

DEPARTMENT OF INSURANCE

Consumer Services Division
Market Conduct Bureau, 11th Floor
Ronald Reagan State Office Building
300 South Spring Street
Los Angeles, CA 90013



July 15, 1998

Honorable Chuck Quackenbush
Insurance Commissioner
State of California
300 South Spring Street
Los Angeles, CA 90013

Dear Commissioner Quackenbush:

Persuant to your instructions and in accordance with the Insurance Code of the State of California, a Market Conduct Examination has been made of:

STATE FARM FIRE AND CASUALTY COMPANY AND
STATE FARM GENERAL INSURANCE COMPANY
Bloomingdale, Illinois

The following report of such examination is respectfully submitted.

Very truly yours,

MARKET CONDUCT EXAMINATION REPORT
OF

**STATE FARM FIRE AND
CASUALTY COMPANY
(NAIC # 25143) AND
STATE FARM GENERAL
INSURANCE COMPANY
(NAIC # 25151)
BLOOMINGTON, ILLINOIS**

10/12/2011
10/12/2011
10/12/2011

STATE OF CALIFORNIA



DEPARTMENT OF INSURANCE

CONFIDENTIALITY STATEMENT

The Market Conduct Examination Report contained herein, including any addendum hereto, is CONFIDENTIAL unless and until the Insurance Commissioner, by the authority vested in him or her pursuant to Section 735.5 of the California Insurance Code, determines otherwise.

State of California
County of Los Angeles

I _____ certify under penalty of perjury under the laws of the State of California that I have read the Market Conduct Examination Report, know the contents thereof, and assert that the same are true and correct.

Dated this 15th day of July, 1998 at Los Angeles, California.

Associate Insurance Policy Officer
Market Conduct Bureau

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AUTHORITY

The Market Conduct Examination of State Farm Fire and Casualty Company and State Farm General Insurance Company (hereinafter referred to as "SFF & C" and "SFG" respectively, "the Companies" or SF) was conducted pursuant to the authority granted under Part 2, Chapter 1, Article 4, Sections 730, 733, 736, and Article 6.5, Section 790.04 of the California Insurance Code; and Title 10, Chapter 5, Subchapter 7.5, Section 2695.3(a) of the California Code of Regulations.

DURATION OF EXAMINATION

The on-site examination of the non-litigated claim files was conducted from August 26 through November 25, 1997 at the Companies' regional claims office located at 313 Agoura Road, Westlake Village, California and continued periodically (off-site) through July 10, 1998. The litigated claims examination was primarily conducted at One Francisco Street, San Francisco, Ca. 94133.

REASON FOR EXAMINATION

This examination was conducted to review the Companies' claims handling practices as respects claims presented for losses incurred as a result of the California earthquake of January 17, 1994, a.k.a. The Northridge Earthquake.

PURPOSE OF EXAMINATION

This examination was conducted for the purpose of evaluating the Companies' compliance with contractual obligations, its own procedures, the California Insurance Code, the Unfair Claims Settlement Practices Regulations, Fair Claims Practices Regulations (as applicable), applicable case law, and other applicable legal requirements.

COMPANY PROFILE

SFF & C was organized on June 12, 1935, under the laws of Illinois and was licensed to commence business on June 29 of the same year. This entity is licensed to do business in all states and the District of Columbia. It is also licensed in Canada in the provinces of Alberta, New Brunswick and Ontario. All outstanding stock for each company is owned by the State Farm Mutual Automobile Insurance Company of Bloomington which is the lead member of State Farm Group.

SFG was organized on April 3, 1962 under the laws of Illinois and was licensed to commence business on May 11 of the same year. This entity is licensed in the District of Columbia and all states except Connecticut and Rhode Island.

According to the 1996 edition of Best's Insurance Reports - Property/Casualty, California ranks first as a source of direct premium writings, by state, for both Companies.

<u>YR</u>	<u>Company</u>	<u>All Lines Total Direct Premium</u>	<u>All Lines California Premium</u>	<u>Percentage of Written Premium</u>
1996	SFF&C	\$9,320,266,000	\$1,265,955,000	13.6%
1996	SFG	638,326,000	129,917,000	20.4%

A copy of the "Best" report is attached as Exhibit I-1.

Earthquake Market Share

<u>YR</u>	<u>Company</u>	<u>Total Direct Premium</u>	<u>Total Calif.EQ Premium (All Co.)</u>	<u>Market Share</u>
1996	SFF&C	\$254,547,791	\$950,812,762	26.7716%
1996	SFG	30,643,470	950,812,762	3.2229%

<u>Total</u>	<u>\$285,191,261</u>	<u>\$950,812,762</u>	<u>29.9945%</u>
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Homeowners Market Share

<u>YR</u>	<u>Company</u>	<u>Total Direct Premium</u>	<u>Total Calif. HO Premium (All Co.)</u>	<u>Market Share</u>
1996	SFF&C	\$659,122,596	\$3,090,172,058	21.3296%
1996	SFG	89,075,628	3,090,172,058	2.8825%
<u>Total</u>		<u>\$748,198,224</u>	<u>\$3,090,172,058</u>	<u>24.2121%</u>

NORTHRIDGE CLAIMS PROCEDURES

State Farm advised that in addition to its normal claims handling, it processed approximately 117,000 earthquake claims with payments totaling almost \$3 billion. The examiners requested that SF provide a description of the procedures established and actions taken to address the needs of their policyholders affected by the Northridge earthquake. The Companies submitted the document attached as Exhibit I-2.

