laws and regulations regarding claims handling processes and holding the insurance industry liable for violations of those laws and regulations. Although holding insurance companies accountable and requiring them to pay the full amount owed on claims may eventually result in a crisis of insufficient funds, the industry is currently nowhere near financial insolvency. Creating a national fund to assist an industry that fraudulently cheats its policyholders out of proper payment and repeatedly acts in bad faith following catastrophes only compounds the problem. In the event the insurance industry is actually faced with insufficient funds, a catastrophe fund might prove to be

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231. Homeowners Insurance Protection Act of 2007, H.R. 91, 110th Cong. (2007).

232. Policyholder Disaster Protection Act of 2007, S. 926, 110th Cong. (2007).

233. Catastrophe Savings Accounts Act of 2007, H.R. 1787, 110th Cong. (2007).

234. Lipman, *supra* note 14, at 9A.

235. *Id.*

236. *Id.*

237. Gosselin, *supra* note 11, at A1.

a proper solution. Nevertheless, until that time arises, the government should decline to further aid insurance companies in avoiding liability by accepting additional risks that insurance companies are being paid to bear.

*C. Shifting the Risk to Global Reinsurance Companies*

Over the past several years, insurers have shifted their risks by investing in reinsurance—insurance bought by insurance companies.<sup>238</sup> When obtaining reinsurance, the insurance company pays the reinsurer part of the policyholders' premiums, and the reinsurer assumes a portion of the risk of loss.<sup>239</sup> In the event of a major catastrophe, the reinsurer does not pay a policyholder's claim itself, but, rather, reimburses the insurer for the claims the insurance company pays.<sup>240</sup> Therefore, by purchasing reinsurance, the insurer increases the money available to pay policyholders' claims, resulting in the insurance company being able to sell more policies.<sup>241</sup> As a result of the protection afforded by reinsurance, insurance companies can operate without maintaining billions of dollars in capital.<sup>242</sup>

By investing in reinsurance, insurance companies have effectively overextended themselves financially. Reinsurance has eliminated much of the insurance companies' risks associated with major catastrophes, allowing insurance companies to engage in more risky business ventures. As a result, insurance companies are issuing more policies and purportedly guaranteeing more protection than their individual corporate structure can financially bear. Although policyholders benefit greatly by the increased protection provided by reinsurance, this protection becomes problematic when the insurance company becomes over-insulated from liability. If the insurance company becomes too far removed from the consequences and risks associated with its business decisions, the insurance company could engage in overly risky behavior to the detriment of the policyholders, thereby resulting in a crisis parallel to the current mortgage lending crisis. In effect, an insurance company can issue more coverage than it can financially bear because, in the event of a major catastrophe, the burden of paying claims is shifted to the reinsurance company.

Although global reinsurance provides insurance companies much needed protection against devastating losses, the insurance industry complains that reinsurance has become too expensive.<sup>243</sup> Insurance companies must transfer

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238. Ins. Info. Inst., *supra* note 6 (search "Glossary" for the term "reinsurance").

239. *Id.*

240. *Id.*

241. *Id.*

242. Beatrice E. Garcia, *Standing up to Insurance Catastrophes*, MIAMI HERALD, July 3, 2006, at 11G.

243. Herrndobler, *supra* note 14, at E1.

the cost of purchasing reinsurance to the policyholders.<sup>244</sup> As a result, the consistent increase in the market for global reinsurance causes the price of policyholders' premiums to simultaneously increase.<sup>245</sup> The rising cost of global reinsurance is a major factor in the push for a national catastrophe plan and increased governmental involvement.<sup>246</sup> Insurance companies that are no longer willing to pay the high price to shift the risk to reinsurers now prefer to shift the risk to the government. Either way, insurance companies are unwilling to bear the risk of major catastrophes and continue to find ways to shift the risk and avoid liability.

