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VIA E-MAIL & HAND DELIVERY

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P.O. Box 420603
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**RE: Labor Code Section 5814.6 – Administrative Audits and Penalties**
Article 1, Subchapter 1.8.1 to Chapter 4.5 of Title 8, California Code of Regulations, commencing with section 10225

Dear Mesdames Nevans & Gray:

These comments on the Labor Code Section 5814.6 Administrative Penalties regulations are presented on behalf of the members of the California Workers' Compensation Institute. Recommended modifications are indicated by *underline* and ~~*strikethrough*~~.

**Recommendation -- Division of Workers' Compensation Audit Authority**
The Institute recommends that all auditing performed by the Division of Workers' Compensation (DWC) remain within the confines of the statutory scheme created in Labor Code Sections 129 and 129.5 (AB 749).

**Discussion**
**Separate and Independent Audits**
The proposed Section 5814.6 Administrative Penalty regulations require independent auditing with separate standards, rules, processes, and penalties. The model for these new audits is not the tiered approach of increasing scrutiny reflected in the profile audit review (PAR) (Labor Code Section 129), but the pre-1998 model – the program that the Commission on Health and Safety and Workers' Compensation (CHSWC), the Legislature, and the workers' compensation community sought to scrap in 2002 because is was ineffective, unfair, wasteful, and ineptly administered.

Whether the section 5814.6 penalty review is to be done by the Audit Unit, an Independent Investigation Unit, or the administrative director's designee, the proposed regulations establish separate and distinct units within the Division to conduct independent audits. That structure is directly contrary to the statutory scheme adopted by the Legislature in AB 749 and implemented in 2003. The social policy decision regarding the Division's audit authority has been made and the proposed expansion of the audit function is not required or authorized by SB 899. Failing to follow the audit scheme contained in Labor Code section 129 will produce redundant audits, chaotic administration, and wasted resources, as it has in the past.

**Background**

According to the Commission's analysis, by the late 90s, the Division's overall auditing function was inefficient and ineffective. The Audit Unit lacked the resources to visit more than a small percentage of claims administrators each year. In April of 1998 Senator Solis, Chair of the Senate Industrial Relations Committee, and Assemblywoman Figueroa, Chair of the Assembly Insurance Committee, jointly requested that the Commission on Health and Safety and Workers' Compensation to evaluate the effectiveness of the DWC's audit function. The resulting 67-page study is still available from the Commission.

The Legislature charged the Commission to develop recommendations on the effectiveness of the program, staffing, the adequacy of the deterrent effect, and to consider the application of other insurance audit procedures to workers' compensation claims administration.

The Commission's stated purpose was to revise the Division's claims evaluation procedures to impose a more efficient audit, so that all claims administrators would be reviewed at least once in a 5-year period. The cornerstone of the Commission's analysis was the importance of developing performance standards for claims administrators. The Commission's recommendations included:

- Focus on "key indicators" of quality claims performance,
- Require simplified, random audits of all locations every 5 years,
- Provide that targeted audits will comprise 25% of the audits,
- Limit penalties to audits that exceed a certain threshold,
- Extrapolate penalties from a sample at poor performing locations.

The Commission's summary conclusions stated:

> "The Commission project team researched the issue and conducted thoughtful discussions with DWC audit unit management and staff, the audit study advisory committee and other community members.
>
> The research team found that the audit procedure did not include all insurers within a reasonable period of time, did not focus on the worst performers and concentrated penalties on relatively inconsequential violations. Under those procedures, locations are rarely subject to random audits and almost never subject to targeted audits.

The study participants concluded that although much time and effort was being expended by the DWC audit unit in performing audits of workers' compensation insurers, a redirection of these activities would produce more effective outcomes.

The Commission recommended revisions to the audit function, in order to:

- Reward good performers by eliminating administrative penalties and resource requirements,
- Increase incentive to improve benefit delivery by raising administrative penalties substantially on poor performers,
- Focus administrative penalties on important violations.

Provide balance to the audit process:

- Bad business practices by claims administrators mean that injured workers are not receiving proper indemnity payments and appropriate medical services in a timely manner,
- Excessive audit penalties and regulation mean employers are paying higher costs to deliver the same benefits.

The Commission recommends the replacement of current audit procedures with the following:

- Simplified audit, focusing on key violations,
- Auditing of all locations on a five-year cycle,
- Electronic monitoring of key performance indicators where possible,
- Increased use of targeted audits to identify poor performers.