SCOPE OF THE EXAMINATION

The examiners reviewed 746 non-litigated files drawn from populations of Northridge earthquake claims which were processed at SF's three claims locations. Representative samples were selected and specific files were reviewed as follows:

STATE FARM FIRE & CASUALTY

<u>Category</u>	<u>Population</u>	<u>Sample</u>
Closed Paid EQ Stand Alone - Westlake Village	31,609	55
Closed Paid EQ Stand Alone - Bakersfield	577	42
Closed Paid EQ Stand Alone - Rhonert Park	36	29
Closed CWP EQ Stand Alone - Westlake Village	7,950	37
Closed CWP EQ Stand Alone - Bakersfield	380	37
Closed CWP EQ Stand Alone - Rohnert Park	10	7
Closed Paid HO/EQ - Westlake Village	22,197	40
Closed Paid HO/EQ - Bakersfield	322	48
Closed Paid HO/EQ - Rohnert Park	25	17
Closed CWP HO/EQ - Westlake Village	25,683	50
Closed CWP HO/EQ - Bakersfield	769	40
Closed CWP HO/EQ - Rohnert Park	11	9
Closed Paid Rental EQ Stand Alone - Westlake Village	3,210	48
Closed Paid Rental EQ Stand Alone - Bakersfield	98	30
Closed Paid Rental EQ Stand Alone - Rohnert Park	14	14
Closed CWP Rental EQ Stand Alone - Westlake Village	2,149	20
Closed CWP Rental EQ Stand Alone - Bakersfield	76	20
Closed CWP Rental EQ Stand Alone - Rohnert Park	8	8
Open-7-31-97 EQ Stand Alone - Westlake Village	320	37
Sub-total	95,444	588

STATE FARM GENERAL

<u>Category</u>	<u>Population</u>	<u>Sample</u>
Closed Paid EQ Stand Alone - Westlake Village	2,158	51

Closed Paid EQ Stand Alone - Bakersfield	19	18
Closed Paid EQ Stand Alone - Rohnert Park	5	3
Closed CWP EQ Stand Alone - Westlake Village	824	53
Closed CWP EQ Stand Alone - Bakersfield	14	10
Closed CWP EQ Stand Alone - Rohnert Park	3	2
Open 7-31-94 EQ Stand Alone - Westlake Village	22	21
Sub-Total	3,045	158
Total	98,489	746

Actual file selection was accomplished through the Market Conduct Bureau's automated random sampling program.

Additionally, 79 claim/litigation files were reviewed by CDI Legal Division staff.

GLOSSARY

ACV:	Actual Cash Value
ALE:	Additional Living Expense
CDI:	California Department of Insurance
CIC:	California Insurance Code
CWP:	Closed Without Payment
Delay:	Claims handling must reflect compliance with standards of timeliness contained in the Unfair Claims Settlement Practices Regulations and/or the Fair Claims Settlement Practices Regulations as applicable. Specified types of processing transactions enumerated in the Regulations (e.g., acknowledgment and payment) are to be handled immediately , but in no event beyond the maximum number of days specified in CIC and/or Regulation.
EQ:	Earthquake
Error:	Any violation or act of non-compliance with the UCP or FCP Regulations or CIC 790.03(h); or violation or act of non-compliance or act prohibited by the CIC.
Examiners:	CDI/Consumer Services Division/ Legal Division personnel
Faulty Documentation:	Absence of billings, drafts, letters, diary notes, date stamps and other essential information substantiating the handling or disposition of the claim; the

inclusion of material not related to the file; the misdirection of correspondence (including form letters) to parties involved in the settlement process; the failure to fully comply with existing CDI regulatory requirements pertaining to documentation.

FCP Regulation(s): Fair Claims Settlement Practices Regulations, CIC Title 10, Chapter 5, Subchapter 7.5, effective 5/10/97

HO: Home Owner (Policy)

Improper Settlement: Any questionable practice employed to deny or limit coverage or settlement; the failure to investigate claims and defend or indemnify the insured; the failure to apply consistent standards and procedures; payment inaccuracies; the failure to comply with all applicable CDI Regulations regarding full disclosure of benefits, coverages, time limits or other policy provisions.

O&P: Overhead and Profit

RC: Replacement Cost

SDA: Structural Damage Appraiser.

TLEA: Temporary Living Expense Allowance

UCP Regulation(s): Unfair Claims Settlement Practices Regulations, of the California Code of Regulations, Title 10, Chapter 5, Subchapter 7.5, effective prior to 5/10/97.

EXECUTIVE SUMMARY
(OVERVIEW OF FINDINGS)

As indicated in the Scope of the Examination section, the **Market Conduct staff** examiners reviewed **746 non-litigation claim files in which 971 claims handling violations of the UCP Regulations and/or CIC** were identified. Errors detected involve deficiencies noted across sample lines. However, the majority of significant errors were primarily discovered in the "Paid and Open EQ Stand Alone" samples. Significant errors indicative of improper claims handling include: inadequate investigations and scoping of damages; low settlement offers; unsupported depreciation reductions; failure to explain settlement reductions; and failure to clearly explain policy benefits to insureds. Additionally, while not cited as specific errors, the examiners noted: the Companies depreciated the cost of labor; failed to include general contractors' overhead and profit in ACV settlements; and were inconsistent when handling salvage, TLEA, food spoilage claims, and overhead and profit.

