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LEGAL DIVISION  
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6 Attorneys for The California Department of Insurance

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8 **BEFORE THE INSURANCE COMMISSIONER**  
9 **OF THE STATE OF CALIFORNIA**

10  
11 In the Matter of the Rates, Rating Plans, or  
Rating Systems of

12 Farmers Insurance Exchange; Fire  
13 Insurance Exchange; Mid-Century  
Insurance Company,

14 Respondents.  
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File No. NC03029253

FIRST AMENDED NOTICE OF  
NONCOMPLIANCE PURSUANT TO  
CALIFORNIA INSURANCE CODE  
SECTION 1858.1

16  
17 YOU ARE HEREBY NOTIFIED that the Insurance Commissioner of the State of  
18 California (hereafter "Commissioner") has good cause to believe that the rating plans, rating  
19 systems and rates of Respondents, FARMERS INSURANCE EXCHANGE, FIRE  
20 INSURANCE EXCHANGE AND MID-CENTURY INSURANCE COMPANY (hereafter  
21 "Respondents") have violated California Insurance Code (hereafter "CIC") sections 1857,  
22 1861.01 and 1861.05, and Title 10, California Code of Regulations (hereafter "CCR")  
23 sections 2360.2, 2360.3, 2360.4 and 2360.6. The manner and extent of the noncompliance is  
24 set forth below.  
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I.

GENERAL ALLEGATIONS / APPLICABLE LAW

- 1.1 Respondents are, and were at all relevant times, an insurer group licensed to transact the business of insurance in the State of California.
- 1.2 Respondents transact the business of insurance in California on risks or lines subject to the provisions of CIC sections 1857, 1861.01 and 1861.05, and also subject to the provisions of CCR, sections 2360.2, 2360.3, 2360.4, and 2360.6.

**THE PROPERTY EXPERIENCE RATING PLAN**

- 1.3 On or after April 16, 2002, Respondents began implementing a new rating scheme, known as the Property Experience Rating Plan (hereafter "PERP"). PERP represents a change in Respondents' rating and underwriting procedures.
- 1.4 PERP is a rating plan affecting Homeowners policies in California. According to Respondents' rating rules, PERP provides that a discount or surcharge will be applied to an insured's Homeowners policy premium based upon each insured's claims experience for the last three years. (See Exhibit 1, attached.)
- 1.5 If an insured has not had a "chargeable loss" in the last three years, PERP provides that the insured is entitled to a discount. The discount may be stated in terms of the following formula:  $(\text{base rate} \times .67 = \text{discounted rate})$ .
- 1.6 If an insured has had one chargeable loss in the past three years, PERP will neither reduce nor increase the insured's base rate. Stated as a formula, an insured with one qualifying claim in the last three years will have his or her premium affected as follows:  $(\text{base rate} \times 1 = \text{base rate})$ .
- 1.7 If an insured has had two chargeable losses in the past three years, PERP will surcharge the insured's premium. Stated as a formula, an insured with two chargeable losses in the past three years will have his or her premium surcharged as follows:  $(\text{base rate} \times 1.15 = \text{surcharged rate})$ . Similarly, if an insured has had three chargeable losses in the past three years, PERP will surcharge the premium as follows:  $(\text{base rate} \times 2.00$

1 = surcharged rate). An insured with four chargeable losses in the past three years will  
2 be surcharged as follows: (base rate x 2.5 = surcharged rate).

3 1.8 Respondents non-renew those insureds with five or more chargeable losses in the last  
4 three years.

5 1.9 In order for a claim to be considered a “chargeable loss” for purposes of PERP, the  
6 claim must have resulted in at least one dollar of payment; or alternatively,  
7 Respondents must have set money aside in reserve to pay for the claim. One of  
8 Respondents’ memoranda concerning PERP states that: “any chargeable loss with a  
9 zero paid amount and no reserve set won’t be used for rating...”

10 1.10 The rating rules of PERP also provide that if a claim constituting a chargeable loss is  
11 withdrawn, denied or ultimately falls under the policy deductible amount, “any  
12 existing pending reserve will be eliminated and the loss will not be subject to  
13 surcharge.”

14 1.11 Respondents’ rating rules dictate that claims for damage arising from fire catastrophe,  
15 wind, hail, lightning or earthquake will never be considered “chargeable losses” for  
16 purposes of PERP surcharges.

