

STATE OF WASHINGTON

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BEFORE THE STATE OF WASHINGTON
OFFICE OF INSURANCE COMMISSIONER

In the Matter of)

Docket No. 13-0084

EDMUND C. SCARBOROUGH and)
WALTER W. WOLF,)

ORDER DENYING SCARBOROUGH'S
MOTION FOR SUMMARY
JUDGMENT AND GRANTING OIC'S
CROSS-MOTION FOR SUMMARY
JUDGMENT

Respondents.)

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NATURE OF PROCEEDING

On March 8, 2013, the Washington State Insurance Commissioner (“Commissioner” or “OIC”) issued a Notice of Request for Hearing for Imposition of Fines to Edmund C. Scarborough and Walter W. Wolf (collectively, “Respondents”). Said Notice of Request for Hearing proposes that the OIC take disciplinary action against the Respondents for alleged violations of the Insurance Code involving the sales and issuance of surety bonds to both federal and other entities.

Following various motions and prehearing conferences concerning primarily discovery issues and the issue of representation of the Commissioner by his OIC staff, on January 21, 2014, Respondent Scarborough (“Scarborough”) filed a Motion for Summary Judgment with Declaration of Scarborough in Support thereof. On February 3, 2014, the OIC filed its OIC’s Opposition to Scarborough’s Motion for Summary Judgment and Cross-Motion for Summary Judgment. On February 10, 2014, Scarborough filed a Reply in Support of his Motion for Summary Judgment and Declaration of Jason W. Anderson in Support thereof. The purpose of the instant proceeding was to hear and determine Scarborough’s and the OIC’s motions for summary judgment on the issues presented therein.

SCARBOROUGH’S MOTION FOR SUMMARY JUDGMENT;
OIC’S CROSS-MOTION FOR SUMMARY JUDGMENT

On January 21, 2014, Respondent Scarborough filed a Motion for Summary Judgment with Declaration of Scarborough in Support thereof. In his Motion, Scarborough requests that the undersigned grant judgment in his favor on four bases: (1) that Scarborough, who is a person who issues bonds as an individual surety, is not required to obtain a Certificate of Authority from the OIC or utilize or be licensed as a surplus lines broker in order to issue his bonds in Washington; (2) assuming that any part of the Insurance Code applies to individual sureties, the Code does not apply to federal projects where the federal government has accepted a bond issued by an individual surety; (3) assuming that an individual surety was required to obtain a Certificate of Authority from the OIC as an insurer before issuing bonds in Washington, the OIC is not authorized to impose a fine on that individual surety for failure to obtain the Certificate of Authority, and (4) assuming that the OIC was authorized to impose a fine on that individual surety for failure to obtain a Certificate of Authority before issuing bonds in Washington, the OIC is not authorized to impose cumulative fines on that individual surety. On February 3, 2014, the OIC filed its Opposition to Scarborough’s Motion and Cross-Motion for Summary Judgment on these same issues. Following Scarborough’s Reply with Declaration of Anderson in Support thereof which was filed February 10, 2014, the undersigned considered the parties’ arguments and made the following determinations:

1. Is Scarborough required to obtain a Certificate of Authority or utilize or be licensed as a surplus lines broker?

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Scarborough argues that he is an individual surety (i.e., a bond issued by an individual surety) and as such he is not governed by the Insurance Code and therefore not required to obtain a Certificate of Authority (or utilize or be licensed as a surplus lines broker). He argues that the Insurance Code applies to "surety insurance" but that term in the Insurance Code only includes insurance transactions by "corporate sureties" and not "individual sureties." Instead, he argues that chapter 19.72 RCW governs individual sureties, defining them, authorizing them, establishing the eligibility criteria and qualifications for them, and making clear that the Insurance Code (chapter 48.28 RCW) only governs corporate sureties. More specifically, Scarborough points out that RCW 19.72.060 provides: *Corporate surety. See surety insurance: Chapter 48.28 RCW* which he argues means that the "surety insurance" governed by chapter 48.28 RCW includes corporate sureties but not individual sureties. Scarborough further argues that a review of chapter 48.28 RCW also confirms that it applies only to a "surety insurer" which for purposes of that chapter means only corporate sureties and not individual sureties, e.g., RCW 48.28.050 provides *A surety insurer may be released from liability on the same terms and conditions as are provided by law for the release of individuals as sureties.* This statute, he argues, plainly recognizes that individual sureties may be sureties but they are governed by a different law than "surety insurers" meaning corporate sureties.