The findings of this examination indicate that SF's practices affect all first party property losses and are not necessarily exclusive to earthquake claims.

It should also be noted that at the outset of the examination, SF refused to allow the examiners to retain photocopies of file documents. After many discussions and writings, SF agreed to provide copies of specific documents provided a special form was completed by CDI examiners. Further, the Companies were not timely in providing responses to written inquiries or requested photocopies.

Additionally, the CDI Legal Division staff reviewed **79 claim/litigation files in which 418 violations of the UCP Regulations and/or CIC Code** were identified. Significant errors detected were similar to those discovered in the non-litigation review. In addition, the legal division staff identified: 1) unreasonable denial of expert fees; 2) inadequate notice of reductions of coverage; 3) misrepresentation of coverage; 4) improper denial of claims based

on erroneous application of statute of limitations; 5) failure to provide access to books and records (Companies failed to provide certain litigation files). An overview of findings and a complete listing of citations is attached as an Addendum to this report.

While specific citations are identified in both the Specific Findings and Legal Addendum sections of this report, the following is a statistical overview:

<u>Category</u>	<u>No. Of Files</u>	<u>No. Of Files With Citations</u>	<u>No. OF Citations</u>
EQ Paid Stand Alone	290	221	681
EQ Open	58	52	196
EQ CWP	194	23	43
Homeowners Paid	105	22	33
Homeowners CWP	99	14	19
Claim/Litigation Files	79	63	418
Total:	825	395	1,390

The following is an overview of non-litigated file citations:

NON - LITIGATED CLAIM FILES TABLE OF TOTAL CITATIONS			
	CIC or UCP Description	State Farm Fire & Casualty Number of Citations	State Farm General Number of Citations
2695.3(a) & 790.03(h)(5) & 790.03(h)(3)	Unsupported Depreciation Reduction.	165	53
2695.4(a) & 790.03(h)(1) & 790.03(h)(3)	Failure to explain settlement reductions to insured.	165	53
2695.6(a) & 790.03(h)(3) &790.03(h)(5)	Company failed to perform necessary, proper, timely investigation. Inadequate or incorrect initial inspections.	64	37

NON - LITIGATED CLAIM FILES
TABLE OF TOTAL CITATIONS

	CIC or UCP Description	State Farm Fire & Casualty Number of Citations	State Farm General Number of Citations
2695.4(a) & 790.03(h)(1)	Company failed to clearly explain policy benefits such as: the status of Building Ordinance coverage; additional benefits for Temporary Living Expense; etc.	197	79
2695.3(a) & 790.03(h)(3)	General Documentation Error. Claim file did not contain all documents, notes and work papers.	25	7
2695.7(g) &790.03(h)(5)	Low Settlement	47	30
2695.5(b) & 790.03(h)(3)	Agent failed to immediately transmit notice of claim to the insurer.	1	0
2695.5(g) & 790.03(h)(2) &790.03(h)(3)	The Company did not respond to communication within 15 days.	4	3
2695.7(b) & 790.03(h)(4)	Company did not accept or deny within 40 calendar days.	3	0
2695.7(b)(1) &790.03(h)(3)	Factual basis for denial not stated in writing.	2	1
2695.7(b)(3) &790.03(h)(3)	Company did not notify the claimant that the claim may be reviewed by the CDI.	7	1
2695.7(c)(1) &790.03(h)(3)	Company did not notify the claimant additional time was needed to investigate claim	9	0
2695.7(h) & 790.03(h)(5)	Company did not tender payment within 30 days of accepting claim	11	2
2695.3(b)(2) &790.03(h)(3)	Company failed to record date relevant document received	1	0
2695.5(a) & 790.03(h)(2) & 790.03(h)(3)	Company failed to acknowledge notice of claim immediately, but in no case later than 15 calendar days.	1	0
790.03(h)(1)	Misrepresenting pertinent facts or policy provisions.	3	0

Sub-Total:	705	266
Total Non-Litigated Claims Citations: 971		

ITEMIZED SUMMARY CRITICISMS

1. **Inadequate Investigations:** A number of claim files were cited relevant to inadequate investigation and incorrect estimating of the insureds' damages. Files in which damages were grossly underestimated by the Companies' representatives indicate, in many instances, the overlooking of crawl spaces, attics, fireplaces and entire rooms; carpet had not been pulled back by the adjuster. Many files reveal: 1) insureds were required to request additional inspections (especially) when confronted with estimates by contractors (hired by the insured) indicating damages which substantially exceeded the Companies' original settlement offers; 2) as a result of improper investigations, initial settlements were unreasonably low in some instances; 3) in some cases insureds were advised erroneously that damages were less than the deductible; 4) the Companies failed to investigate coverage questions in a timely manner; 5) the Companies failed to investigate ownership of fences prior to settlement (assuming common ownership in all cases). While the examiners recognize the possibility of hidden damage and the effects of after shocks, there is substantial evidence to indicate insufficient investigations and gross oversight on the part of SF. Excerpts of claim files indicative of the deficiencies cited are included as examples in **Exhibit I-3.**

The examiners noted that the majority of settlement disputes arose when initial scoping was performed by a claim representative rather than by a Structural Damage Analyst (SDA). However, there are also many instances of underestimating by SDAs. This calls into question the quality of training and expertise of those individuals responsible for scoping and estimating insured damages.

