2nd Civ. No. B194463

IN THE COURT OF APPEAL
OF THE STATE OF CALIFORNIA
SECOND APPELLATE DISTRICT, DIVISION 1

JERRY HILL, JOSEPHINE HILL, WILSON MALLORY AND NORENE MALLORY,
Individually and on Behalf of Themselves and All Others Similarly
Situated and on Behalf of the Plaintiff Class
Plaintiffs - Appellants,

v.

STATE FARM MUTUAL AUTOMOBILE INSURANCE COMPANY,
Defendant - Respondent.

TAKEN FROM AN ORDER OF THE LOS ANGELES COUNTY SUPERIOR COURT
THE HONORABLE CAROLYN B. KUHL, JUDGE PRESIDING
CASE NO. BC194491 (CLASS ACTION)

APPLICATION FOR LEAVE TO FILE AMICUS CURIAE BRIEF AND [PROPOSED] AMICUS CURIAE BRIEF OF NATIONAL ASSOCIATION OF INSURANCE COMMISSIONERS IN SUPPORT OF DEFENDANTS-RESPONDENTS

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APPLICATION FOR LEAVE TO FILE AMICUS CURIAE BRIEF

To the Honorable Presiding Justice:

The National Association of Insurance Commissioners (NAIC), by its undersigned counsel, respectfully requests leave to file the attached Amicus Curiae Brief in support of Respondents State Farm Mutual Automobile Insurance Company (State Farm).

To support this application, the NAIC offers the following explanation:

The NAIC, representing the interests of chief insurance regulators nationwide, is concerned that, if the Superior Court's ruling were reversed, the remedy and class relief originally requested by Appellants would necessarily require a court to determine the adequacy of the surplus of an insurance company whose financial regulation is the statutory responsibility of a department of insurance in a different state.

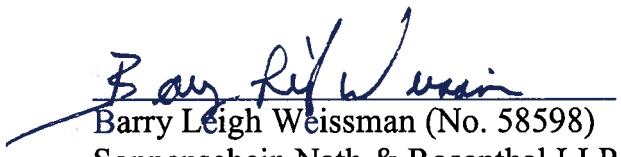
Due to its extensive experience in the content and application of state insurance laws, many of which are based on NAIC model laws, the NAIC is uniquely qualified to assist this court in determining whether the Superior Court's judgment should be affirmed.

The NAIC will show that under the established system of state insurance regulation, the domiciliary regulator of an insurance company is primarily responsible for monitoring and enforcing financial solvency laws, regulations and rules. The NAIC will also show that failure to uphold the Superior Court's judgment would open the door to further proceedings, the result of which could have troublesome implications for insurance consumers, insurers and state insurance regulators that extend beyond the case at hand.

WHEREFORE, the NAIC respectfully prays this court grant it leave to file the attached Amicus Curiae Brief.

Dated: October 23, 2007

Respectfully submitted,



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AMICUS CURIAE BRIEF
NATIONAL ASSOCIATION OF INSURANCE COMMISSIONERS

I. INTEREST OF AMICUS CURIAE.

Founded in 1871, the NAIC is a voluntary association of the chief insurance regulators in the 50 states, the District of Columbia, and five territories and insular possessions of the United States. As a private, not-for-profit corporation, the NAIC's purpose is to provide its members with a national forum for discussing common issues and interests and for working cooperatively on regulatory matters that transcend the boundaries of their own jurisdictions. Collectively, commissioners work to develop model legislation, rules, regulations and white papers to coordinate regulatory policy. Their overriding objectives are to protect consumers and help maintain the financial stability of the insurance industry. The NAIC acts to support regulators in achieving these fundamental objectives.

The NAIC performs numerous crucial services on behalf of state government, including the management of accreditation standards for and coordination of the review of insurance departments, the operation of extensive solvency, financial and regulatory databases and regulatory analysis of insurance company financial data, education and training programs for state, federal and international financial regulators, the operation of the Securities Valuation Office and the International Insurers Department, the development and publication of model laws, regulations and bulletins, financial and accounting standards, coordination of quarterly national meetings and interim meetings of various NAIC committees, task forces and working groups and the creation and publication of white papers, consumer guides, handbooks, periodicals and the *Proceedings of the NAIC*. Hundreds of state and federal laws assign duties to the NAIC and make

reference to and incorporate NAIC standards, models and publications.[1]

The members of the NAIC are uniquely qualified and situated to assist the court by presenting the regulatory and public policy concerns involved in this case. Individually and collectively, the members of the NAIC have a wealth of experience in the financial regulation of insurers. The members of the NAIC have this experience, and are interested in this case, because they are required by federal and state law to regulate the corporate and financial affairs of insurers, which the Plaintiffs-Appellants in this case would have the trial court undertake.