#### *V. Changing Claims Handling Practices Following Catastrophes*

The Oklahoma Legislature has implemented detailed legislation regarding claim handling practices.<sup>247</sup> The Oklahoma Insurance Code has an entire article dedicated to claims settlement practices including a section describing fifteen specific acts that constitute violations of the Unfair Claims Settlement Practices Act.<sup>248</sup> Although Oklahoma has sufficient laws to regulate claim handling practices, insurers continue to take advantage of Oklahoma policyholders during the claim settlement process.<sup>249</sup> Because the Unfair Claims Settlement Practices Act does not provide a private right of action for violation, to prevent insurance companies from taking advantage of policyholders during catastrophes, the Oklahoma Insurance Commissioner and the Oklahoma Attorney General must advocate for policyholders and hold the insurance industry accountable under current regulations.<sup>250</sup>

Oklahoma can implement a more strictly regulated insurance industry through a restructuring the Department of Insurance and its practices. The Insurance Commissioner's role as an advocate for the insurance industry needs to be changed back to the intended role as an advocate for policyholders.

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244. *Id.*

245. *Id.*

246. Garcia, *supra* note 242, at 11G.

247. 36 OKLA. STAT. § 1250.5 (2001).

248. *Id.*

249. A unanimous jury found by clear and convincing evidence that State Farm intentionally and with malice breached its duty to deal fairly and act in good faith while handling the claims of over seventy known class members, although, under the class definition, State Farm could be liable to thousands of Oklahoma policyholders. Journal Entry of Judgment on Class Question Verdicts, *Watkins v. State Farm Fire & Cas. Co.*, No. CJ-2000-303 (Okla. Dist. Ct. May 25, 2006), *appeal docketed*, No. DF-103756 (Okla. Civ. App. Sept. 13, 2006), *appeal dismissed per stipulation, verdict vacated and confidential settlement entered*, No. DF-103756 (Jan. 12, 2007).

250. *Gianfillippo v. Northland Cas. Co.*, 1993 OK 125, ¶ 4, 861 P.2d 308, 310 (holding that "the Unfair Claim Settlement Practices Act provides no private right of action").

Additionally, criminal charges for violations of insurance laws and regulations need to be aggressively pursued as a means of regulation. Because of the immense profits insurers gain from corporate schemes to settle catastrophe claims fraudulently and in bad faith, civil damages are often insufficient as a means of changing insurers' behavior.<sup>251</sup> When the conduct of insurance companies is so appalling that civil damages are an insufficient deterrent, the threat of criminal charges may help internalize the costs of insurance companies' wrongdoings, thereby altering insurance companies' cost-benefit analysis, discouraging future violations, and improving outcomes for claimants. The Oklahoma legislature has provided the tools for strict regulation of claims settlement practices.<sup>252</sup> The Oklahoma Insurance Code empowers both the Insurance Commissioner and the Attorney General to take action in the event of violations.<sup>253</sup> The responsibility to enforce the standards set out by the legislature now lies in the hands of these government officials to act as advocates for Oklahoma policyholders.

*A. Restructuring the Role of the Oklahoma Insurance Commissioner*

The Department of Insurance is a state agency established to enforce the laws implemented by the legislature relevant to the insurance industry.<sup>254</sup> Within the Oklahoma Insurance Code, the legislature empowers the Insurance Commissioner with the authority to enforce the established standards.<sup>255</sup> For example, in the event of a violation of the Unfair Claims Settlement Practices Act, the legislature mandates that the Insurance Commissioner issue a cease and desist order directing the insurer to stop the unlawful practices.<sup>256</sup> If the insurer fails to comply with the order, the Insurance Commissioner is further empowered to suspend the insurer's certificate of authority and limit, regulate, and control the insurer's line of business, as well as regulate the insurer's volume of business.<sup>257</sup> Although the Insurance Commissioner is seemingly empowered with the tools necessary to regulate the insurance industry,

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251. Jim Hood, the Mississippi Attorney General, is pressing charges against five insurance companies, including Nationwide Mutual Insurance Co., State Farm Fire and Casualty Co., Allstate Property and Casualty Co., and United Services Automobile Association, for attempting to cheat Hurricane Katrina survivors out of millions of dollars regarding their homeowners' claims. *Miss. AG Accuses*, *supra* note 80.