17 1.12 According to Respondents’ rating rules, in calculating an insured’s premium,  
18 Respondents will cease to surcharge and/or consider a particular chargeable loss, as of  
19 the renewal date following the three-year anniversary of the date of the chargeable  
20 loss.

21 1.13 The Department of Insurance (hereafter “Department”) has received numerous  
22 complaints and continues to receive complaints regarding the manner in which  
23 Respondents apply PERP in practice.

24 **PUBLIC PROTECTION CLASS UPDATES**

25 1.14 On or after October 1, 2001 for new business and June 16, 2002 for renewal business,  
26 Respondents made changes to their rating methodology for rating homeowners  
27 insurance fire risks.

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- 1 1.15 Respondents assign each residential homeowners property address with a class code  
2 multiplier that affects the homeowners premium charged for a particular residence.
- 3 1.16 The class codes are derived from Public Protection Class data that the Insurance  
4 Services Office makes available to the insurance industry. The purpose of the Public  
5 Protection Class codes (hereafter “PPC”) is to quantify the strength of the local fire  
6 department’s fire suppression capabilities, as those capabilities relate to a particular  
7 residential address.
- 8 1.17 Respondents’ ultimate choice of PPC code assignment for a particular residential  
9 address largely depends upon the property’s proximity to a fire hydrant.
- 10 1.18 The PPC codes range from a “smallest risk of fire” rating of 1 to a “greatest risk of  
11 fire” rating of 10.
- 12 1.19 On or after October 1, 2001 for new business and June 16, 2002 for renewal business,  
13 Respondents initiated a new, web-based Geographic Underwriting System (hereafter  
14 “GUS”). The GUS is an automated database, designed to help Respondents assign  
15 more accurate PPC codes for assessing the fire risk of particular addresses within the  
16 State of California.
- 17 1.20 Respondents have informed the Department that the GUS program can identify the  
18 general distance between a fire hydrant and a particular residence for most residential  
19 properties in the State of California.
- 20 1.21 Respondents acknowledge, however, that for 20 to 25 percent of the residential  
21 properties in urban areas, the GUS program will fail to identify whether the property is  
22 within 1,000 feet of a fire hydrant. Respondents note, further, that the use of its GUS  
23 program will result in an even higher percentage of failure for those policyholders  
24 located in rural areas.
- 25 1.22 The GUS program’s failure to identify the proximity of a particular residential address  
26 to a fire hydrant is an event Respondents characterize as a “split class” event.
- 27 1.23 Respondents apply a counteractive procedure to protect Respondents loss reserves  
28 against this “split class” defect in the GUS program. Specifically, Respondents send

1 an automated “agent referral” system warning message to the agent assigned to the  
2 particular homeowners policyholder whenever a “split class” event appears on an  
3 upcoming renewal.

4 1.24 Approximately 90 days prior to the renewal date for the “split class” policyholder,  
5 Respondents’ agents are given 15 days to follow up with Respondents’ “split class”  
6 policyholder, and determine the distance between the home and the nearest fire  
7 hydrant for that residence.

8 1.25 In the event that Respondents’ agent does not make this determination within the  
9 allotted 15 days, Respondents automatically assign a PPC code of 9, in calculating the  
10 “split class” policyholder’s premium at renewal.

11 1.26 An assigned PPC code of 9 to a particular property means that Respondents believe  
12 the property presents a very high risk of fire danger. The assignment of a PPC code of  
13 9, therefore, will typically result in a significant increase in the renewal premium for  
14 those policyholders that are located in “split class” regions.

15 1.27 Respondents acknowledge that these “split class” policyholders may be entitled to a  
16 lower PPC code than the PPC of 9.

17 1.28 With respect to approximately 1,945 “split class” policyholders, Respondents have  
18 also acknowledged that the policyholders’ fire hydrant information was available  
19 through Respondents’ old rating system, but was never transferred to the GUS for  
20 appropriate rating.

21 1.29 The Department has received numerous consumer complaints and continues to receive  
22 complaints regarding the manner in which Respondents apply this rating methodology  
23 in practice.

