

California Department of Insurance Prohibited from Enforcing Cease and Desist Order Against Auto Dealers RRG

On March 7, 2008, a hearing was held in the most important litigation regarding risk retention groups to occur in several years. Following the refusal by the California Department of Insurance to register Auto Dealers Risk Retention Group, Inc. and the issuance of a Cease and Desist Order against the RRG, the RRG has brought suit against the Commissioner of Insurance of the State of California to block enforcement of the Cease and Desist Order and to obtain an order requiring the California DOI to accept its registration. Muldoon Murphy & Aguggia LLP serves as corporate and regulatory counsel for Auto Dealers RRG.

Following oral argument, Judge Frank C. Damrell, Jr. granted a preliminary injunction blocking enforcement of the Cease and Desist Order. The Court based its decision on the finding that there are serious questions regarding California's authority to bring a cease and desist order against a licensed risk retention group and not on whether Auto Dealers RRG satisfies the requirements of the Liability Risk Retention Act (LRRRA). It is hoped that this victory by the RRG will provide much needed relief from overzealous non-domiciliary regulators.

About Auto Dealers Risk Retention Group

Auto Dealers RRG (originally named AD-COMP MED Risk Retention Group, Inc.) is a Montana-domiciled risk retention group formed under the Liability Risk Retention Act (LRRRA) to provide contractual liability stop-loss insurance to automobile dealers who maintain self-funded health plans. The RRG was formed in 2007 by a group of California auto dealers who participate in a workers' compensation self-insurance group called Auto Dealers Compensation of California (known as AD-COMP). The insurance provided by Auto Dealers RRG covers the potential contractual liability faced by automobile dealers that maintain self-funded employee benefit plans. Under a self-insured arrangement, an employer establishes a set of benefits that are reflected in a plan document. Each plan has the obligation to provide the benefits to the employees, while the sponsoring employer maintains the obligation to fund the plan. The RRG has nothing to do with the operation or management of the employer's health plan or its provision of benefits to the employees. The RRG only provides liability insurance to the employer for its potential contractual liabilities to the plan.

California Issues a Cease and Desist Order

Auto Dealers RRG received its certificate of authority from Montana at the end of April 2007 and a few days later filed a notice of registration with the California Department of Insurance. In late September, the Department of Insurance notified the RRG that it intended to deny its registration because of its determination that the coverage provided by the RRG is not liability insurance within the scope of the LRRRA. The formal denial was issued on October 18, 2007. Counsel for the RRG provided a detailed rebuttal to California's arguments and even met with senior members of the California DOI, including senior advisors to the Commissioner, to discuss the registration of Auto Dealers RRG. Nevertheless, the California DOI was unmoved. On December 5, 2007, the California DOI issued a Cease and Desist Order against Auto Dealers RRG. The Cease and Desist Order required the RRG to immediately cease and desist the transaction of insurance in the State of California and, within 10 days of receiving the order, to notify all of its policyholders in California that any policy of stop-loss coverage issued by the RRG is null and void and immediately cancelled.

Auto Dealers RRG Goes to Federal Court and Obtains a TRO

Although Auto Dealers RRG could request an administrative hearing to challenge the Cease and Desist Order, because the Cease and Desist Order required the RRG to cancel all of its outstanding policies within 10 days – action that would be highly detrimental to the policyholders, who would likely be unable to find replacement coverage – the RRG needed immediate relief. Accordingly, on December 10, 2007, Auto Dealers RRG filed a complaint in Federal court seeking a preliminary and permanent injunction against the California DOI. The first step was to request a temporary

restraining order (TRO) that would prohibit the California DOI from enforcing the Cease and Desist Order. On December 14, 2007, after concluding that the balance of hardships tipped in the favor of the RRG as to the need for the RRG's policies not being immediately canceled, the Court issued a TRO that enjoined California from enforcing the portion of its Cease and Desist Order that required the RRG to cancel its outstanding policies. The portion of the order that prohibits the RRG from conducting an insurance business in California remained in effect.

The RRG Seeks a Preliminary Injunction

In connection with issuing the TRO, the Court set a hearing on the request for a preliminary injunction. If granted, the preliminary injunction would provide Auto Dealers RRG relief from the Cease and Desist Order until a final decision is reached in the case. Although the motion for preliminary injunction would not resolve the case, the Court's decision on the motion is of crucial importance for the RRG, as it would indicate whether the Court is likely to issue a permanent injunction against California.