In response, the OIC argues, and cross-moves for summary judgment on this issue, that although there are differences between classic indemnity coverage and surety insurance, under the Insurance Code and case law precedent Scarborough's bonds are "insurance" governed by the Insurance Code. In support, the OIC cites RCW 48.01.040, which defines "insurance" as *a contract whereby one undertakes to indemnify another or pay a specified amount upon determinable contingencies.* Indeed, Scarborough's bonds promise that a contractor's failure to perform under a construction contract is a determinable contingency triggering Scarborough's duty (as the principal and surety) to make payment to others in the amount specified in the bond. Therefore, just as with a corporate surety, Scarborough undertakes to pay a specified amount upon determinable contingencies, and his bonds constitute "insurance" under the Insurance Code as defined in RCW 48.01.040. In addition, RCW 48.11.080(4) provides: *"Surety insurance" includes: ... (4) Guaranteeing the performance of contracts, ... and guaranteeing and executing bonds, undertakings, and contracts of suretyship.* This is precisely what Scarborough's bonds do. Further, even RCW 19.72(1), to which Scarborough refers, indicates that a "surety bond" under that section means and includes *any form of surety insurance as defined in RCW 48.11.080*, which emphasizes that the Legislature intended that the "surety bonds" addressed in RCW 19.72 are also a kind of "surety insurance" included in RCW 48.11.080 and therefore governed by the Insurance Code as well.

As the OIC argues, case law has also recognized that construction bonds such as Scarborough's performance and other bonds are properly considered "surety insurance" subject to provisions of the Insurance Code. E.g., citing RCW 48.11.080, the Washington State Supreme Court in Ritter¹

¹ *Ritter v. Shotwell*, 63 Wn.2d 601, 603 (1964).

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noted that [a] *performance bond is presently defined as 'surety insurance'*, and in Seattle-First² Nat'l Bank, the State Supreme Court stated that [s] *uretyship is a contractual relation whereby one person, called the surety, agrees to be answerable for the debt or default of another, called the principal. Hence, surety insurance is commonly defined as insurance against defaults on the part of persons who have undertaken contract obligations....surety insurance tends to insure against contractual default and establishes a surety-principal relationship.* Further, in Colorado Structures³, the State Supreme Court provided a more detailed explanation of its conclusion that surety bonds of compensated sureties are contracts of insurance: *The undertakings of compensated sureties are regarded as 'in the nature' of insurance contracts. ... A bond is a contract that governs the surety's liability to the obligee.* The bonds analyzed by the Court in Colorado Structures are the same as Scarborough's performance bonds, and in that case the Court found those bonds to be no different than any other insurance contracts, concluding that [t] *here is little to distinguish construction performance bonds from other forms of insurance.⁴*

After review, there is no dispute that the bonds which Scarborough issues in Washington are contracts which provide his promise (as the principal and surety in the contract) to pay the amount specified in the contract should a determinable contingency occur, the determinable contingency being a contractor's failure to perform under a construction contract. If and when a contractor fails to perform under the construction contract, Scarborough is obligated to make payment to others in the amount agreed upon in the contract. Based upon a reading of the Insurance Code including RCW 48.01.040, precedent provided in substantial case law on this issue and the arguments presented herein, it is hereby concluded that Scarborough's bonds fall squarely under the definition of "insurance" which is governed by the Insurance Code along with corporate sureties and classic indemnity insurance. It is further concluded that, based on the undisputed facts that Scarborough issued his bonds in Washington without holding a Certificate of Authority from the OIC (or utilized or been licensed as a surplus lines broker), Scarborough acted as an "insurer" by being in the business of making and otherwise "transacting" Washington insurance contracts without a Certificate of Authority issued by the OIC and thereby violated RCW 48.05.030(1) which provides that [n] *o person shall act as an insurer and no insurer shall transact insurance in this state other than as authorized by a certificate of authority issued to it by the commissioner....* In doing so, it is further concluded that Scarborough also violated RCW 48.15.020(1) which provides that *An insurer that is not authorized by the commissioner may not solicit insurance business in this state or transact insurance business in this state,* and he is an "unauthorized insurer" under chapter 48.15 RCW. Additionally, because it has been concluded that Scarborough's bonds are "insurance" governed by the Insurance Code, and because it is undisputed that Scarborough or his agents sold these bonds in Washington, this selling, soliciting and negotiation activity in Washington required Scarborough and/or his agents to hold a Washington producer's license under RCW 48.17.060(1) which provides that *A person shall not sell, solicit, or negotiate insurance in this state for any line or lines of insurance unless the person is licensed for that line of authority* Finally, it is hereby concluded that since