While a number of claims were eventually settled at a higher amount than the original offer, it was noted that most of these settlements were driven by the insured requesting reinspection. In a number of instances, multiple reinspections were required in order to reach a final settlement. Additionally, the Companies failure to perform adequate investigations resulted in delays in claims settlements. These acts are violations of UCP Regulation 2695.6(a); CIC 790.03(h)(3); 790.03(h)(5).

Remedial Action: To be determined.

2. **Improper/Low Settlements:** Inadequate investigation and/or inspection of damages resulted in unreasonably low settlements in some instances. These acts are violations of UCP Regulation 2695.7(g) and CIC 790.03(h)(5).

Remedial Action: To be determined.

3. **Unsupported Depreciation:** While the policies provide replacement cost coverage, settlements were reduced by unsupported depreciation. The files do not contain justification or any basis for depreciation. This was especially evident in the settlement of structure claims. The Companies' standard estimate of damage form ("Xactimate") specifies depreciation dollar amounts but does not document how these figures were determined, resulting in low and unsupported settlement offers. Additionally, in some instances, the Companies took excessive depreciation on items such as fireplaces (which are known to have long life spans). In numerous instances there is no other reference to depreciation within the file. An example of the "Xactimate" used by the Companies is included as **Exhibit I-4**. These acts are violations of UCP Regulation 2695.3(a); CIC 790.03h(5).

Remedial Action: The Companies have agreed not to depreciate structures (Coverage A) as outlined in their letter of July 8, 1998. See **Exhibit I-9**.

4. **Lack of Explanation of Settlement Reductions:** The Companies failed to explain depreciation reductions to policyholders. These acts are violations of UCP Regulation 2695.4(a); CIC 790.03(1); CIC 790.03(h)(3).

Remedial Action: See item 3 above.

5. **Failure to Explain Policy Benefits:** The Companies failed to definitively disclose policy benefits to policyholders. In some files no advice was given, while in other files, ambivalent language is used. The standard letter states that "Your policy 'may' provide limited coverage for an additional expense because of building code or ordinance requirements . . . etc.". Illustrative of this deficiency is the letter designated as **Exhibit I-5**. Additionally, the examiners also noted a number of files in which letters ostensibly issued to inform policyholders regarding benefits (such as TLEA, glass, etc.) were vague, equivocal and ambiguous. Terminology such as "may provide coverage," "may include payment," and "may be entitled to receive" is included as standard language in the Companies' correspondence. These acts are violations of UCP Regulation 2695.4(a) & CIC 790.03(h)(1).

Remedial Action: The Companies have agreed to review the language of their letters to insureds and make appropriate changes. The goal is to issue written statements to policyholders clearly identifying coverages and benefits available under the policy.

6. **Unreasonable Denial of Expert Fees:** The litigation review revealed the Companies failed to pay insureds' experts' fees (i.e., structural or soils engineers, etc.) unless that expert or his/her report contributed to the Companies' assessment of the damage. If that practice can be accepted at face value, there still exists a problem with some experts' fees which SF refused to pay. In several files, insureds' experts' opinions clearly caused the Companies to further investigate the damage, for example by sending in an SDA or an outside expert of its own. Even so, SF refused to pay for the insureds'

expert fees. These acts are violations of UCP Regulation 2695.7(g) & CIC 790.03(h)(3) & (5).

Remedial Action: To be determined.

7. **Inadequate Notice of Reduction of Coverage / Misrepresentation of Coverage**

The litigation review revealed that a primary issue in the [redacted] (some of the other files) was that SF failed to provide adequate notice to insureds that the change from an EQ endorsement (attached to a Homeowner policy) to a single limit stand-alone policy would (in fact) result in a reduction in coverage. An ancillary issue was the allegation that, during the sale of the policy, the agent had misrepresented the coverage provided in the EQ stand-alone through either incompetence or untrustworthiness. The "Allegro" trial court determined the notice was inadequate, and SF was in the process of appealing that finding when it settled with the plaintiffs. A review of the notices shows the trial court's ruling to have been correct. These acts are violations of CIC 678(a)(1); 790.03(a); 790.03(b); 1668(I), (j), (k); 1738, unproven.

Remedial Action: To be determined.

8. **Statute of Limitations** In several litigation files, damage discovered more than a year after the EQ, was improperly denied by SF on grounds that the "time" to file a suit against the Companies had expired. SF's position was unreasonable absent a determination as to when a reasonable insured would have discovered "appreciable" damage. These acts are violations of CIC 790.03(h)(1); CIC 2071 and common (Prudential-LMI - among other cases) law.

Remedial Action: To be determined.

9. **Failure to Provide Files:** Some litigation files were not provided for review (although the claim files were provided). These acts are violations of CIC 734.

Remedial Action: To be determined.

10. **Failure to Document Files:** The Companies failed to properly document files in some instances. The examiners noted log entry notations were often incomplete or missing from files; estimates were missing; security deposit payments or lack of payment notations were missing. These acts are violations of UCP Regulation 2695.3(a).

Remedial Action: To be determined

11. **Failure to Tender Payment Within 30 days:** In some instances, the Companies failed to tender payment immediately or within 30 days. These acts are violations of UCP Regulation 2695.7(h) and CIC 790.03(h)(5).

