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TESTIMONY OF THE MARYLAND INSURANCE ADMINISTRATION BEFORE THE SENATE FINANCE COMMITTEE FEBRUARY 3, 2021

SENATE BILL 372 – CIVIL ACTION – SURETY INSURANCE - FAILURE TO ACT IN GOOD FAITH

LETTER OF INFORMATION

Thank you for the opportunity to provide written testimony in regards to Senate Bill 372. Senate Bill 372 will expand the scope of Section 27 subtitle 3 (*Unfair Claim Settlement Practices*) and subtitle 10 (*Property and Casualty Insurance – First Party Claims*) to include claims under surety agreements. With respect to subtitle 3, Senate Bill 372 removes the exclusion of surety contracts from the scope of the Unfair Claim Settlement Practices Act (UCSPA) and makes that line of business subject to the UCSPA. With respect to subtitle 10, Senate Bill 372 extends to surety contracts the statutorily imposed obligation of insurers to act in good faith when evaluating certain kinds of first-party claims, notwithstanding that surety contracts are not contracts of indemnity, but financial instruments by which the surety guarantees to pay the contractual obligation of the purchaser to a third-party, subject to the right of the surety to be reimbursed by the purchaser of the surety contract.

With respect to Senate Bill 372's impact on the UCSPA, we note that the specific exemption of surety disputes from the UCSPA has been in place for over 25 years. Maryland's UCSPA closely follows the National Association of Insurance Commissioner's (NAIC) model act, which exempts surety claim matters, workers compensation claims, and reinsurance claims. Each of these lines of business are exempt from the NAIC's model act and from the UCSPA for specific reasons. Workers compensation insurance claims are exempt from the Maryland Insurance Administration's (MIA) oversight under the UCSPA, because the claim by the injured worker is subject to the authority of Maryland's Workers Compensation Commission, which determines the amount due to the injured worker and, thus, the amount compensable under the workers compensation policy. Reinsurance claims are exempt, because reinsurance contracts (i) are complex financial arrangements between insurance companies, which are sophisticated parties of equal bargaining power; (ii) do not impact the consumers' rights under the primary

policies (which policy claims are subject to the UCSPA); and disputes under the reinsurance contract are typically subject to mandatory arbitration.

Surety contracts are exempt from the UCSPA, because they are not insurance policies and do not indemnify the purchaser of the surety contract. Rather, surety contracts/bonds are essentially financial instruments through which the surety agrees to advance (not indemnify) the payment of a financial obligation of the purchaser/principal to a third-party/obligee if a specified event/contingency occurs. These instruments exist to substitute the credit of the surety for the credit of the principal, much like a letter of credit or statutory deposit, and provide an easy and direct source of payment to the third-party/obligee from a credit worthy source. The specified contingency that triggers the payment obligation is typically an underlying adjudication or finding of liability, a mandated governmental or statutory requirement, or the happening of an event specified in the contract (e.g. failure to make a payment of a specific date). Payments by the surety are not dependent on the surety's evaluation of the purchaser/principal's liability or negligence, as is the case with claims subject to the UCSPA. Further, surety contracts/bonds are not insurance policies and the surety has not agreed to indemnify the principal. The surety has only agreed to advance the payment of the obligation on the principal's behalf. Hence, unlike insurance, the surety is entitled to recoup any payment made to an obligee from the principal, typically under a related indemnity agreement.

The exemption of surety claims from the scope of the UCSPA does not mean that the MIA lacks regulatory authority over a surety that fails to honor its contractual obligations. If a surety fails to issue payment of a clear (typically adjudicated) obligation, the MIA has existing authority to direct the surety to issue payment in fulfillment of its obligation.

With respect to the impact of Senate Bill 372 on good faith claim evaluation, the MIA has two concerns. First, surety obligations are not first-party claim obligations. As discussed above, surety contracts and bonds are issued to satisfy the obligation of the purchaser/obligee to a *third-party*/principal, subject to the right of the surety to recoup the advancement of that financial obligation. Hence, subjecting surety arrangements to the good faith standard is actually the extension of that standard to third-party claims. While that is a public policy decision for the legislature, from a technical perspective, the MIA wants to make sure that the policy makers are aware that this is the impact of Senate Bill 372.

Second, surety claims are often time sensitive and where there are disputes, those disputes typically involve complex governmental contracting or construction claims where the underlying facts are disputed and resolved only through litigation or mandated arbitration. Given that, to the extent that quick adjudication is a goal of that portion of Senate Bill 372 that would require the submission of a surety claim alleging the failure of the surety to act in good faith to bring that claim before the MIA, that requirement is likely to have the opposite effect. Rather than expediting claim payment by sureties, Senate Bill 372 will impose a new administrative process, with attendant rights of appeal, that may need to be exhausted prior to the final adjudication of a claim, thereby delaying claim payments. The appeals process will further delay the payment of claims and it is unclear what the impact and collateral estoppel effect of any decision of the MIA would be on related third-party claims or the separate indemnity rights of the surety against the contract purchaser/principal. Additionally, the cost to a surety of

complying with a new administrative process, which will include the cost of responding to complaints and participating in hearings, could exert upward pressure on the cost of surety bonds in our market.

In addition to these issues, there may be (i) federal preemption issues related to federal contracts and intra-state jurisdictional issues related to state contracts that are raised by Senate Bill 372 and that could impact enforcement by the MIA and (ii) res judicata concerns that are beyond the scope of the MIA's analysis.

Finally, as drafted, the MIA would need to hire one or more additional investigators and have access to third-party vendors to address claims against sureties under the UCSPA and expects to need to engage at least one additional hearing officer to evaluate surety claims for breach, for the absence of good faith, and for the bond amount under §27-1001.