² *Seattle-First Nat'l Bank v. Wash. Ins. Guar. Ass'n*, 116 Wn.2d 398, 406 (1991).

³ *Colorado Structures, Inc. v. Ins. Co. of the West, et al.*, 161 Wn.2d 577, 586 (2007).

⁴ *Id.* at 605.

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Scarborough is an unauthorized insurer, and since the transaction and/or sale of this unauthorized insurance may only occur pursuant to RCW 48.15.040, if at all, and because Respondents were not licensed to conduct surplus lines business, Respondents' sale of these bonds violated RCW 48.15.020(2)(a) which prohibits a person from representing an unauthorized insurer without a license to conduct the business of surplus lines insurance. The OIC's cross-motion for summary judgment on these issues is granted.

2. Assuming that the Insurance Code applies to individual sureties, does the Insurance Code still apply when those individual sureties were accepted by the federal government relative to federal projects?

Scarborough cites three cases in support of his position that those of Scarborough's individual surety bonds which were accepted by the federal government relative to federal projects are exempt from the requirements of the Insurance Code. First, he argues that the U.S. Supreme Court's decision in Sperry⁵ applies, which ruled that [a] *state may not enforce licensing requirements which, though valid in the absence of federal regulation, give the state's licensing board a virtual power of review of the federal determination that a person or agency is qualified and entitled to perform certain functions, or which impose upon the performance of activity sanctioned by a federal license additional conditions not contemplated by Congress. Federal preemption of state laws and regulations will occur if enforcement of the state law would frustrate accomplishment of a federal purpose by providing for state review over a determination by the federal government.* In Leslie Miller⁶ (and the related case of Gartrell Construction⁷ which relied on and simply applied Miller), the U.S. Supreme Court held that a state may not require a contractor on a federal project to obtain a state contractor's license because enforcement of the state law would give the state licensing board a "virtual power of review" over the federal determination of whether a contractor is a "responsible bidder" noting that the factors identified by the state and federal laws for evaluating contractors were actually similar factors. Further, Scarborough argues that the federal Miller Act requires a contractor for a federal construction project to furnish bonds "for the protection of the United States." Under the Miller Act, each such bond must be approved by the federal contracting officer and the Federal Acquisition Regulation ("FAR") provides standards for acceptability of individual sureties for Miller Act bonds. This regulation allows acceptance of individual sureties and requires the contracting officer to ensure that the assets pledged by the surety are sufficient to cover the bond obligation: *An individual surety is acceptable for all types of bonds except The contracting officer shall determine the acceptability of individuals proposed as sureties, and shall ensure that the surety's pledged assets are sufficient to cover the bond obligation* and sets forth other requirements the federal contracting officer must meet relative to individual sureties to ensure that the unencumbered value of the assets pledged by the individual surety must equal or exceed the penal amount of each bond (and other factors to protect the federal government).

⁵ *Sperry v. State of Florida ex Rel. Florida Bar*, 373 U.S. 379 (1963).

⁶ *Leslie Miller, Inc. v. State of Ark.*, 352 U.S. 187 (1956).

⁷ *Gartrell Constr. Inc. v. Aubry*, 940 F.2d 437 (9th Cir. 1991).