Remedial Action: To be determined

12. **Failure to Include General Contractors' Overhead & Profit in ACV Settlements:** While the MC staff did not cite these instances as errors, the Companies failed to include the General Contractors' overhead and profit when ACV settlements were paid. When repairs are of such magnitude and complexity that it could be logically assumed that the insured will need to hire a general contractor, a reasonable estimate of costs (typically 20%) for overhead and profit should be included in the ACV settlement.

Additionally, the Companies were inconsistent in their approach to this issue. In some instances SF required the insured to provide signed contracts and building permits in order to obtain payments; in other cases only a signed contract was required. Insureds were

also advised, in some instances, that repairs must be underway in order to obtain overhead and profit. Exhibit I-6

Remedial Action: Effective April 1, 1998, the Companies modified their procedure with respect to the payment of General Contractors' Overhead and Profit. The Companies' new procedure is outlined in Exhibit I-9 attached.

13. Depreciation of Labor Costs: While not cited as errors, the Companies depreciated labor costs when determining ACV settlements. Labor costs should not be depreciated. This matter is referred to CDI Legal Division for review and opinion.

Remedial Action: The Companies are in disagreement with the examiners and their position is attached as Exhibit I-7.

14. Referral to CDI When Claim Was Denied: In some instances, the Companies failed to advise the insured that the claim could be reviewed by CDI when the claim was denied. These acts are violations of UCP Regulation 2695.7(b)(3).

Remedial Action: To be determined.

15. Salvage Values: While not cited as errors, inconsistent handling of salvage values was noted. SF did not establish guidelines as to how the dollar value of salvage would be determined or documented. Claim representatives negotiated with insureds and the basis for salvage was not always discernible. Insureds were encouraged to retain salvage and the examiners could not determine that salvage reductions were fair and represented proper value Exhibit I-8.

Remedial Action: To be determined.

16. **Status Letters:** In some instances, the Companies failed to advise the insured that additional time was needed to investigate claims. These acts are violations of UCP Regulation 2695.7(c)(1).

Remedial Action: To be determined.

17. **Written Basis for Denial:** In some instances, SF failed to provide a written basis for denial to the insured. These acts are violations of UCP 2695.7(b)(1).

Remedial Action: To be determined.

18. **Accept or Deny Claims:** In some instances, the Companies failed to accept or deny claims within 40 days of receiving proof of claims. These acts are violations of UCP Regulations 2695.7(b) and CIC 790.03(h)(4).

Remedial Action: To be determined.

19. **Inconsistent Handling:** While not cited as errors, inconsistent handling was noted: 1) food spoilage - some adjusters required an itemized list, while others accepted verbal statements. 2) Temporary Living Expense - some adjusters required documentation, others did not.

Remedial Action: To be determined.

RECOMMENDATIONS

1. The Companies must implement comprehensive training guidelines and procedures for all adjusters in order to ensure quality and adequate, timely and proper initial inspection of property damages.
2. The Companies must employ experts with the appropriate level of expertise to address damages in the early stages of the scoping process.
3. The Companies must improve the quality and timeliness of investigation standards.
4. The Companies must review and revise all form letters to ensure that coverage and benefits are clearly explained to policyholders.
5. When the Companies depreciate non structural losses, they must adequately document the basis for depreciation. Therefore, current standards must be reviewed and improvements in depreciation procedures implemented. Additionally, all depreciation must be justified, and if so, discernible, measurable and fair. Further, all adjusters must be thoroughly trained in such standards and quality control procedures must be adopted and implemented.
6. The Companies must investigate and determine ownership of block walls/fences prior to settlement rather than assuming that all fences are common, i.e., only 50% owned by the insured.
7. The Companies must adopt and implement standards to ensure consistent handling of Additional Living Expense, Temporary Living Expense, Salvage, and Food Spoilage claims.
8. While the Companies have agreed to include O & P in ACV settlements "when it is reasonably likely that a covered repair will require the services of a general contractor to coordinate and supervise the repair.....etc.", the CDI recommends that standardized guidelines be established for adjusters in administering this coverage.

9. The Companies must improve documentation procedures to ensure that all necessary and pertinent information is contained in the claim files. This includes, but is not limited to, personal property inventory forms, estimates, log notes, and documentation of telephone discussions.

10. The Companies must implement quality control standards to ensure that status letters are issued to policyholders in a timely manner when additional investigation of claims is necessary.

11. To ensure that all time lines outlined in the FCP regulations are met, the Companies must establish procedures to provide for the on-going monitoring of active files.

12. As indicated in the Itemized Summary, the issue of Depreciation of Labor Costs is referred to CDI Legal Division for review and opinion.

13. Except in cases where replacement cost benefits or policy limits were paid, the Companies must review all first party property claims received over the last 5 years and review settlements and offers of settlements. The Companies must issue payments to insureds in the following instances:

1. Settlement was reduced by unsupported depreciation.
2. Labor Costs were depreciated (subject to opinion from CDI Legal Division)
3. General Contractors' overhead and profit were omitted from ACV settlements.

The Companies must report progress, including an accounting of additional payments, to CDI Market Conduct Bureau at quarterly intervals.