252. 36 OKLA. STAT. § 1250.5.

253. *Id.* § 1250.13.

254. Dave Thomas, *Oklahoma Insurance Commissioner Puts Pen to Paper, Resigns*, *INS. J.*, Oct. 11, 2004, <http://www.insurancejournal.com/magazines/southcentral/2004/10/11/features/48875.htm>.

255. 36 OKLA. STAT. § 1250.13.

256. *Id.*

257. *Id.*

particularly claims settlement practices, the Commissioner often fails to uphold the standards articulated by the legislature.

Oklahoma has an unfortunate history of corruption within the Department of Insurance.<sup>258</sup> Insurance Commissioner Carroll Fisher was forced to resign after felony charges of embezzlement and mismanagement of funds were brought against him in 2004.<sup>259</sup> The Assistant Attorney General alleged that Fisher had engaged in a pattern of corruption while Fisher occupied the office from 1998 to 2004.<sup>260</sup> Furthermore, the Oklahoma House of Representatives accused Fisher of neglect of duty, corruption, and incompetency.<sup>261</sup> Although the recently appointed Insurance Commissioner, Kim Holland, claims she is working hard “to bolster the public’s confidence in the department,” the Oklahoma Department of Insurance is currently far from satisfactory.<sup>262</sup>

Oklahoma is in need of a proactive Insurance Commissioner willing to be an advocate for policyholders. The Insurance Commissioner has the responsibility of receiving and processing complaints alleging violations of the Unfair Claims Settlement Practices Act.<sup>263</sup> The Insurance Commissioner further has the duty to initiate an investigation if the number and type of complaints do not meet minimum standards of performance or are out of proportion to complaints against other insurers.<sup>264</sup> Because the Insurance Commissioner has the responsibility of receiving all complaints, he or she is in the best position to recognize when complaints against a particular insurer are out of proportion and take the initiative to start an investigation on behalf of Oklahoma policyholders. Nevertheless, if the Insurance Commissioner is advocating on behalf of the insurance industry rather than policyholders—which seems to be the present situation in Oklahoma—such investigations will never occur.

Oklahoma Insurance Commissioner Kim Holland has clearly expressed her loyalty to the insurance industry. Holland, a former insurance agent for more than twenty years, stated that her top priority during her tenure is dealing with the issue of uninsured Oklahomans, noting that a number of Oklahomans are not complying with compulsory insurance laws.<sup>265</sup> Holland’s top priority

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258. *Oklahoma Commissioner Charged in Corruption Scheme*, INS. J., Mar. 8, 2004, <http://www.insurancejournal.com/magazines/west/2004/03/08/features/39879.htm>.

259. *Id.*

260. *Id.*

261. Thomas, *supra* note 254.

262. *Holland Intends to Keep ‘Raising the Bar’ for Ethics and Integrity*, INS. J., Sept. 25, 2006, <http://www.insurancejournal.com/magazines/southcentral/2006/09/25/features/73139.htm>, [hereinafter *Raising the Bar*].

263. 36 OKLA. STAT. § 1250.10 (2001).

264. *Id.*

265. *Raising the Bar*, *supra* note 262.

appears to be providing more business to insurance companies rather than assuring that insurance companies deal with existing policyholders in compliance with the legislative standards. In addition, while discussing her role as an intermediary between consumers and the insurance industry, Holland excused most disputes as the result of policyholders merely being misinformed or having a lack of understanding of the claim filing process, stating that sometimes things just “fall through the cracks” at an insurance company.<sup>266</sup> Other initiatives discussed by Holland include resolving complaints without lawsuits, maintaining a competitive pro-business environment, reducing costs to insurance companies, and giving independent agents the opportunity to develop their business and conduct it how they choose.<sup>267</sup> Although Holland is a significant improvement upon her predecessor, the Oklahoma Department of Insurance remains sub-par as an advocate for policyholders, particularly when compared to other jurisdictions.