24 1.30 Respondents advised the Department in December of 2002, that Respondents would  
25 investigate the “split class” error for its remaining homeowners policies; however, the  
26 Department continues to receive complaints related to this PPC coding methodology.

27 1.31 CIC section 1857 requires every insurer to maintain records reasonably adapted to the  
28 insurer’s method of operation and experience, including, but not limited to any

1 information used by the insurer in connection with the insurer's rates and underwriting  
2 rules. CIC section 1857 also requires that insurers maintain records used in  
3 connection with the rating plans used by the insurer.

4 1.32 CIC section 1861.05, subdivision (a) provides that no rate can remain in effect if it is  
5 excessive, inadequate, unfairly discriminatory or otherwise in violation of Division 1,  
6 Part 2, Chapter 9 of the Insurance Code. CIC section 1861.05, subdivision (b) requires  
7 that every rate change must be filed with the Commissioner via a complete rate change  
8 application. Pursuant to CIC section 1861.01, subdivision (c), an insurer cannot  
9 implement a rate change until after the Commissioner has approved of the insurer's  
10 proposed change.

11 1.33 CCR section 2360.2 requires insurers to maintain eligibility guidelines for all lines of  
12 insurance in sufficient detail so that the appropriate rating plan can be determined for  
13 each insured. That section also provides that any insured that meets the guidelines  
14 must qualify to buy the insurance.

15 1.34 CCR section 2360.3 specifically provides: "An insurer shall charge each insured the  
16 lowest Premium for which the insured qualifies. At each policy renewal the insurer  
17 shall adjust the Premium charged to the insured, as necessary, to reflect the lowest  
18 Premium for which the insured qualifies at that time."

19 1.35 CCR section 2360.4 provides that it is the insurer's responsibility to determine and  
20 charge the lowest Premium for which an insured qualifies. If an insurer delegates this  
21 responsibility to an agent, the insurer remains responsible for its agent's determination.

22 1.36 CCR section 2360.6 states that an insurer must keep documentation in the  
23 underwriting files of each policy issued that identifies all information considered by  
24 the insurer in determining the premium charged.

25 1.37 Based upon the Department's review of Respondents' rating and underwriting  
26 practices and applicable law, the Department has good cause to believe that  
27 Respondents' practices are in violation of various provisions of the CIC and CCR.  
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**II.**  
**SPECIFIC ALLEGATIONS**

**2.1**

**RESPONDENTS' UNDERWRITING GUIDELINES VIOLATE CCR SECTION 2360.2 BECAUSE THEY LACK SUFFICIENT DETAIL TO ENSURE THAT QUALIFYING POLICYHOLDERS CONSISTENTLY RECEIVE AN APPROPRIATE PERP RATE.**

- 2.1.1 The Department incorporates, by reference, paragraphs 1.3 through 1.13, above.
- 2.1.2 CCR section 2360.2 requires that eligibility guidelines be sufficiently detailed to determine the appropriate rating plan for each insured. CCR section 2360.0 defines eligibility guidelines as “specific, objective factors, or categories of specific, objective factors, which are selected and/or defined by an insurer, and which have a substantial relationship to an insured’s loss exposure.”
- 2.1.3 The Department is informed and believes that Respondents’ PERP rating rules expressly provide that losses withdrawn, denied or that ultimately fall under a policy’s deductible, shall not adversely impact a policyholder’s eligibility for a PERP discount.
- 2.1.4 The Department is informed and believes that Respondents commonly surcharge policyholders for damage claims arising from fire catastrophe, wind, hail, lightning or earthquake, despite Respondents’ PERP rating rules, which prohibit such surcharges.
- 2.1.5 The Department is informed and believes that Respondents commonly surcharge policyholders for claims losses, despite the fact that those losses are ultimately withdrawn, denied or fall within a policy’s deductible.
- 2.1.6 Because Respondents commonly surcharge policyholders for losses in contravention of Respondents PERP rating rules, and because Respondents eligibility guidelines do not contain sufficient detail to prevent this common occurrence, Respondents guidelines are of insufficient detail to determine the appropriate rating plan for each insured, and Respondents are in violation of CCR section 2360.2.
- 2.1.7 Respondents routine erroneous application of PERP surcharges to policyholders, in contravention of Respondents’ rating rules is also an unfairly discriminatory practice, in violation of CIC section 1861.05, subdivision (a).