The results of the routine audits should be used to:

- Identify poor performers for an in-depth review,
- Verify data integrity,
- Benchmark performance on key indicators,
- Rank performance of adjusting locations."

The Commission's recommendations were enacted by the Legislature in 2002 (AB 749) in the revisions to Labor Code Section 129 and 129.5.

**DWC Audit Function**

The Institute's members agree that an efficient auditing apparatus is essential to the effective operation of the workers' compensation system. CWCI supported the work of the Commission and has always promoted a professional, proficient, and productive audit function that focused the Division's resources on the poor performers. The Institute supports the creation of a strong audit program because it requires a specific performance standard for all claims administrators in the system.

Whether the Division's audit function is centralized in the Audit Unit or independent based on clear statutory authority, the essential features of a performance review must reflect the findings of the Commission and the legislative philosophy of Labor Code

Sections 129 and 129.5. As the Commission noted, the level of scrutiny must be just right. Too little and poor performance goes unchecked. Too much and the process becomes bureaucratic, unproductive, and costly.

Effective enforcement can be thwarted by inconsistent, contradictory, vague, and irrelevant performance standards. The audit function needs a focused, consistent process with clear objectives and standards that everyone understands, so that the regulated community knows what the agency expects.

**Core Features of the Audit Function**

Key Indicators of Performance: With regard to section 5814.6 penalty, the Division is limited to the review of section 5814 penalties awarded by a WCALJ. Any enforcement effort must focus on these awards. Auditors can determine conduct equivalent to "a general business practice" or a company policy of unreasonable denial or delay in the payment of benefits from a straightforward comparison between penalty awards and the number of files being managed. This can be done most efficiently during the PAR audit.

Review All Claims Administrators Periodically: The section 5814.6 penalty audit program must be set up to cover all programs within a reasonable period of time and it must be coordinated with the other aspects of the Division's audit function. The best way to accomplish that goal is to include the review of section 5814 penalties at the time of the routine PAR audits under section 129.

The Initial Review: The initial review of section 5814 penalty awards should be within the context of a routine audit and should be sufficient on which to base a determination. But a more serious pattern of failures at this stage would also allow the Division to conduct a more thorough review, followed by a targeted audit, if necessary.

Complaint Audits: Based on a verified complaint relating to specific section 5814 penalties, the Division can trigger a focused audit under section 129 and impose any necessary enforcement tools to correct a poorly performing program.

Enforcement Tools: While section 5814.6 permits only the application of a monetary penalty, the resulting penalties might cause the administrative director, under the broader authority of Labor Code section 129, to target poor performing programs, identify the specific problems causing multiple section 5814 penalties, and set up a remedial plan to ensure compliance with or without multiple additional monetary penalties.

While SB 899 gave the administrative director the authority to apply administrative penalties for a pattern of knowing violations of section 5814 penalty, for all the reasons stated above, the best way to accomplish that goal is through the routine DWC audits that are already in place. The Division has proposed separate and independent audits not just for section 5814.6 penalties, but also the UR program and WCIS.

CWCI supports the effective enforcement of these new standards but the Institute's members are concerned that the creation of new separate and independent audits is not only abandoning a functioning program, but seems to be a rejection of the social policy decision made by the Legislature in 2002 and a repudiation of the Commission's research. The Institute is troubled that the Division plans to conduct 4 separate audits of claims administrators without needing to do so. The community wants to avoid a diluted and ineffective program with duplicative procedures, inadequate coordination, and wasted resources by both the regulated community and the DWC.

**Recommendation – Applicable Conduct**

The regulation must include an unambiguous notice advising the regulated community of the operative date of the statute and a statement that conduct occurring before that date will not be considered for the purposes of this penalty.

**Discussion**

**Authority**

In accordance with subsection (c), Labor Code Section 5814.6 became effective on June 1, 2004. It states:

(a) Any employer or insurer that knowingly violates Section 5814 with a frequency that indicates a general business practice is liable for administrative penalties of not to exceed four hundred thousand dollars ($400,000). Penalty payments shall be imposed by the administrative director and deposited into the Return-to-Work Fund established pursuant to Section 139.48.

(b) The administrative director may impose a penalty under either this section or subdivision (e) of Section 129.5.