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After review, case law other than that cited by Scarborough above actually offer more guidance in the instant situation. In *K-W Industries*,⁸ the court notes that *The U.S. Supreme Court has outlined three ways in which a federal law may preempt state law: the federal law may do so expressly; it may reflect a Congressional intent to occupy the entire legal field in the area; or the state law may conflict with the federal law either directly in that it is not possible to comply with both, or indirectly in that the state law is an obstacle to the accomplishment of the federal objective.* In *Medtronic v. Lohr*,⁹ the U.S. Supreme court indicated that it starts with the assumption that there is no federal preemption of an area (such as insurance) traditionally occupied by the states absent clear and manifest support: *Because the States are independent sovereigns in our federal system, we have long presumed that congress does not cavalierly preempt state-law In all pre-emption cases, and particularly in those in which Congress has "legislated ... in a field which the States have traditionally occupied," ..., we "start with the assumption that the historic police powers of the States were not to be superseded by the Federal Act unless that was the clear and manifest purpose of Congress."* This presumption against preemption can only be overcome by evidence of a "clear and manifest" intent of Congress to preempt state law.¹⁰

As the OIC argues, since passage of the McCarran-Ferguson Act, the U.S. Supreme Court has continued to recognize that it will exercise reluctance when it is asked to disturb the states' insurance regulatory schemes, noting that the regulation of insurance is one particular area that has long been occupied by the states. In *Variable Annuity Life Ins. Co.*,¹¹ the U.S. Supreme Court has indicated it will proceed *with a reluctance to disturb the state regulatory schemes that are in actual effect, either by displacing them or by superimposing federal requirements on transactions that are tailored to meet state requirements. When the States speak in the field of "insurance," they speak with the authority of a long tradition. For the regulation of "insurance," though within the ambit of federal power ..., has traditionally been under the control of the States.* This case and others disfavor Scarborough's argument that the Miller Act or the FAR, or both, preempt the Insurance Code.

Further, Scarborough's Motion does not point to any language in either the Miller Act or the FAR that expressly preempts the Insurance Code or that indicates a Congressional intent to occupy the entire legal field in the area of the regulation of insurance, which are the first two of the three grounds for preemption stated above. The only recognized ground upon which Scarborough appears to argue is the third ground, i.e., that preemption should lie in that he believes the Insurance Code conflicts with the Miller Act and/or FAR either directly (in that it is not possible to comply with both) or indirectly (in that the Insurance Code is an obstacle to the accomplishment of the federal objective supposedly reflected in the Miller Act and/or FAR). However Scarborough points to no directly controlling language, authority, or legal precedent which supports his preemption argument: his Motion fails to identify any court decision holding

⁸ *K-W Industries v. National Surety Corp.*, 885 F.2d 640, 642, fn. 3 (C.A. 9th Cir. 1988).

⁹ *Medtronic v. Lohr*, 418 U.S. 470, 485, 116 S.Ct. 2240, 135 L.Ed.2d 700 (1996).

¹⁰ *Wisconsin Public Intervenor v. Mortier*, 501 U.S. 597, 610, 111 S.Ct. 2476, 115 L.Ed.2d 532 (1991).

¹¹ *SEC v. Variable Annuity Life Ins. Co. of America et al*, 359 U.S. 65, 68-69 (1959).

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that the Miller Act or the FAR preempts state insurance regulators from regulating the business of insurance. Scarborough only supports his argument that the Miller Act implicitly preempts the Insurance Code by citing just one provision in the Miller Act (former 40 U.S.C. Sec. 270a(a)), however this provision contains no “clear and manifest” intent of Congress to preempt the Insurance Code, it does not show that Congress’ purpose was to displace state insurance regulations, and no case law has been cited to reflect that this was its intention or purpose. To the contrary, courts have held that *[t]he purpose of the Miller Act ‘is to protect persons supplying materials and labor for federal projects.’*¹² *The [Miller] Act simply requires the posting of a payment bond of a specified amount; it neither regulates the conduct of sureties nor ensures that such conduct remains unregulated.*¹³ *The Miller Act requires a contractor for a federal construction project to furnish a payment bond of a statutorily specified amount to secure payment for all suppliers of labor and material.*¹⁴ In addition, the Insurance Code does not conflict with the Miller Act either directly (i.e., in that it is not possible to comply with both) or indirectly (i.e., in that the Code is an obstacle to the accomplishment of the federal objective), no provision of the Miller Act cited by Scarborough demonstrates Congress’s intent to occupy the traditionally long held field of state insurance regulation, and none demonstrates that the Insurance Code conflicts with them. Indeed, not only is there no conflict between the Miller Act and the Insurance Code, but also the Insurance Code’s provisions are consistent with the Miller Act’s purpose of protecting the Federal Government and other parties to federal contracts/projects.