The motion for a preliminary injunction presented two issues of major importance for the industry. First, there is the question of whether California has the authority to refuse the registration of a risk retention group. Auto Dealers RRG argued that it would frustrate the purpose of the LRRRA if California could reexamine Montana's decision to license the RRG. As the RRG explained, the LRRRA exempts risk retention groups from regulation by non-domiciliary states except in certain specified matters, the list of which does not include compliance with the requirements of the LRRRA. Furthermore, under the LRRRA, if a state wants to act against a risk retention group, it must seek an injunction from a court of competent jurisdiction. California offered no legal support for its right to deny the RRG's registration, but instead relied on the argument that domiciliary states will run wild if non-domiciliary states cannot keep them in check.

The second question before the Court was whether Auto Dealers RRG is a valid risk retention group. California argued that the coverage provided by the RRG is not liability insurance within the scope of the LRRRA for the following reasons: (1) the definition of liability under the LRRRA encompasses only liability arising out of tort and does not include contractual liability; (2) the insurance coverage provided by the RRG does not insure the employer against a loss incurred by a third person; (3) the insurance coverage does not arise out of the insured's business; and (4) the coverage provided by the RRG falls within the exclusion in the statute for an "employer's liability with respect to its employees." In addition, California argued that the RRG is not a proper risk retention group because it does not satisfy the requirement that its members be "engaged in businesses or activities similar or related with respect to the liability to which such members are exposed by virtue of any related, similar, or common business..." Finally, California attempted to cast doubt on the licensing process in Montana and compliance with the California registration process, but those arguments appeared desperate and are not likely to be the basis on which the case is ultimately decided.

In response to California, the RRG argued that the LRRRA is broadly written and that the intent of the statute is to encompass all types of liability insurance. The statute does not by its terms exclude contractual liability coverage and there are numerous risk retention groups that provide this coverage, such as those that insure obligors under vehicle service contracts, including several that are registered in California. In response to California's claim that the coverage provided by the RRG is first party coverage, the RRG explained that, under ERISA, the health plan is recognized as a separate entity with the ability to sue and be sued and, therefore, constitutes a third party. As to whether the policyholder's liability arose out of its business, the RRG explained that the health plan is offered as a part of the compensation and benefits package offered to employees and, therefore, arises out of the business of the policyholder. Finally, with respect to the whether the members of the RRG are exposed to similar liability as a result of being engaged in a similar business, the RRG responded by showing that commercial stop-loss carriers underwrite on the basis of industry classification and maintain lists of ineligible industries, which typically include auto dealers. This practice shows that the extent and nature of the carrier's liability is related to the industry in which the employer is engaged.

The Court's Decision

Following the hearing on the motion for a preliminary injunction on March 7, the Court granted the RRG's motion and issued a preliminary injunction against the California Department of Insurance. The injunction prohibits California from enforcing the Cease and Desist Order and from issuing any other order concerning the subject matter of the Cease and Desist Order. The injunction also relieves Auto Dealers RRG from the obligation to appeal, challenge or otherwise comply with the Cease and Desist Order and precludes the initiation of any other proceeding concerning the Cease and Desist Order until this case is heard on the merits.

In reaching its decision, the Court found that the balance of hardships tips sharply in favor of the RRG. Auto Dealers RRG presented evidence that the enforcement of the Cease and Desist Order would irreparably harm its members, its financial viability, its goodwill and reputation and its future as a business. On the other hand, California offered no evidence that the State of California or the public would suffer if the injunction is issued. With respect to the merits of the case, the Court found that, in light of the evidence regarding the licensing application process and approval by Montana and the broad purpose of the LRRRA to decrease regulation of risk retention groups by non-charting states, there are serious questions regarding the California DOI's authority to issue the Cease and Desist Order.

The Court did not make any findings regarding whether Auto Dealers RRG is a valid risk retention group under the LRRRA or whether Montana's determinations with respect to this matter are entitled to any deference. This does not mean that the Court will reach these issues at a future stage in the litigation. It is possible that the Court will issue a permanent injunction on the grounds that California lacked authority under the LRRRA to issue a cease and desist order against a validly licensed risk retention group and never reach the question of whether Auto Dealers RRG is a valid risk retention group under the LRRRA.

What Happens Next

The Court's decision is immediately appealable to the Circuit Court of Appeals. Accordingly, the California Department of Insurance faces the strategic decision of whether to continue towards a final decision in the District Court, to take the case up to the Circuit Court, or to initiate its own lawsuit challenging the status of Auto Dealers RRG as a valid risk retention group.

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