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**2.2**

**RESPONDENTS ROUTINELY SURCHARGE AND NEGLECT TO RERATE  
PREMIUM FOR POLICYHOLDERS WITH CLAIMS THAT ULTIMATELY  
RESULT IN NO PAYMENT, IN VIOLATION OF CCR SECTIONS 2360.3, 2360.4  
AND CIC SECTION 1861.05.**

2.2.1 The Department incorporates, by reference, paragraphs 1.3 through 1.13, above.

2.2.2 CCR section 2360.3 and 2360.4 provide that it is Respondents' duty to ensure that each policyholder is charged the lowest premium for which the insured qualifies.

2.2.3 CIC section 1861.05, subdivision (a) prohibits rates or rating plans that are applied in an unfairly discriminatory manner.

2.2.4 The Department is informed and believes that Respondents' PERP rating rules expressly provide that losses withdrawn, denied or that ultimately fall under a policy's deductible, will not adversely impact a policyholder's eligibility for a PERP discount.

2.2.5 The Department is informed and believes that Respondents commonly surcharge policyholders for claims losses, despite the fact that those losses ultimately result in no payment because they are withdrawn, denied or fall within a policy's deductible.

2.2.6 Additionally, the Department is informed and believes that Respondents have attempted to apply a PERP surcharge to some policyholders, despite the fact that the policyholders have never filed a claim of any sort within the last three years.

2.2.7 Respondents' failure to determine the lowest premium for which each of its policyholders qualifies is a violation of CCR sections 2360.3 and 2360.4.

2.2.8 Respondents' routine erroneous application of PERP surcharges to policyholders with no claims history is also an unfairly discriminatory practice, in violation of CIC section 1861.05, subdivision (a).

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**2.3**

**RESPONDENTS LACK DISCERNIBLE GUIDELINES TO DEAL WITH COMMON  
SITUATIONS WHERE A CLAIM SHOULD RESULT IN NO PAYMENT, DUE TO  
SUBROGATION, IN VIOLATION OF CCR SECTION 2360.2.**

2.3.1 The Department incorporates, by reference, paragraphs 1.3 through 1.12, above.



- 1 2.3.2 CCR section 2360.2 requires that eligibility guidelines be sufficiently detailed to  
2 determine the appropriate rating plan for each insured. CCR section 2360.0 defines  
3 eligibility guidelines as “specific, objective factors, or categories of specific, objective  
4 factors, which are selected and/or defined by an insurer, and which have a substantial  
5 relationship to an insured’s loss exposure.”
- 6 2.3.3 The Department is informed and believes that Respondents’ PERP rating rules  
7 expressly provide that losses withdrawn, denied or that ultimately fall under a policy’s  
8 deductible, will not adversely impact a policyholder’s eligibility for a PERP discount.
- 9 2.3.4 The Department is informed and believes that Respondents commonly surcharge  
10 policyholders for claims losses, despite the fact that those losses are ultimately subject  
11 to subrogation, or fall within a policy’s deductible.
- 12 2.3.5 The Department is informed and believes that Respondents’ underwriting guidelines  
13 do not contain sufficiently detailed instructions for its underwriters, so that claims  
14 appropriately subject to subrogation will not result in a PERP surcharge.
- 15 2.3.6 Respondents’ failure to maintain underwriting guidelines sufficiently detailed to  
16 determine the appropriate rating plan for those insureds with claims subject to  
17 subrogation is in violation of CCR section 2360.2.

## 18 2.4

19 **RESPONDENTS ONLY REIMBURSE POLICYHOLDERS THAT FORMALLY**  
20 **OBJECT TO SURCHARGES FOR SUBROGATED CLAIMS, AND DO NOT MAKE**  
21 **EFFORTS TO REVIEW OTHER CLAIMS SUBJECT TO SUBROGATION TO SEE**  
22 **IF A PERP DISCOUNT SHOULD APPLY; AN UNFAIRLY DISCRIMINATORY**  
23 **PRACTICE IN VIOLATION OF CIC SECTION 1861.05.**

- 23 2.4.1 The Department incorporates, by reference, paragraphs 1.3 through 1.13, above.
- 24 2.4.2 CIC section 1861.05, subdivision (a) prohibits rates or rating plans that are applied in  
25 an unfairly discriminatory manner.
- 26 2.4.3 The Department is informed and believes that Respondents commonly refuse to pursue  
27 subrogation of claims made by a policyholder, despite the fact that an insurer other  
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1 than Respondents has offered to pay for some or all of the policyholder's damages  
2 resulting from a particular claim.

