

**State of California
Office of Administrative Law**

**In re:
Department of Insurance**

**Regulatory Action: Title 10
California Code of Regulations**

Adopt sections: 2194.70

**DECISION OF DISAPPROVAL OF
REGULATORY ACTION**

Government Code Section 11349.3

OAL File No. 2010-0820-01 S

SUMMARY OF REGULATORY ACTION

The California Department of Insurance (Department) proposed to adopt section 2194.70 to title 10 of the California Code of Regulations. Proposed section 2194.70 sought to impose a \$5,000 limitation on the liability of an underwritten title company (UTC) to a title insurer when entering into an underwriting agreement.

DECISION

The Department submitted the proposed action on August 20, 2010, to the Office of Administrative Law (OAL) for review. OAL notified the Department that it had disapproved section 2194.70 on October 4, 2010. OAL disapproved section 2194.70 because the Department did not comply with the necessity standard of the California Administrative Procedure Act (APA).

DISCUSSION

The adoption of regulations by the Department must satisfy requirements established by the part of the APA that governs rulemaking by a state agency. Any rule or regulation adopted by a state agency to implement, interpret, or make specific the law enforced or administered by it, or to govern its procedure, is subject to the APA unless a statute expressly exempts the rule or regulation from APA coverage. (Gov. Code, sec. 11346.)

Before any rule or regulation subject to the APA may become effective, the rule or regulation is reviewed by the OAL for compliance with the procedural requirements of the APA and for compliance with the standards for administrative regulations in Government Code section 11349.1. Generally, to satisfy the standards a rule or regulation must be legally valid, supported by an adequate record, and easy to understand. In this review, OAL is limited to the rulemaking record and may not substitute its judgment for that of the rulemaking agency with regard to the substantive content of the regulation. This review is an independent check on the exercise of

rulemaking powers by executive branch agencies intended to improve the quality of rules and regulations that implement, interpret, and make specific statutory law, and to ensure that the public is provided with a meaningful opportunity to comment on rules and regulations before they become effective. (Gov. Code, sec 11349.1.)

Government Code section 11349.1(a)(1) requires that OAL review all regulations for compliance with the “necessity” standard. Government Code section 11349(a) defines the necessity standard:

(a) “Necessity” means the record of the rulemaking proceeding demonstrates by substantial evidence the need for a regulation to effectuate the purpose of the statute, court decision, or other provision of law that the regulation implements, interprets, or makes specific, taking into account the totality of the record. For purpose of this standard, evidence includes, but is not limited to, facts, studies, and expert opinion.

To explain the meaning of substantial evidence in the context of the necessity standard, Title 1, California Code of Regulations, section 10(b) provides:

In order to meet the “necessity” standard of Government Code section 11349.1, the record of the rulemaking proceeding shall include:

- (1) a statement of the specific purpose of each adoption, amendment, or repeal; and
- (2) information explaining why each provision of the adopted regulations is required to carry out the described purpose of the provision. Such information shall include, but is not limited to, facts, studies, or expert opinion. When the explanation is based upon policies, conclusions, speculation, or conjecture, the rulemaking record must include, in addition, supporting facts, studies, expert opinion, or other information. An “expert” within the meaning of this section is a person who possesses special skill or knowledge by reason of study or experience which is relevant to the regulation in question.

In order to provide the public with an opportunity to review and comment upon an agency’s perceived need for a regulation, the APA requires that the agency describe the need for the regulation in the Initial Statement of Reasons (ISOR). (Gov. Code, sec. 11346.2(b).) The ISOR is the primary document in the rulemaking record that demonstrates that the adoption, amendment, or repeal of a regulation satisfies the “necessity” standard. The ISOR must include a statement of the specific purpose for each adoption, amendment, or repeal, and the rationale for the determination by the agency that each regulation is reasonably necessary to carry out the purpose for which it is proposed or, simply restated, “why” a regulation is needed and “why” the particular provisions contained in this regulation were chosen to fill that need. (Gov. Code, sec. 11346.2(b)(1).)

Agencies must submit the ISOR to OAL with the Notice of the Proposed Action and make the ISOR available to the public during the public comment period, along with all the information upon which the proposal is based. (Gov. Code, secs. 11346.2(b) and 11346.5(a)(16) and (b).) In

this way, the public is informed of why the regulation is needed and why the particular provisions contained in the regulation were chosen to fill that need. This information is essential in order to provide the public with a meaningful opportunity to comment knowledgeably.

The ISOR provided with this regulatory action does not adequately establish the necessity for section 2194.70. The first two paragraphs suggest the overall need for section 2194.70 by describing a relationship between a UTC and a title insurer where the two parties “are not equals,” resulting in title insurers being in a superior bargaining position in negotiating underwriting agreements with provisions that “may be economically disadvantageous to the [UTCs].” To remedy these inequities, section 2194.70 would limit:

the liability that may be transferred from the title insurer, that is generally more highly capitalized and able to bear the loss, to the underwritten title company agent that is generally less able to bear the loss. The proposed action also creates an incentive for underwritten title companies to use a duty of care by permitting the transfer of some risk to underwritten title companies. [ISOR, p. 1.]