14. Except in cases where replacement cost benefits or policy limits were paid, the Companies must review initial inspections in all first party property loss claims received over the last 5 years to determine whether or not the scope of damages was adequate and

representative of the actual damages. When scopes are determined to be inadequate or questionable, the Companies must contact the insureds and perform fair and adequate investigations. The Companies must report progress, including additional payments (if any), at quarterly intervals to CDI Market Conduct Bureau.

15. The Companies must review this report and provide a plan for remedial action to address each criticism. Further the Companies must comply with all recommendations. A response to this report shall be provided by the Companies within 30 days of receipt.

ADDENDUM TO MARKET CONDUCT EXAMINATION REPORT
State Farm Insurance Company
Northridge Earthquake Litigation/Claim Files

The Legal Division examined 79 earthquake litigation/claim files. Recurrent issues, constituting business practices, were found in the files. Discussion follows, not necessarily in order of prevalence of the issue in files. Each act is violative of the Unfair Practices Act (Ins. Code, § 790.03) and the Fair Claims Settlement Practices Regulations promulgated thereunder (Cal. Code Regs., § 2695.1 et seq.). **418 violations were found in the 79 files examined.**

Scope of Investigation

There was a pattern of failing to thoroughly investigate. Many investigations by SF turned up little covered damage until the insured brought in his or her own contractor to rescope the loss. This violates not only the Unfair Practices Act and Fair Practices regulations, but also basic tenets of bad faith law. It is impossible to say how many insureds may have accepted State Farm's inadequate estimates and resulting low settlement offers without challenging them. Moreover, inadequate early inspections made for inordinate delays in the claims-handling process.

These actions on State Farm's part were violative of statutes and regulations as follows:

- failing to adopt and implement reasonable standards for prompt claim investigation and processing (*CIC § 790.03(h)(3)*);
- failing to affirm or deny coverage within a reasonable time (*CIC § 790.03(h)(4)*);
- not attempting in good faith to promptly, fairly, and equitably settle claims where liability has become reasonably clear (*CIC § 790.03(h)(5)*);
- compelling insureds to institute litigation by offering substantially less than the amounts ultimately recovered through that litigation, when the insureds had claimed similar amounts before litigation (*CIC § 790.03(h)(6)*);
- trying to settle a claim for less than the amount a reasonable person would believe she or he was entitled by reference to advertising material accompanying or made part of the application (*CIC § 790.03(h)(7)*);
- failing, upon notice of claim, to begin any necessary claim investigation (*CCR § 2695.6(a)*);
- failing, upon proof of claim, to accept or deny the claim in whole or in part, immediately but in no event more than 40 calendar days later (*CCR § 2695.7(b)*), but in the event more time is needed, notifying the claimant in writing of that need and the reasons for it, including specific information needed from the claimant (*CCR § 2695.7(c)*);
- trying to settle a claim by making an unreasonably low settlement offer (*CCR § 2695.7(g)*).

Unreasonable Denial of Expert Fees

SF refused to pay insureds' experts' fees (i.e., structural or soils engineers, etc.) unless that expert or his/her report contributed to SF's assessment of the damage. If that policy can be accepted at face value, there still exists a problem with some experts' fees SF refused to pay. For example, in several files, insureds' experts' opinions clearly caused SF to go further in investigating the damage, sending in an SDA (see below) or an outside expert of its own, yet SF refused to pay for insureds' experts.

These actions on State Farm's part were violative of statutes and regulations as follows:

- failing to adopt and implement reasonable standards;
- not attempting in good faith to promptly, fairly, and equitably settle claims.

Inadequate Notice of Reduction of Coverage / Misrepresentation of Coverage

A primary issue in the Allegro litigation files (see explanation below) and in some of the others was that of inadequate notice having been provided to insureds that the change from EQ endorsement to single-limit stand-alone policy would result in a reduction in coverage. An ancillary issue was the allegation that in the sale of the policy, the agent had misrepresented the coverage provided in the EQ stand-alone, through either incompetence or untrustworthiness. The Allegro trial court determined the notice was inadequate, and State Farm was in the process of appealing that finding when it settled with the plaintiffs, presumably without making admissions. A review of the notices shows the trial court's ruling to have been correct.

These actions on State Farm's part were violative of statutes and regulations as follows:

- failing to provide, upon offer of renewal, a statement of any reduction of limits or elimination of coverage (*CIC § 678(a)(1)*);
- misrepresenting the terms, benefits, advantages, etc., of a policy (*CIC § 790.03(a)*);
- making statements known to be untrue, deceptive, or misleading or which through reasonable care should be known to be so regarding the business of insurance (*CIC § 790.03(b)*);
- agent's dishonesty, untrustworthiness, knowing misrepresentation of terms/effects of policy (*CIC §§ 1668(i), (j), (k); 1738*), unproven.

Coverage Letter

Letters sent by State Farm adjusters ostensibly for the purpose of informing the claimant of policy terms and available benefits are vague, equivocal, and ambiguous. For example, the 3-10-94 letter to Irene Allegro stated,

Even though earthquake damage is excluded, your Homeowners Policy *may* provide certain coverage for damage from earthquake. These coverages *may* include payment for damage to building glass, as well as damage caused by the broken building glass, spoilage of food due to loss of refrigeration, damage from explosion, fire, theft and limited temporary living expenses

. . . [Y]ou *may* be entitled to receive a Temporary Living Expense Allowance while your property is being repaired Should the building repairs render the property uninhabitable, please contact us to discuss this provision of your policy (Italics added.)