3 2.4.4 The Department is informed and believes that, rather than pursue the possible  
4 subrogation of claims referenced in paragraph 2.4.3, Respondents often elect to  
5 impose a PERP surcharge on the policyholder's Premium.

6 2.4.5 The Department is informed and believes that, on other occasions, when a similarly-  
7 situated policyholder protests a PERP surcharge on the grounds that the underlying  
8 basis for the surcharge is a subrogated claim, Respondents often remove the surcharge.

9 2.4.6 Respondents varied application of its PERP rating rules to policyholders with  
10 similarly-situated claims subject to subrogation results in an unfairly discriminatory  
11 application of Respondents' rates, in violation of CIC section 1861.05, subdivision (a).

## 12 13 **2.5**

### 14 **RESPONDENTS LACK SUFFICIENT GUIDELINES TO CONSISTENTLY** 15 **DETERMINE WHEN TO NONRENEW A POLICYHOLDER FOR HAVING TOO** 16 **MANY CLAIMS, A VIOLATION OF CCR SECTION 2360.2 AND CIC SECTION** 17 **1861.05.**

18 2.5.1 The Department incorporates, by reference, paragraphs 1.3 through 1.13, above.

19 2.5.2 CCR section 2360.2 requires that eligibility guidelines be sufficiently detailed to  
20 determine the appropriate rating plan for each insured. CCR section 2360.0 defines  
21 eligibility guidelines as "specific, objective factors, or categories of specific, objective  
22 factors, which are selected and/or defined by an insurer, and which have a substantial  
23 relationship to an insured's loss exposure."

24 2.5.3 CIC section 1861.05, subdivision (a) prohibits rates or rating plans that are applied in  
25 an unfairly discriminatory manner.

26 2.5.4 The Department is informed and believes that Respondents' internal underwriting  
27 bulletin concerning the application of PERP states that policyholders with five or more  
28 chargeable losses in the last three years are ineligible for coverage and will be referred  
to underwriting for nonrenewal.

1 2.5.5 The Department is informed and believes that Respondents commonly nonrenew  
2 policyholders with less-than five claims on the grounds that those policyholders have  
3 too many claims, despite the fact that such policyholders should, instead, only receive  
4 a Premium surcharge in accordance with PERP.

5 2.5.6 The Department is informed and believes that Respondents lack sufficiently detailed  
6 underwriting guidelines to determine when a policyholder is ineligible for coverage  
7 due to excessive claims.

8 2.5.7 Respondents' failure to maintain eligibility guidelines that are sufficiently detailed to  
9 determine the appropriate rating plan for each insured is a violation of CCR section  
10 2360.2.

11 2.5.8 Because some policyholders with less-than five claims in a three-year period are  
12 renewed, while other similarly situated policyholders with less-than five claims in a  
13 three-year period are nonrenewed, Respondents' rating plan operates in an unfairly  
14 discriminatory manner. Respondents' rating plan, therefore, operates in violation of  
15 CIC section 1861.05, subdivision (a).

## 16 2.6

### 17 **RESPONDENTS AUTOMATICALLY UPRATE ANY HOMEOWNERS** 18 **POLICYHOLDER FALLING WITHIN A COMPUTER-ASSIGNED "SPLIT CLASS,"** 19 **THEREBY, FAILING TO CHARGE THE LOWEST PREMIUM FOR WHICH THE** 20 **HOMEOWNERS INSURED QUALIFIES, IN VIOLATION OF CCR SECTIONS** 21 **2360.3 AND 2360.4 AND CIC SECTION 1861.05.**

21 2.6.1 The Department incorporates, by reference, paragraphs 1.14 through 1.30, above.

22 2.6.2 CCR section 2360.3 specifically provides: "An insurer shall charge each insured the  
23 lowest Premium for which the insured qualifies. At each policy renewal the insurer  
24 shall adjust the Premium charged to the insured, as necessary, to reflect the lowest  
25 Premium for which the insured qualifies at that time."