With regard to the several FAR provisions Scarborough argues present grounds for preemption, none demonstrate sufficient grounds to conclude that any of the FAR preempts the Insurance Code, none of them conflict with the Insurance code, and none of them show an intent to occupy or displace the Insurance Code. Scarborough does not argue that the Insurance Code’s requirements serve as an obstacle to the accomplishment of a federal objective contained in the provisions he cites. In fact, as above, not only is there no conflict between the Insurance Code and the FAR, but a key common purpose is shared between them: they, along with the Miller Act, all intend to protect parties to insurance contracts, including governmental entities and subcontractors that have fully performed. Indeed, federal courts have concluded that the Miller Act did not preempt state laws to prevent Miller Act sureties from being held civilly liable.¹⁵

Finally, while it appears that no court decision has specifically addressed the specific issue of whether the Miller Act or FAR preempt any state’s insurance regulatory requirements as to Miller Act sureties, the Montana State Auditor and Commissioner of Insurance in a 2007 order held that *the Miller Act was not intended to occupy the entire legal field of regulating sureties on federal construction projects and Montana law is not an obstacle to the objective of the Miller Act and the Act requires the posting of a bond, [but] does not regulate the conduct of sureties*

¹² *K-W Industries, supra*, at 642-43.

¹³ *Id.* at 642, fn. 3.

¹⁴ *Id.*

¹⁵ See, e.g., *Scandale Associated Builders & Engineers Ltd. V. Bell Justice Facilities Corp.*, 455 F.Supp.2d 271 (M.:D.Pa. 2006) and *K-W Industries, supra*.

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and does not provide that such sureties are unregulated by state law. [Declaration of Singer, Ex. A.] Thus, the Montana insurance regulator concluded that the purported individual surety was violating insurance laws by selling construction bonds without an insurer's license or other authority.

Based upon the above analysis, the OIC's cross-motion for summary judgment on the issue of whether the fact that some of Scarborough's individual sureties were accepted by the federal government relative to federal projects preempts the Insurance Code is granted. Those of Scarborough's individual sureties which were accepted by the federal government relative to federal projects are not preempted and are subject to the Insurance Code just as Scarborough's other non-federally related bonds are subject to the Insurance Code.

3. Assuming that Scarborough was required to obtain a Certificate of Authority as an insurer before issuing his bonds, is the Insurance Commissioner authorized to impose a fine on Scarborough for failure to obtain a Certificate of Authority?

Scarborough argues that even if the Code required Scarborough to obtain a Certificate of Authority from the Commissioner before selling his bonds, no provision of the code authorizes the Commissioner to impose a fine for failing to obtain a Certificate of Authority. This is because, Scarborough argues, the OIC's general authority to enforce the code is set forth in RCW 48.02.080 and includes the authority to issue a cease and desist order and bring an action in court to enforce such an order, but it does not authorize the OIC to impose a fine. Under RCW 48.05.185, Scarborough argues, the OIC is authorized to impose a fine *in addition to or in lieu of the suspension, revocation, or refusal to renew any certificate of authority* but if one does not have a Certificate of Authority then there is none to suspend, revoke or refuse to renew and as a result no fine may be imposed.

After review, RCW 48.05.185 does provide: *After hearing ... and in addition to or in lieu of the suspension, revocation, or refusal to renew any certificate of authority the commissioner may levy a fine upon the insurer in an amount not less than two hundred fifty dollars and not more than ten thousand dollars.* However, contrary to Scarborough's argument, RCW 48.05.185 authorizes the OIC to impose a fine whether or not there exists any Certificate of Authority to also *suspend, revoke or refuse to renew.* The OIC's authority to impose a fine under this statute is not conditioned on whether the person also has a Certificate of Authority for the OIC to suspend, revoke or refuse to renew. The OIC's cross-motion for summary judgment on this issue is granted.

4. Assuming that the OIC had authority to Impose a Fine on Scarborough for Failing to Obtain a Certificate of Authority before issuing his bonds, did the OIC have authority to Impose Cumulative Fines on Scarborough?