(c) This section shall become operative on June 1, 2004.

Government Code section 11342.2 states:

> Whenever by the express or implied terms of any statute a state agency has authority to adopt regulations to implement, interpret, make specific or otherwise carry out the provisions of the statute, no regulation adopted is valid or effective unless consistent and not in conflict with the statute and reasonably necessary to effectuate the purpose of the statute.

To the extent that the regulations state, infer, or suggest that conduct occurring before the operative date of the statute can be used to inform the imposition of the section 5814.6 penalty, the regulations are in conflict with the statute. The proposed regulations are replete with ambiguous references relating to whether claim files, documents, or other conduct can be "used as evidence of violations of Labor Code section 5814".

The only evidence of a violation of section 5814 is a findings and award issues by a WCALJ. The only section 5814 penalty awards that are relevant to the inquiry posed by these regulations are those involving conduct on or after June 1, 2004. Any conduct prior to the operational date of the statute is beyond the scope of the enabling act. The regulations should state that unambiguously.

**Introduction**

**The Statutory Standard**

Section 5814.6 imposes an entirely new administrative penalty with the highest upper end limit in the Labor Code. It is the most significant monetary enforcement device available to the administrative director (AD). The conduct on which this penalty is based is equally as significant: knowing violations of section 5814 "with a frequency that indicates a general business practice" of the employer or insurer.

As defined by the proposed regulations, the statutory standard has been diluted to mean that anyone charged with corporate knowledge could be penalized to the maximum extent of the statute for having "more than one" section 5814 penalty award imposed against them. This wordplay eviscerates the meaning of the law.

An administrative regulation authorized by statute is invalid unless it is consistent and not in conflict with the statute and is reasonably necessary to effectuate purpose of the statute, and a regulation which fails to satisfy such standard is properly subject to judicial challenge. Desert Environment Conservation Ass'n v. PUC (1973) 106 CR 31, 8 C3d 739; Government Code section 11342.2.

Just as the regulations cannot diminish or increase the limit of the monetary penalty under section 5814.6, neither can the regulations alter the level of conduct required by the statute in order to impose the penalty.

**Recommendation – 10225(l) – General Business Practice**

"General business practice" means a pattern of penalties for which the Workers' Compensation Appeals Board has awarded a section 5814 penalty for conduct occurring on/or after June 1, 2004 ~~violations of Labor Code section 5814 at a single adjusting location~~ that can be distinguished by a reasonable person from an isolated event. The pattern of violations must occur in the handling of 20% or more ~~than one~~ of the claims. ~~The pattern also may be based on evidence of violations of Labor Code section 5814 for failure to comply with an earlier compensation order in more than one claim.~~ The conduct may include a single practice and/or separate, discrete acts or omissions. ~~in the handling of more than one claims~~.

**Discussion**

One of the ways that the Legislature chose to enforce the obligations of the workers' compensation system is through monetary penalties. There are "automatic" penalties that are imposed without litigation (Labor Code Section 4650(d)), penalties for the unreasonable delay or denial of benefits (section 5814), and specific penalties imposed after the audit (sections 129 and 129.5). All of these penalties are based on particular enforcement philosophies and have distinct rationales. Labor Code section 5814.6, too, is based on a specific enforcement philosophy and has a distinct rationale. From the plain language of the statute, the penalty exists in order to sanction employers and insurers who have incurred penalty awards for so many violations of Labor Code section 5814 as to indicate a general business practice of the unreasonable denial or delay in the payment of workers' compensation benefits.

The appropriate application of a section 5814.6 penalty, therefore, requires an auditor to establish conduct equivalent to "a general business practice" or a company policy of unreasonable denial or delay in the payment of workers' compensation benefits. In proposed regulation 10225(l), the AD relies on a numerical indicator of "more than one" penalty award. Finding "more than one" violation does not accomplish the task set out by the Legislature in section 5814.6.

The work of the auditor under the plain meaning of the statute is more difficult, and rightfully so, since the potential penalty is the largest administrative penalty permitted under the Labor Code. The regulation must define not just a pattern of conduct but a pattern of conduct performed "with a frequency that indicates a general business practice". Establishing a pattern of intentional misconduct that constitutes a general business practice involves the consideration of the size of the employer or insurer, the scope of the conduct (whether it was an isolated incident or pervasive), the awareness and involvement of company management, and other factors that will be unique to each review.