26 2.6.3 CCR section 2360.4 states that it is the insurer's responsibility to determine the lowest  
27 premium for which an insured qualifies. In the event that an insurer delegates this  
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1 responsibility to one of its agents, CCR section 2360.4 states that the insurer remains  
2 responsible for its agent's conduct in determining the lowest premium.

3 2.6.4 The Department is informed and believes that Respondents neglect their responsibility  
4 to determine the lowest premium for those insureds that fall within a "split class," as  
5 determined by Respondents' computerized GUS program.

6 2.6.5 The Department is informed and believes that Respondents automatically assign "split  
7 class" insureds with a PPC code of 9, resulting in an increase in the premium charge  
8 for most, if not all, of Respondents' "split class" insureds.

9 2.6.6 The Department is informed and believes that Respondents allow their agents 15 days  
10 to determine whether the PPC code of 9 is an appropriate code for a given "split class"  
11 insured.

12 2.6.7 In the event that Respondents' agent does not provide Respondents with more accurate  
13 PPC code information for a "split class" insured within the 15 days, the Department is  
14 informed and believes that Respondents elect to impose the second-highest risk PPC  
15 code to such insureds, despite Respondents knowledge that most of these insureds  
16 should be eligible for a lower PPC code and a concomitantly lower premium charge.

17 2.6.8 Respondents failure to determine the lowest premium for which its "split class"  
18 insureds qualify violates CCR sections 2360.3 and 2360.4.

19 2.6.9 Because Respondents' GUS program assigns those policyholders in "split class" zones  
20 a PPC code of 9, while Respondents' GUS program assigns other similarly situated  
21 policyholders with lower PPC codes, similarly situated policyholders are charged  
22 dissimilar rates. Respondents' rating methodology, therefore, operates in an unfairly  
23 discriminatory manner, in violation of CIC section 1861.05, subdivision (a).

### 24 III.

#### 25 RELIEF REQUESTED

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27 3.1 **RESPONDENTS ARE HEREBY NOTIFIED** that, to the extent Respondents'  
28 unlawful practices are ongoing at the time of delivery of this notice, the

1 noncompliance referred to herein must be corrected within twenty (20) days of receipt  
2 of this notice. For each allegation listed above, proof of system-wide correction, or  
3 other response permitted by California Insurance Code section 1858.1, must also be  
4 provided within twenty (20) days of receipt of this notice.

5 3.2 **RESPONDENTS ARE FURTHER NOTIFIED** that if Respondents fail to make an  
6 adequate or timely response, a public hearing will be set pursuant to California  
7 Insurance Code sections 1858.2 and 1858.3. If, at the conclusion of the hearing, the  
8 Commissioner finds that the facts as alleged above have occurred and that these facts  
9 constitute violations of the applicable sections of the Insurance Code and/or Code of  
10 Regulations, as set forth, he may issue an order for payment of money penalties and  
11 any other corrective action as he may deem appropriate.

12 3.3 **RESPONDENTS ARE FURTHER NOTIFIED** that if the noncompliance referred  
13 to above constitutes willful acts involving the use of rates, rating plans, and/or rating  
14 systems in violation of Chapter 9, Part 2, Division 1 of the California Insurance Code,  
15 pursuant to section 1858.07 of the California Insurance Code, the imposition of civil  
16 penalties will be sought in the amount of \$10,000.00 for each act. This Notice may be  
17 amended to set forth additional willful acts in violation of Chapter 9, Part 2, Division  
18 1, of the California Insurance Code and to seek additional penalties therefor in the  
19 amount of \$10,000.00 for each act.

20 3.4 **RESPONDENTS ARE FURTHER NOTIFIED** that, alternatively, in the event that  
21 those acts involving the use of rates, rating plans, and/or rating systems in violation of  
22 Chapter 9, Part 2, Division 1 of the California Insurance Code are not found to be  
23 willful violations of that chapter, then pursuant to California Insurance Code section  
24 1858.07, the imposition of civil penalties will be sought in the amount of \$5,000.00 for  
25 each act. The Commissioner further reserves the right to seek any other penalties  
26 provided for under California Insurance Code section 1858.07 in the event that the acts  
27 set forth above, or such acts as may be alleged upon amendment hereof, were  
28 inadvertent.