Mississippi’s Insurance Commissioner, George Dale, has initiated an investigation regarding the handling of Hurricane Katrina claims.<sup>268</sup> Dale plans on performing market conduct examinations to investigate several major insurance companies.<sup>269</sup> Market conduct examinations consist of interviews with Mississippi residents and a review of company files, followed by whatever corrective actions are deemed necessary.<sup>270</sup> Nevertheless, some critics are disappointed with Dale for not doing more to hold insurance companies accountable and have expressed hope that Dale would be a more aggressive advocate for Mississippi policyholders.<sup>271</sup> Robert Hartwig, the chief economist for the Insurance Information Institute, stated that investigations such as those conducted by Dale are routinely ordered following catastrophes, but serious sanctions are rare.<sup>272</sup> Although no serious sanctions have yet been enforced by the Mississippi Insurance Commissioner, industry-wide market conduct examinations are a step in the right direction toward a full investigation, an initiative Oklahoma has yet to see.

California Insurance Commissioner, John Garamendi, is a prime example of a proactive Insurance Commissioner who advocates for the state’s policyholders. For example, following the Oakland firestorm catastrophe, Garamendi brought action against Allstate Insurance Company and eight of its

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266. *Id.*

267. *Id.*

268. Michael Kunzelman, *Miss. to Investigate State Farm: Katrina Claims Checked; Other Insurers to Follow*, COM. APPEAL (Memphis, Tenn.), Nov. 22, 2006, at DSB8.

269. *Id.*

270. *Id.*

271. *Id.*

272. *Id.*



agents alleging violations of California's Unfair Practices Act, misrepresentation, breach of duty, and failure to perform an expressly enjoined duty.<sup>273</sup> The actions were taken in response to a public meeting convened by Garamendi following the Oakland firestorm in 1992, where hundreds of angry policyholders testified about misleading marketing practices, a lack of good faith in settlement offers, and other complaints.<sup>274</sup>

Because of these violations, Allstate was faced with penalties of more than \$2.5 million and suspension of its certificate of authority to provide homeowners insurance.<sup>275</sup> Agents faced revocation or suspension of their licenses as well.<sup>276</sup> Garamendi stated that these actions were intended to "send a clear signal to insurance companies and agents that violations of insurance laws and regulations will be vigorously prosecuted."<sup>277</sup> Garamendi embodied the active role policyholders expect an insurance commissioner to assume following a catastrophe. Garamendi held public meetings, investigated complaints, set deadlines for claims to be settled, sent threatening letters to top executives of major insurers, held investigatory hearings, imposed fines for violations, and initiated market conduct examinations.<sup>278</sup> Oklahoma policyholders need a proactive Department of Insurance, like California's, to advocate for policyholders' interests and ensure that Oklahoma's insurance laws and regulations are being adequately enforced.

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273. John Schmeltzer, *Allstate Oakland Fire Dealings Hit*, CHI. TRIB., Sept. 24, 1992, at 1.

274. *Oakland Fire Coverage up by \$151M*, NAT'L UNDERWRITER PROP. & CASUALTY, Aug. 31, 1992, at 4.

275. Larry Hicks, *State Sues Allstate in Oakland Fire: Agents Misrepresented Coverage, Insurance Commissioner Charges*, SACRAMENTO BEE, Sept. 24, 1992, at D1.

276. *Id.*

277. Don Martinez, *Allstate Cited over Fire Claims: State Charges Stem from E. Bay Blaze*, S.F. EXAMINER, Sept. 24, 1992, at A8.

278. *Oakland Fire Coverage up by \$151M*, *supra* note 274, at 4.

*B. Utilizing the Power Given to the Attorney General*

After a catastrophe, insurers can avoid paying millions of dollars in claims by engaging in wrongful conduct, such as coercing structural engineers to pre-construct biased reports, using delay tactics during litigation, and encouraging victims to sign waivers to receive immediate personal expense money.<sup>279</sup> Unfortunately, the repercussions brought against the insurance company in a civil suit for wrongful conduct are often not sufficiently burdensome to change the insurance company's behavior. To achieve reform in the insurance industry's claim handling practices the court must impose a penalty that will be sufficiently harsh to weigh heavily on insurers' cost-benefit analysis. Because insurance companies accrue a substantial benefit through fraudulent and bad faith practices, the penalty for such practices must be sufficiently great to outweigh these benefits. Only then will insurance companies change their behavior. For example, a \$3 million verdict against a major insurer such as State Farm, which had a net worth of \$50.2 billion in 2005,<sup>280</sup> may not be a substantial cost.<sup>281</sup> Because it is unlikely that a jury will ever render a verdict sufficiently large to influence a major insurer's policies, a better alternative might be criminal charges against the decision-making executives.

