Legal Backgrounder

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202.588.0302

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COURT'S RULING APPLYING CREDIT ACT TO INSURERS LEGALLY UNSUPPORTABLE

By

Robert Detlefsen

In a democratic republic, the principle that judges should refrain from "legislating from the bench" seems unassailable. Hence judges, the corollary goes, should enforce statutes precisely as written — a method of statutory construction that Justice Antonin Scalia calls "textualism." But critics respond that textualism presupposes a statutory regime in which statutes are written with precision. Unfortunately, that is not always so. As Justice Felix Frankfurter — hardly a proponent of judge-made law — observed nearly 60 years ago, "Pledges to honor the plain meaning of a statute — or an article of the Constitution — cannot carry much weight when the words do not in fact convey a plain meaning." Lecture given before the Association of the Bar of the City of New York, March 18, 1947, *Record of the Association of the Bar of the City of New York*, Vol. 2, June, 1947.

No one familiar with federal law would deny that statutes are sometimes ambiguous in their meaning. Statutory ambiguity may even be deliberate, as when legislators wish to be on record as voting for a measure that promotes values generally favored by voters (e.g., protecting individual "rights"), while punting the hard policy-making questions to the courts. Frankfurter nonetheless admonished judges against treating statutory ambiguity as an invitation to indulge their own policy preferences. Confronted with a statute whose meaning in a particular context is less than clear, judges should not only "listen attentively to what a statute says," but "also listen attentively to what it does not say." *Id*.

All of which brings us to *Reynolds v. Hartford Financial Services Group*,[1] a case that provides a striking illustration of what can happen when judges are resolutely *inattentive* to statutory language. In *Reynolds*, a three-judge panel of the U.S. Court of Appeals for the Ninth Circuit purported to construe a key provision of the Fair Credit Reporting Act (FCRA), 15 U.S.C. § 1681 et seq, that applies to property-casualty insurers. This LEGAL BACKGROUNDER argues that the *Reynolds* panel used the FCRA's "adverse action" notice requirement to eviscerate a perfectly legal insurance underwriting practice by selectively listening to what the FCRA says, while strenuously ignoring what it does not say.

Insurers' Use of Credit Information as an Underwriting Tool is Actuarially Sound, but Politically Controversial. In the 1990s, automobile and homeowner insurers began using credit-based "insurance scores" — scores based in part on credit report information — to decide whether to issue or renew a policy, and to establish

[1] *Reynolds v. Hartford Financial Services Group, Inc*. No. 03-35695, 2005 U.S. App. LEXIS 21389 (9th Cir, Oct. 3, 2005). Shortly after the decision was handed down, the defendant companies filed a motion requesting an *en banc* re-hearing of the case. As of this writing, the court has not yet ruled on the motion. On January 25, 2006, the panel withdrew its original opinion and substituted a revised opinion. *See* 2006 U.S. App. LEXIS 1787 (9th Cir. Jan. 25, 2006).

Robert Detlefsen is Director of Public Policy at the National Association of Mutual Insurance Companies.

its price. The use of insurance scores enables insurers to assess and classify insurance risks more accurately, allowing them to set premiums that are more closely aligned with the level of risk presented by an individual policyholder. This has the effect of markedly decreasing the extent to which lower-risk consumers subsidize the insurance costs of higher-risk consumers.

Government studies have confirmed that an individual's experience managing credit is an accurate predictor of whether he will file a claim for automobile or homeowners insurance, and the potential size of the loss.[2] Nevertheless, the use of credit information for underwriting and pricing insurance products has generated much controversy. Some policymakers and consumer advocates have sought to ban the practice because it allegedly has a disparate adverse impact on particular racial and ethnic minority groups. *See* Robert Detlefsen, *'Disparate Impact' Theory Provides No Support for Banning Credit Scoring in Insurance*, LGL. BACKGROUNDER (Wash. Lgl. Found'n), Vol. 20, No. 17 (Apr. 8, 2005). Others object because they regard insurance as a mechanism for spreading risk broadly across risk classes. To the extent that using credit information facilitates greater homogeneity within risk classes (thereby minimizing the transfer of insurance costs from high-risk to low-risk insureds), the practice poses a significant threat to the egalitarian model of insurance favored by many of the industry's critics. *See* Robert Detlefsen, *In All Fairness: The Propriety of Credit-Based Insurance Scoring*, THE STATE FACTOR, (Am. Legis. Exchange Council) (Nov. 2003).

The Fair Credit Reporting Act Permits Insurers to Use Credit Information in Underwriting and Pricing Decisions. The FCRA is a federal consumer protection statute designed to promote fairness and accuracy in credit reporting. While the Act expressly authorizes the use of credit information as an insurance underwriting tool, it also provides that "any person" who "takes any adverse action with respect to any consumer that is based in whole or in part on any information contained in a consumer report" must provide "notice of the adverse action to the consumer." 15 U.S.C. § 1681m(a). The Act defines an "adverse action" as "a denial or cancellation of, an increase in any charge for, or a reduction or other adverse or unfavorable change in the terms of coverage or amount of, any insurance, existing or applied for, in connection with the underwriting of insurance." 15 U.S.C. § 1681a(k)(1)(B)(i).