Scarborough argues that even assuming the OIC had authority to impose a fine for failing to obtain a Certificate of Authority, the maximum total fine would be \$10,000 regardless of the

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number of bonds issued, asserting that the statute under which the OIC imposes the fine on Scarborough for failure to obtain a Certificate of Authority is RCW 48.05.185, cited above. Scarborough argues that because this statute does not contain clear and unambiguous language demonstrating legislative intent to impose a separate penalty for each violation of a statute a court will presume that the Legislature intended to authorize a single fine even though more than one violation may have occurred, asserting that where the Legislature intends to permit cumulative fines for violation of a statute it has done so expressly. Indeed, as Scarborough points out, the Insurance Code alone contains over two dozen different provisions in which the legislature has used terms such as “per violation,” “each violation,” “each offense,” or “per day” to grant the OIC express authority to impose cumulative monetary penalties.

After review, the OIC is authorized to act against unauthorized insurers under multiple statutes, and not just under RCW 48.05.185 which is addressed by Scarborough. In this matter, in both the Notice of Request for Hearing for Imposition of Fines and in the OIC’s November 1, 2013 letter,¹⁶ Scarborough was informed that at hearing fines of \$25,000 will be sought for each violation, such as for each bond sold because, in part, Scarborough’s transaction of insurance as an unauthorized insurer in this state violated RCW 48.15.020(1) which provides that *[a]n insurer that is not authorized by the commissioner may not solicit insurance business in this state or transact insurance business in this state,* RCW 48.15.023(5)(a)(ii) expressly provides that *If the commissioner has cause to believe that any person has violated the provisions of RCW 48.15.020(1), the commissioner may: ... (ii) Assess a civil penalty of not more than twenty-five thousand dollars for each violation, after providing a notice and an opportunity for a hearing in accordance with chapters 34.05 and 48.04 RCW.* Therefore RCW 48.15.023(5)(a) expressly authorizes the OIC to seek the fines the OIC seeks here against the unauthorized insurer, Scarborough, and to calculate those fines for each violation. The OIC’s cross-motion for summary judgment is granted on this issue.

In addition, Scarborough’s representation of an unauthorized insurer violated RCW 48.15.020(2)(a) which provides that *A person may not, in this state, represent an unauthorized insurer* RCW 48.15.020(3) provides that *Each violation of subsection (2) of this section constitutes a separate offense punishable by a fine of not more than twenty-five thousand dollars,* Therefore RCW 48.15.020(3) expressly authorizes the OIC to impose a fine on Scarborough for his activities in representing an unauthorized insurer of not more than \$25,000 per violation for every violation involving a solicitation or a transaction of insurance business in this state. The OIC’s cross-motion for summary judgment is granted on this issue.

Finally, pursuant to RCW 48.15.023(2), for purposes of identifying the violations involved in this matter and calculating the fines permitted under RCW 48.15.023 for these activities, RCW 48.15.023(2) provides that *For purposes of this section, an act is committed in this state if it is committed, in whole or in part, in the state of Washington, or affects persons or property within*

¹⁶ Filed as an attachment to the OIC’s Declaration in support of its Motion to Compel herein.

the state and relates to or involves an insurance contract. The OIC's cross-motion for summary judgment on this issue is granted.

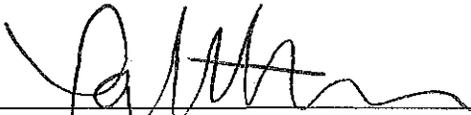
ORDER

Based upon the above activity,

IT IS HEREBY ORDERED that Respondent Scarborough's Motion for Summary Judgment is DENIED.

IT IS FURTHER ORDERED that the OIC's Cross-Motion for Summary Judgment is GRANTED as to all of the issues as set forth above.

ENTERED AT TUMWATER, WASHINGTON, this 16th day of April 2014, pursuant to Title 48 RCW and specifically RCW 48.04 and Title 34 RCW and regulations applicable thereto.



PATRICIA D. PETERSEN
Chief Presiding Officer

Declaration of Mailing

I declare under penalty of perjury under the laws of the State of Washington that on the date listed below, I mailed or caused delivery through normal office mailing custom, a true copy of this document to the following people at their addresses listed above: Walter W. Wolf, James A. McPhee, Esq., Michael Miles, Esq., Timothy J. Parker, Esq., Jason W. Anderson, Esq., Mike Kreidler, James T. Odiorne, John F. Hamje, Esq., AnnaLisa Gellermann, Esq. and Alan Singer, Esq.

DATED this 17th day of April 2014.



KELLY A. CAIRNS