In the aftermath of Hurricane Katrina, Mississippi Attorney General Jim Hood has launched a criminal investigation into the conduct of several major insurance companies regarding their claim settling conduct.<sup>282</sup> Specifically, Hood is investigating allegations that insurers encouraged victims to sign waivers agreeing that their home was damaged from a flood in order to receive immediate personal expense funds<sup>283</sup> as well as allegations that State Farm manipulated engineering reports to deny claims.<sup>284</sup> While Hood is proceeding with the criminal investigation, the threat of criminal charges is playing a significant role in settlement negotiations with State Farm in Mississippi.<sup>285</sup> If the negotiations are successful, it will be the first mass settlement following the

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279. See *supra* Part III.B.1 (discussing biased engineering reports); *supra* Part III.A.2 (discussing delay tactics); see also *The Latest on Katrina's Aftermath*, CNN.COM, Sept. 15, 2005, <http://www.cnn.com/2005/US/09/15/news.update/index.html> [hereinafter *Katrina Aftermath*] (discussing insurance companies coercing policyholders to sign waivers).

280. *State Farm Net Income*, *supra* note 10.

281. A State Farm employee testified that \$3 million was insignificant. Trial Transcript, *supra* note 70, at 28.

282. *Katrina Aftermath*, *supra* note 279.

283. *Id.*

284. *Judge Denies State Farm Bid to Stop Prosecutor from Reviewing Docs*, INS. J., Apr. 13, 2006, <http://www.insurancejournal.com/news/southeast/2006/04/13/67267.htm>.

285. Lee, *supra* note 81, at A1.

wave of litigation spawned by Hurricane Katrina.<sup>286</sup> Perhaps coincidentally, but seemingly strategically, Mississippi is the only state to initiate a criminal investigation and the only state in which mass settlement negotiations have begun.<sup>287</sup> State Farm's willingness to consider settlement negotiations hinged on Attorney General Hood's agreement to drop the criminal proceedings.<sup>288</sup> The direct link between the settlement negotiations and the criminal proceedings indicate the persuasive effect the threat of criminal repercussions have on getting policyholders' claims paid.

While the threat of a criminal investigation seems to have a positive effect on settlement negotiations and ensuring that policyholders' claims are paid, the effect that criminal charges will have on changing insurers' corporate policies regarding claims handling practices is still uncertain. Some policyholders in Mississippi are extremely troubled by Attorney General Hood's willingness to use the criminal investigation as leverage to facilitate settlement.<sup>289</sup> These policyholders fear the government is allowing State Farm to buy their way out of being penalized for criminal conduct, thereby increasing corporate arrogance and encouraging wrongful behavior.<sup>290</sup>

Through the work of Mississippi Attorney General Hood, a glimpse of the persuasive effect criminal charges can have on corporate executives can be seen. Nevertheless, for criminal charges to be effective in changing corporate policies of major insurance companies, the criminal charges must be carried out to fruition. Rather than using criminal investigations to deal merely with the issue at hand, the charges could be used on a grander scale to initiate a national reform in the way insurance companies handle claims and deal with policyholders.

The Oklahoma Insurance Code empowers the Insurance Commissioner to seek the assistance of the Oklahoma Attorney General to carry out any penalties or investigations involving an insurance company.<sup>291</sup> The Oklahoma Legislature specifically empowered the Attorney General with the authority to deal with violations of the Unfair Claims Settlement Practices Act.<sup>292</sup> The Attorney General and the Insurance Commissioner, together, have the capability to enforce the standards set out by the legislature and reform the insurance industry's conduct within Oklahoma. Although insurance companies continue

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286. Michael Kunzelman, *State Farm Tries to Reach Accord on Katrina Claims*, CHI. TRIB., Jan. 9, 2007, at 1.