Attesting to the opacity of this language, each insurance company that uses credit-based insurance scores made its own determination of the circumstances that would trigger its FCRA duty to provide adverse-action notices. Not surprisingly, separate determinations made by hundreds of individual insurers, often on advice of counsel, resulted in a variety of practices. Since the Act took effect in 1970, no court had ever interpreted the FCRA's definition of adverse action in the context of insurance, nor had any agency issued binding regulations. Insurers thus attempted to comply with the adverse action notice requirement based on their own good-faith interpretations of the FCRA's text.

Many insurers determined that the Act did not require adverse-action notices upon the setting of an *initial charge* for insurance. After all, inasmuch as the Act defines an adverse action as "an increase in any charge for […] any insurance, existing or applied for," it seems illogical to suppose that a first-time buyer could be faced with a price *increase*. True, the definition applies both to "existing" insurance policies and to policies "applied for." But in the absence of an existing policy with an existing price, it would be difficult to identify a standard according to which one could fairly be said to have experienced a price "increase." Among those insurers that did provide notices in such "initial charge" situations, most attempted to determine when their use of insurance scores, compared to *not using* such scores, would adversely affect the consumer, and issued adverse-action notices in those circumstances.

The panel, however, decided that not even this practice conformed to the requirements of the Act. Writing for the court, Judge Stephen Reinhardt declared that the "adverse action notice requirement applies whenever a consumer would have received a lower rate for insurance had his credit information been more

[2]*See, e.g.*, "Report to the 79th Legislature: Use of Credit Information by Insurers in Texas," Texas Department of Insurance (Dec. 30, 2004), and especially, "Supplemental Report to the 79th Legislature: Use of Credit Information by Insurers in Texas: The Multivariate Analysis," Texas Department of Insurance (Jan. 31, 2005).

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favorable, *regardless of whether his credit rating is above or below average*." *Reynolds*, 2005 U.S. App. LEXIS 21389 (9th Cir, Oct. 3, 2005) (Emphasis added). According to this reasoning, a hypothetical first-time applicant for an auto insurance policy who was offered a premium discount because of her above-average credit score would nonetheless have suffered an "adverse action" at the hands of the insurer if an even better credit score would have qualified her for the insurer's very best rate. Even granting that the meaning of FCRA's adverse-action notice requirement is less than crystal clear, the panel's interpretation — that an insurer should be required to notify the consumer that she had been *adversely* affected when in fact she was helped by the use of her insurance score — defies common sense. Indeed, one wonders how an insurer would go about drafting such a notice.[3] The panel's reasoning evokes that of a student who regards an "A" grade as an adverse action because his professor could conceivably have given him an "A-plus."

In Addition to Imposing a New Regulatory Burden on Insurers, the Panel's Original Ruling Potentially Exposed Them to Massive Liability. Having divined the "plain meaning" of the FCRA's adverse-action notice requirement, the panel effectively saddled insurance companies doing business in states covered by the Ninth Circuit with a costly new mandate, whose likely effect will be to confuse tens of thousands of consumers whose insurance premiums are lower due to their favorable credit histories. The opinion handed down last October went still further, however, declaring that the insurers' failure to anticipate the panel's tortured construction of the adverse-action notice requirement constituted a willful violation of the Act. In so doing, the panel would have permitted the plaintiffs to return to federal district court (where their suit had been summarily dismissed), *Rausch v. Hartford Fin. Services Group, Inc*., 2003 U.S. Dist. LEXIS 25892 (D. Or., July 31, 2003), and sue the insurers for damages.[4]

To be liable under the FCRA, according to the panel, a company would have to violate the Act "either knowing that [its] action violates the rights of consumers or in reckless disregard of those rights…." *Reynolds*, 2005 U.S. App. LEXIS 21389 (9th Cir, Oct. 3, 2005). It allowed that a company would not be considered to have recklessly disregarded consumers' rights "if it has diligently and in good faith" attempted to understand its statutory obligations, but nonetheless came to "a tenable, albeit erroneous, interpretation of the statute." Without citing any evidence that the insurers had failed to make such an effort, the panel's October opinion simply asserted that insurers' construction of the adverse-notice requirement was not merely erroneous, but "untenable," "implausible," and "plainly unmeritorious" — never mind that the insurers' construction was shared by the federal district court whose decision the appellate panel was now overturning. *See Rausch*, 2003 U.S. Dist. LEXIS 25892 (D. Or., July 31, 2003). Far from having engaged in a good-faith effort to comply with the law, the panel accused the insurers of relying on "creative lawyering" to evade the law.