While these ISOR statements may portray the overall necessity for section 2194.70, they do not adequately demonstrate the necessity for the specific provisions of section 2194.70. There is nothing in the file, such as evidence of actual harm to UTCs or to the public, demonstrating the need for section 2194.70. Moreover, the stated purpose of the proposed action “is to enact a long standing position of the [Department] to limit the liability of [UTCs] to indemnify title insurers to five thousand dollars (\$5,000)” The fact that the Department has a longstanding position or rule similar to section 2194.70 is not evidence of the need for the regulation. If anything, the existence of a problem while such a rule has been in effect might be evidence of the need for a different rule.

Another asserted need for section 2194.70 is the protection of the public by “facilitat[ing] fair dealing, prevent[ing] fraud and promot[ing] fair claims practices for California consumers of title insurance” There is no evidence in the ISOR demonstrating that the current practices between UTCs and title insurers present a threat to the public, let alone to UTCs.

Insurance Code section 12389 is of particular relevance to this regulation. Insurance Code section 12389 is the primary authority that the Department relies on throughout the record for adopting section 2194.70. The express purpose of Insurance Code section 12389 is provided in subdivision (d):

The purpose of this section is to maintain the solvency of the companies subject to this section and to protect the public by preventing fraud and requiring fair dealing. In order to carry out these purposes, the commissioner may make reasonable rules and regulations to govern the conduct of its business of companies subject to this section. [Emphasis added.]

The ISOR statements appear to be overly broad in comparison to these purposes. First, these purposes appear to be applicable only to UTCs (“companies subject to this section”), not to title insurers, and include only (a) maintaining the solvency of UTCs, (b) protecting the public from fraud committed by UTCs, and (c) protecting the public by requiring fair dealing in UTC

transactions. While the ISOR statements purport to provide necessity to implement these three purposes, none of the statements are supported by facts, studies, expert opinion, or other information that appear to further the purposes of Insurance Code section 12389.

1. Compliance with Authority and Consistency Standards Unclear.

Additional ISOR statements, such as, “these proposed regulations are reasonably necessary to carry out the purpose of the Underwritten Title Company statute, namely to promote the regulation of the business of title insurance, to facilitate new market entry, to promote California small businesses, to provide for proper risk bearing amongst the licensed entities ...,” are essentially statements of policies, conclusions, intent, or conjecture and inadequately describe the need for section 2194.70. However, such statements raise legitimate issues expressed by some of the public comments as to whether section 2194.70 fails to meet the APA authority and consistency standards in Government Code section 11349.1(b) and (d).

In this regard, the express purpose of Insurance Code section 12389 could be interpreted to limit the Department’s rulemaking authority over UTCs. Since Government Code section 11349.1(b) and (d) mandates OAL to review each regulatory action for authority and consistency, OAL will need to see the Department’s explanation of the necessity in order to complete its review. For this reason, OAL is withholding judgment on the authority and consistency standards and must reserve its review for these standards until the explanation of the need for section 2194.70 is adequately supplemented and provided upon resubmission.

2. Basis for the \$5,000 Limit Unclear.

The Department has not established any factual basis for setting the liability limit at \$5,000. The ISOR refers to the fact that the Department wants UTCs to retain some level of responsibility for their own acts presumably to retain an incentive not to commit negligence. “This regulation will create an incentive for underwritten title companies to perform their functions carefully and diligently.” This statement is conclusory and fails to demonstrate why or how the \$5,000 liability limit in particular would be an adequate incentive to motivate a UTC against committing negligence, as opposed to other monetary amounts or another incentive such as a percentage of the total claim or as a percentage of the revenue received for the work on the particular property at issue. Nothing in the rulemaking record demonstrates that the \$5,000 liability limit bears a relationship to the risk of UTCs’ exposure or that it works as an economic incentive for the UTCs to perform its functions carefully and diligently.

As stated above, the fact that \$5,000 limit represents a longstanding position or rule by the Department that is similar to section 2194.70 is not evidence of the need for the regulation.

CONCLUSION

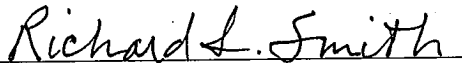
The rulemaking file contains insufficient supporting facts, studies, expert opinion, or other information for the conclusion that section 2194.70 is necessary. Because the rulemaking record lacks a factual showing of the problem that motivates this regulation and an explanation of how

section 2194.70 corrects that problem, the rulemaking file as submitted fails to demonstrate necessity as required by the APA.

It is vital that a sufficient demonstration of necessity be made available to the public in the ISOR during the rulemaking process so that the public is informed of the basis of the proposed action and can comment knowledgably during the public comment period. In that the 45-day comment period has already been completed, the defect can be remedied by making the information required to be contained in the ISOR available to the public for a 15-day written comment period pursuant to sections 11346.8(d) and 11347.1 of the Government Code. Government Code section 11347.1(b) requires that the rulemaking agency mail a notice to persons who commented or requested notification of changes and make documents added to the record available for public inspection and written comment for at least 15 days. In the event any comments that are received by the agency on the documents during the 15-day comment period, Government Code section 11346.8(a) requires that the comments be considered by the Department, included in the rulemaking file, and summarized and responded to in the final statement of reasons.

As explained above, OAL disapproves the regulatory action for failure to comply with the necessity standard of the APA. If you have any questions, please do not hesitate to contact me at (916) 323-6809.

Date: October 11, 2010


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