Under the Division's current regulatory scheme for conducting audits pursuant to section 129, the "pass/fail" rate to determine whether to conduct a more comprehensive Full Compliance Audit is set at 20%. Title 8, CCR, section 10107.1(c)(3)(B) & (C). As section 5814.6 imposes the most severe monetary penalty in the Labor Code, the Institute recommends the use of that benchmark to demonstrate the existence of a general business practice.

The regulations must include all of the statutory elements to meet the mandate of the scheme set forth in section 5814.6.

**Recommendation – 10225(q) – Knowingly Committed**

"Knowingly" means a managing agent acting with actual knowledge that the act or omission is unlawful, or with conscious disregard for the unlawful nature of the ~~of the facts of the~~ conduct at issue. For the purposes of this article, a corporation has knowledge of the facts ~~an employee~~ a managing agent receives while acting within the scope of his or her authority. A corporation has knowledge of information contained in its records and of the actions of its employees performed in the scope and course of employment, if known to its managing agent. An employer or insurer has knowledge of information contained in the records of its third-party administrator and of the actions of the employees of the third-party administrator performed in the scope and course of employment, if those actions are known to the corporation's managing agent.

**Discussion**

The statute, by its terms, proscribes intentional misconduct committed with such a frequency as to constitute a business practice or company policy. The statute will apply sanctions to company practices, not employer or insurer claims administrators. As drafted, the proposed regulations permit the application of this penalty for negligence, inadvertence, and other lesser forms of misconduct that are currently penalized by a matrix of related penalties set out elsewhere in the Labor Code.

To establish a knowing violation of section 5814, an auditor must be able to provide evidence of scienter: knowledge of the nature of one's act or omission, the intent to engage in particular conduct, or the intent to deceive, manipulate, or defraud. To apply the penalty to the company practice, it must be clear that the company managers were aware of the deficits.

The administrative director's definition of "knowingly" relates only to knowledge imputed to a corporate entity. In so limiting the regulation, the definition eliminates an essential statutory requirement. If, in interpreting the enabling statute, the administrative agency has, in effect, altered or amended statute or enlarged or impaired its scope, then it must be declared void. Association for Retarded Citizens v. Department of Developmental Services (1985) 211 CR 758, 38 C3d 384. The administrative director's regulation must clearly define "a knowing violation" in terms of scienter or the regulation will fail to implement an essential element of the statute, create ambiguity and confusion among the regulated community by applying multiple layers of penalties for the same acts, and result in needless litigation over the intent and application of section 5814.6.

**Recommendation – 10225 (m)**
"Indemnity" means payments made directly to an eligible person as a result of a work injury and as required under Division 4 of the Labor Code. ~~, including but not limited to temporary disability indemnity, salary continuation in lieu of temporary disability indemnity, permanent disability indemnity, vocational rehabilitation temporary disability indemnity, vocational rehabilitation maintenance allowance, life pension and death benefits.~~

**Discussion**
For consistency, the definition of indemnity should be the same as any other regulatory definition. This definition could also be accomplished with a citation to other regulations defining the term.

**Recommendation -- 10225.1(a) – Awards of 5814 Penalties**
Administrative penalties shall only be imposed under this section ~~based on~~ when an employer or insurer has knowingly ~~violations of~~ violated Labor Code section 5814, after ~~more than one~~ penalty awards have been issued by a workers' compensation administrative law judge for unreasonable delay or refusal to pay compensation with a frequency that indicates a general business practice.

**Discussion**
In accordance with previous commentary, these revisions are required to be consistent and not in conflict with the statute.

**Recommendation -- 10225.1(g)(8) – Other Violations:**
Subsection (g)(8) should be deleted.

**Discussion**
The reference to “any other penalty award by a Workers’ Compensation Administrative Law Judge pursuant to Labor Code section 5814” seems to be unique to this subsection. Subsection (a), which refers to the entire penalty schedule, states that all penalties must be based on awards issued by a workers’ compensation administrative law judge. The reference is redundant and unnecessary.

Thank you for your consideration. Please contact for further clarification or if I can be of any other assistance.

Sincerely,

Michael McClain
General Counsel and Vice President

MMc/pm

cc: Destie Overpeck, DWC
CWCI Medical Care Committee
CWCI Claims Committee
CWCI Legal Committee
CWCI Associate Members