Indeed, the plain language of the Act lends no support to — much less does it compel — the panel's assertion that an insurer must provide an adverse-action notice when it *initially* charges a consumer more than some hypothetical alternative charge, based on its use of credit information. Moreover, it was certainly reasonable for the insurers to assume that a rate "increase" could only occur with respect to an existing policy, since one cannot increase something that does not yet exist. And even if the Act could be read as applying to the setting of an initial insurance charge, the panel's "best rate" construction — *i.e.*, that an adverse action occurs whenever "the consumer would have received a lower rate for his insurance had the information in his consumer report been more favorable," *Reynolds*, 2005 U.S. App. LEXIS 21389 (9th Cir, Oct. 3, 2005) — is hardly obvious and, indeed, almost certainly incorrect. Nowhere does the FCRA specify any baseline hypothetical "charge" against which a supposed "increase" is to be measured. Moreover, previous rulings by two district courts

[3]Perhaps it would say something like this: "Dear Insurance Applicant: Due to your favorable credit history, we are able to offer you a premium that is considerably lower than the premium we would have charged had you not had such a favorable credit history. That said, your credit score is not quite good enough to qualify for our very lowest rate. Therefore, our offer of a substantial premium discount based on your excellent credit history constitutes an adverse action against you by us."

[4]The Act states: "Any person who willfully fails to comply with any requirement imposed under this title with respect to any consumer is liable to that consumer" for actual or statutory damages, punitive damages, and reasonable attorney's fees." 15 U.S.C. § 1681n.

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endorsed the insurers' interpretation of the Act. *See Rausch*, 2003 U.S. Dist. LEXIS 25892 (D. Or., July 31, 2003) and *Mark v. Valley Ins. Co.*, 275 F. Supp. 2d 1307, 1313-1319 (D. Or., July 17, 2003).

In sum, the caustic words used by the panel to describe the insurers' efforts to interpret the FCRA — "untenable," "implausible," "plainly unmeritorious" — was an apt characterization of its own opinion. A modified version of the panel opinion issued on January 25, 2006[5] indicates that the panel has come to share that assessment.

The Panel's Recent Modification of the* Reynolds *Opinion is a Tacit Acknowledgment that its Original Ruling was Unsustainable. While the revised opinion adheres to the definition of "willful violation" adopted in the original opinion, it now leaves open the question of whether the defendant insurers' conduct meets that definition. In remanding the case, the panel instructed the district court to make a factual determination as to whether the defendants willfully violated the Act. Gone is the lengthy excoriation of the insurers' "plainly unmeritorious" reasoning and "creative lawyering." Given that the insurers had requested an *en banc* rehearing of the case shortly after the panel handed down its original opinion last October, one may surmise that by deleting the "willful violation" judgment, the panel was hoping to prevent the rest of its embroidered construction of the FCRA from being overturned.

That, after all, is not infrequently the fate of Judge Reinhardt-authored opinions. Since he was appointed to the Ninth Circuit in 1980, Judge Reinhardt has become one of the most overturned judges in American history. Matt Rees, *The Judge the Supreme Court Loves to Overturn*, THE WEEKLY STANDARD, May 5, 1997. In the 1996-97 term alone, the Court reversed seven opinions that Reinhardt had either written or been a party to. All seven reversals were unanimous; three were per curiam. *Id*. His idiosyncratic approach to the judicial function was fully captured in an op-ed he wrote for the *Los Angeles Times* in 1994 when President Clinton nominated Stephen Breyer to the Supreme Court. In the form of an open letter to Breyer, Judge Reinhardt declared that while there are "lots of able technicians" on the Court, the nation "is entitled to at least one justice with vision, with breadth, with idealism, with — to say the word despised in the Clinton administration — a liberal philosophy and expansive approach to jurisprudence." *Who will keep the liberal flame alive, if not Breyer?* L.A. TIMES, May 26, 1994, at B7. In 2002, Judge Reinhardt helped spark a national uproar when he joined a panel decision declaring that reciting the Pledge of Allegiance in public schools violated the First Amendment. The Supreme Court overturned that decision.

Conclusion. The *Reynolds* opinion should be reversed as well, notwithstanding the January 25 revision. It is important to note that while the modified opinion softens the impact of that panel's ruling concerning the willful violation issue, it leaves intact the panel's incorrect interpretation of the FCRA both with respect to an "initial charge" for insurance, and in construing the Act to require insurers to issue an adverse action notice to any consumer who fails to qualify for its best rate. The panel's modified ruling is a less ambitious exercise in policymaking than the original, but it still deserves further scrutiny — not least because some legislators and insurance regulators in states outside the Ninth Circuit's jurisdiction have suggested that their own laws governing credit-based insurance scoring should be revised to conform to the panel's decision. Apparently they believe state officials should defer to federal appellate court rulings, irrespective of whether the ruling is legally binding in their state.

Oddly, many of these same state lawmakers and insurance regulators are staunch defenders of the current system of state-based insurance regulation, and vocal opponents of congressional proposals to establish a federal insurance regulatory regime. They would do well to reflect on the merits of the *Reynolds* opinion before ceding their insurance regulatory authority to crusading federal judges.

[5] 2006 U.S. App. LEXIS 1787 (9th Cir. Jan. 25, 2006).

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