The HO policy *does* provide these coverages. The letter should have fully informed the insured of what was available under the policy, as the UPA and the regulations require.

These actions on State Farm's part were violative of statutes and regulations as follows:

- misrepresenting to claimants pertinent facts or policy provisions re: coverages at issue (*CIC § 790.03(h)(1)*);
- failing to adopt and implement reasonable standards;
- failing to disclose all benefits, coverage, time limits or other provisions of the policy that may apply to the claim (*CCR § 2695.4(a)*).

Overhead and Profit / Depreciation of Labor

Two problems have arisen with State Farm's Xactimate calculations:

Overhead and profit: Where the Xactimate program includes compensation for the general contractor in the form of overhead and profit, that amount appears to have been deducted before the replacement cost is calculated, then depreciation is subtracted to produce actual cash value which is to be tendered to the insured right away as the amount of the claim which has been determined and is not in dispute. Overhead and profit are not tendered, in whole or in part, until the later stages of the claim, after a general contractor has been formally retained. It should be included from the start as part of the replacement cost, not deducted (or completely omitted from the RC calculations) before the ACV is derived.

These actions on State Farm's part were violative of statutes and regulations as follows:

- misrepresenting to claimants pertinent facts or policy provisions re: coverages at issue;
- failing to adopt and implement reasonable standards for prompt claim investigation and processing;

- not attempting in good faith to promptly, fairly, and equitably settle claims where liability has become reasonably clear;
- compelling insureds to institute litigation by offering substantially less than the amounts ultimately recovered through that litigation, when the insureds had claimed similar amounts before litigation;
- trying to settle a claim for less than the amount a reasonable person would believe she or he was entitled by reference to advertising material accompanying or made part of the application;
- failing to disclose all benefits, coverage, time limits or other provisions of the policy that may apply to the claim;
- trying to settle a claim by making an unreasonably low settlement offer (*CCR § 2695.7(g)*).

Depreciation: Nowhere in the claim files is it explained how any depreciation amounts are calculated, nor do the files reflect that the basis for depreciation is ever explained to the insured. Moreover, labor of subcontractors is depreciated; labor is not a depreciable item.

These actions on State Farm's part were violative of statutes and regulations as follows:

- misrepresenting to claimants pertinent facts or policy provisions re: coverages at issue;
- failing to adopt and implement reasonable standards for prompt claim investigation and processing;
- not attempting in good faith to promptly, fairly, and equitably settle claims where liability has become reasonably clear;
- the insurer's claim files, which are subject to examination by the Commissioner, must contain all information that reasonably pertains to the claim, in enough detail to allow the examiner to reconstruct events and determine the insurer's actions (*CCR § 2695.3(a)*);
- failing to disclose all benefits, coverage, time limits or other provisions of the policy that may apply to the claim;
- compelling insureds to institute litigation by offering substantially less than the amounts ultimately recovered through that litigation, when the insureds had claimed similar amounts before litigation;
- trying to settle a claim for less than the amount a reasonable person would believe she or he was entitled by reference to advertising material accompanying or made part of the application;
- trying to settle a claim by making an unreasonably low settlement offer.

Untimely Response

Many of the questions referred to State Farm were not timely answered.

These actions on State Farm's part were violative of statutes and regulations as follows:

- failing to promptly acknowledge and act upon communications regarding claims (*CIC § 790.03(h)(2)*);
- failing to timely respond to an inquiry from CDI regarding a claim (*CCR § 2695.5(a)* [of present regs]).

Statute of Limitations

In several files, after-discovered damage (i.e., damage discovered more than a year after the EQ) was denied by SF on grounds that the post-loss suit limitations period had run. This is unreasonable absent a determination as to when a reasonable insured would have discovered "appreciable" damage.

These actions on State Farm's part were violative of statutes and regulations as follows:

- misrepresenting to claimants pertinent facts or policy provisions re: coverages at issue and failing to disclose all benefits, coverage, time limits or other provisions of the policy that may apply to the claim, in view of statutory (*CIC § 2071*) and common (*Prudential-LMI (among other cases)*) law.

No Referral to CDI

In many files, there was a failure to refer to CDI in the closing letter(s).

These actions on State Farm's part were violative of statutes and regulations as follows:

- failing to adopt and implement reasonable standards for prompt claim investigation and processing;
- failing to notify the claimant that a claim believed to have been wrongfully denied may be reviewed by CDI (*CCR § 2695.7(b)(3)*).

Missing Files

Some litigation files were missing although the claim files were provided. State Farm's failure to provide the files was violative of statutes and regulations as follows:

- failure to provide the Commissioner with timely, convenient, and free access to all books, records, etc. (*CIC § 734*).

Activity Gaps

In some files, there were large gaps in file activity, violative of statutes and regulations as follows:

- failing to promptly acknowledge and act upon communications regarding claims;
- failing to adopt and implement reasonable standards for claims-handling;
- failing to affirm or deny coverage within a reasonable time;
- failing to timely reply to communications from a claimant (CCR § 2695.5(g));
- failing, upon proof of claim, to accept or deny the claim in whole or in part, immediately but in no event more than 40 calendar days later, but in the event more time is needed, notifying the claimant in writing of that need and the reasons for it, including specific information needed from the claimant.