287. *See id.*

288. Lee, *supra* note 81, at A1.

289. *Id.*

290. *Id.*

291. 36 OKLA. STAT. § 1250.13(A) (2001).

292. *Id.*

to engage in illegal and wrongful practices that defraud and take advantage of Oklahoma policyholders, there is no need to implement new regulations until the current regulations have been adequately enforced and proven insufficient.

#### VI. Conclusion

The corporate arrogance that permeates the insurance industry gives insurance companies the notion that they can treat policyholders however they choose. Unfortunately, insurance companies have been caught preying on policyholders at their weakest moment—following major catastrophes.<sup>293</sup> Insurance companies have recently been hit hard by juries imposing massive punitive damage verdicts for bad faith and fraudulent conduct committed while settling catastrophe claims.<sup>294</sup> Nevertheless, these multi-million dollar verdicts may prove to be an insufficient deterrent of future misconduct in claims handling practices. When discussing the insurance industry's corporate arrogance, Mississippi Attorney General Jim Hood stated that “[a] \$2.5 million verdict to a \$58 billion net-worth company like State Farm is a drop in the bucket . . . . They're not afraid of the U.S. government or the devil or God . . . .”<sup>295</sup>

Although Oklahoma and other states have existing laws and regulations to prevent such fraudulent and bad faith conduct,<sup>296</sup> these laws are not being implemented in an effective manner. Because policyholders have no private right of action under the Unfair Claims Settlement Practices Act, the burden is on the Insurance Commissioner and the Attorney General to ensure insurance companies are adhering to the standards set out by the Oklahoma legislature.<sup>297</sup> As advocates for policyholders, the Insurance Commissioner and the Attorney General must impose consequences for violations that act not only as a

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293. *Watkins v. State Farm Fire & Cas. Co.*, No. CJ-2000-303 (Okla. Dist. Ct. May 25, 2006), *appeal docketed*, No. DF-103756 (Okla. Civ. App. Sept. 13, 2006), *appeal dismissed per stipulation, verdict vacated and confidential settlement entered*, No. DF-103756 (Jan. 12, 2007); *see also* Opinion on Rule 50 Motions for Judgment as a Matter of Law, *Broussard v. State Farm Fire & Cas. Co.*, No. 1:06CV6 LTS-RHW, 2007 WL 113942 (S.D. Miss. Jan. 11, 2007).

294. Journal Entry of Judgment on the *Watkins* Verdicts at 2, *Watkins*, No. CJ-2000-303 (imposing a \$12,906,950 verdict consisting of \$3 million in actual damages, \$6 million in punitive damages, and \$3,906,950 for the *Watkins*' share of the class punitive damages); *Judge Cuts Jury Award Owed by State Farm*, CHI. TRIB., Feb. 1, 2007, at 6 (discussing a \$2.5 million punitive damages award in *Broussard*, which was later reduced by the judge to \$1 million).

295. Anita Lee, *Verdict Sends a Message, Lawyers Say*, SUN HERALD (Biloxi, Miss.), Jan. 12, 2007, at A7.

296. *See, e.g.*, 36 OKLA. STAT. § 1250.5.

297. *Gianfillippo v. Northland Cas. Co.*, 1993 OK 125, ¶ 4, 861 P.2d 308, 310.

punishment, but as a deterrent of future violations. Strict implementation of the existing laws and regulations would serve to reform the insurance companies' behavior and restore integrity to the insurance industry. As the CEO of State Farm said, "If there's any business where integrity is critical, it's the insurance business."<sup>298</sup>

*Kelsey D. Dulin*

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298. Edward B. Rust Jr., CEO, State Farm Ins. Co., Keynote Address at the International Conference of the Association to Advance Collegiate Schools of Business 2 (Apr. 22, 2005), transcript available at <http://www.aacsb.edu/handouts/ICAM05/Plenary%20I-%20Rust.doc>.