Date of Notice of Claim

The date "notice of claim" (defined in CCR § 2695.2(o)¹) was received by State Farm is not noted in most of the files. The date the file was opened is noted in the company's computer records.

This is violative of statutes and regulations as follows:

- failing to adopt and implement reasonable standards for claims-handling;
- failing to adequately document claim files so that pertinent claim events can be reconstructed.

ALLEGRO FILES

(in particular)

The case of *Allegro v. State Farm* involved approximately 160 individual State Farm EQ claimants, 35 of whose files were reviewed by the Legal Division.

Suit was filed 4-17-95 (served 5-1-95) alleging bad faith in claims handling, breach of K, professional negligence, fraud, reformation, unfair competition under Business & Professions Code § 17200 (seeking injunction, restitution):

¹ Citations to FCSP regulations are to those in effect prior to April 10, 1997, because the bulk of the claims handling for the examined files occurred before April 10, 1997. The same regulations are still in existence although they may have been renumbered in the amendment process.

Phase One involved State Farm's position that there should be no private cause of action under § 17200 for claims-handling issues since Moradi-Shalal. Trial Court and Court of Appeals ruled for plaintiffs. California Supreme Court denied review.

Phase Two resulted in the Trial Court's denial of SF's Motion for Summary Judgment on grounds that SF's change from EQ endorsement to single-limit policy constituted a reduction in coverage requiring express notice to insureds (CIC § 678) which SF failed to provide.

The case settled confidentially for \$100 million. SF would not provide the examiners with any details.

Category/Family: Litigated Claims

Claim No. = EQ claim only (not HO)

The following is an overview of litigated file citations:

LITIGATED CLAIM FILES TABLE OF TOTAL CITATIONS		
CIC or UCP §§	CIC or UCP Description	State Farm Number of Citations
2695.3(a) 790.03(h)(3),(5)	Unsupported depreciation reduction.	49
2695.4(a) 2695.7(b)(1) 790.03(h)(1), (3),(5)	Failure to inform claimant of basis for depreciation.	49
2695.6(a) 790.03(h)(3)	Failure to timely begin investigation.	3
2695.6(a) 790.03(h)(3),(5)	Failure to perform necessary investigation.	46
2695.4(a) 790.03(h)(1),(3)	Equivocal letters re: policy terms, benefits.	60
2695.3(a) 790.03(h)(3)	Inadequate file documentation.	11
2695.7(g) 790.03(h)(3),(5) (6),(7)	Unreasonably low settlement offer(s).	46
2695.7(g) 790.03(h)(3),(5)	Unreasonable denial of insured's experts' fees.	8
2695.5(g) 790.03(h)(2),(3)	Failure to respond timely to communication from insured.	1
2695.5(a) (new) 790.03(h)(2),(3)	Failure to respond timely to CDI inquiry.	11
2695.7(b) 790.03(h)(3),(4)	Unreasonable delays.	49
2695.7(b)(1) 790.03(h)(13)	Factual basis for denial not stated in writing.	1
2695.7(b)(3) 790.03(h)(3)	Failure to notify claimant that claim may be reviewed by CDI.	2
2695.7(c)(1) 790.03(h)(3)	Failure to notify claimant additional time needed to investigate claim	1

LITIGATED CLAIM FILES TABLE OF TOTAL CITATIONS		
CIC or UCP §§	CIC or UCP Description	State Farm Number of Citations
2695.7(h) 790.03(h)(3),(5)	Failure to timely tender payment.	1
678(a)(1)	Inadequate notice of reduction in coverage upon change from EQ endorsement to stand-alone policy	17
2695.4(a) 790.03(h)(1), (3),(5),(15) 2071	Unreasonable denial of claim on basis of suit limitations clause.	3
2695.4(a) 2695.7(g) 790.03(h)(1), (3),(6),(7)	Failure to include Overhead + Profit in ACV calculations	53
2695.3(a) 790.03(h)(3),(5)	Unsupported determination of % of liability in claim with Calif.FAIR Plan policy.	1
2695.4(a) 2695.7(b)(1) 790.03(h)(1),(3)	Failure to inform claimant of basis for % liability in claim with Calif.FAIR Plan policy.	1
2695.4(c) 790.03(h)(1),(5)	Unreasonable denial based on failure to exhibit property.	1
2695.4(a) 790.03(h)(1)	Unreasonable denial of TLEA coverage in HO claim as being subject to deductible.	1
1668, 1738 790.03(a)	Agent failure to place coverage requested by insured.	1
2695.5(a) 790.03(h)(2),(3)	Failure to timely acknowledge notice of claim.	2
Sub-Total:		418
Total Litigated Claims Citations:		418

LIST OF EXHIBITS

- I-1 Copy of the 1996 Best's Insurance Report on the Company.
- I-2 Companies' description of procedures established and actions taken regarding the Northridge earthquake.
- I-3 Excerpts from claim files illustrating inadequate investigations and low settlements.
- I-4 Copy of "Xactimate" estimate of damage form.
- I-5 Company form letter illustrating ambivalent language regarding policy benefits.
- I-6 Examiner's referral and Company's reply regarding administration of O&P.
- I-7 Companies' position regarding depreciation of labor costs.
- I-8 Examiner's referral and Company's reply regarding the administration of salvage.
- I-9 Companies' letter of July 8, 1998 regarding Overhead and Profit, and Depreciation.