For more than 100 years, states have possessed the authority to regulate the business of insurance. In 1945, Congress codified the primacy of state regulation by enacting the McCarran-Ferguson Act.[2] With regard to the McCarran-Ferguson Act, the Supreme Court has stated that "[t]he views of the NAIC are particularly significant, because the Act ultimately passed was based in large part on the NAIC bill."[3] Furthermore, the Superior Court relied on at least two references published by the NAIC in the decision that is the subject of this appeal.[4]

Recognizing this longstanding regulatory system, the court is obliged to carefully weigh the potential impact of the outcome prayed for by Appellants against the statutory authority of state regulators to

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[1] *See* CAL. INS. CODE § 931 (West 2005).
[2] 15 U.S.C. §§ 1011-1015 (2000).
[3] *Group Life and Health Ins. Co. v. Royal Drug Co.*, 440 U.S. 205, 221 (1979).
[4] *Hill v. State Farm Mutual Automobile Ins. Co.*, slip op. at 7 and 10 (Los Angeles Super. Ct. Aug. 3, 2006) (citing R. KLEIN, A REGULATOR'S INTRODUCTION TO THE INSURANCE INDUSTRY (1st ed. 1999) and the Journal of Insurance Regulation).

effectively regulate the solvency of insurers. The impact of the potential remedy in this case poses troublesome implications for insurance consumers, insurers and state insurance regulators that could extend well beyond the case at hand. Because it is the responsibility of state insurance regulators to protect consumers and to "promote the reliability, solvency and financial stability of insurance institutions," in the words of the NAIC mission statement,[5] the NAIC asks to appear before this court.

For purposes of this amicus curiae brief, the NAIC adopts State Farm's statement as to the Factual Background and Standard of Review. The NAIC joins State Farm in respectfully urging the court to affirm the Superior Court's judgment.

II. THE NATIONAL SYSTEM OF STATE-BASED INSURANCE REGULATION REQUIRES DEFERENCE TO THE DOMICILIARY STATE IN THE REGULATION OF AN INSURER'S FINANCIAL CONDITION.

In 1945, Congress placed responsibility for insurance regulation with the states by declaring "that the continued regulation and taxation by the several States of the business of insurance is in the public interest ... ."[6] The McCarran-Ferguson Act further provides that "[t]he business of insurance ... shall be subject to the laws of the several States which relate to the regulation or taxation of such business."[7]

State insurance regulators have carried out this legislative mandate by developing a complex and interdependent system of regulation, which

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[5] NAIC Mission Statement, http://www.naic.org/index_about.htm (last visited October 16, 2007).
[6] 15 U.S.C. § 1011 (2000).
[7] 15 U.S.C. § 1012 (2000).

applies to not only insurance companies but also insurance agents and related service providers. Over the last 130 years, insurance regulation has developed along two tracks, one related to regulating the market, the conduct of insurers, their contracts with policyholders, and the other related to financial and solvency regulation of the insurer's corporate and financial affairs.[8]

The primary regulator of each insurer's financial and corporate affairs is the state where an insurer's principal place of business is located- the domiciliary regulator. This is financial and solvency regulation. The collective states where an insurer has a presence rely on the domiciliary regulator to effectively monitor and, if necessary, to act to protect the financial condition and solvency of that state's domestic insurers. However, there is no question that state regulators other than the domiciliary must be allowed to regulate the conduct of insurers in their markets. This is market regulation.

This system of domiciliary deference was formally established in the NAIC Financial Regulation Standards and Accreditation Program.[9] By adopting a series of baseline laws, regulations, practices and procedures in conformance with duly adopted program standards, accredited states rely on the domiciliary state's solvency regulation in lieu of conducting redundant, and possibly conflicting, examinations and analyses of multi-state insurance companies.

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[8] R. KLINE, A REGULATOR'S INTRODUCTION TO THE INSURANCE INDUSTRY, 123, 140-194 (2d ed. 2005).

[9] *See generally* Financial Regulation Standards and Accreditation Program Informational Pamphlet, http://www.naic.org/documents/committees_f_FRSA_pamphlet.pdf (last visited October 17, 2007) (containing general program information).

It is this very reliance that is threatened when courts intervene in matters involving solvency regulation. In an earlier decision in this case, this court held that Illinois substantive law governs this case.[10] While the application of Illinois law was an important question in the consideration of this case, the choice of laws is not the only question on which the Illinois legal and regulatory system should be given deference. A similarly critical question is whether the financial and solvency regulation undertaken by Illinois, as the domiciliary regulator of State Farm, can be supplanted by the judgment of a California court or jury.

Financial and solvency regulation includes the verification and oversight of capital and surplus requirements, the adequacy of which are the foundation of the complaint at issue. If the Superior Court's judgment were reversed and the adequacy of State Farm's capital and surplus as a business decision were open to question, California would in fact be regulating an Illinois domestic insurer's corporate and financial affairs. The NAIC believes that California should defer to Illinois on the regulation of the financial and corporate affairs of Illinois domestic insurers.

III. TO SUBJECT THE CAPITAL AND SURPLUS DETERMINATIONS OF THE BOARD OF DIRECTORS TO POTENTIAL REVERSAL RISKS ABANDONMENT OF THE MUTUAL STRUCTURE OF INSURANCE COMPANIES.

As the Superior Court found, the decision of the State Farm Board of Directors whether to declare a dividend was discretionary according to the

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[10] *Hill v. State Farm Mutual Automobile Ins. Co.*, 114 Cal. App. 4th 434, 442 (2003).

governing insurance policies and the company's bylaws.[11] In deciding questions related to dividends and surplus, the governing board of a mutual insurance company like State Farm encounters distinctive considerations based on the mutual ownership structure of the insurer. In the chapter on insurer organizational forms in A Regulator's Introduction to the Insurance Industry, the author discusses the nature of mutual insurers:

> [M]utual insurers are not motivated by profits but, rather, to serve their policyholder-members. This may be reflected in lessened incentives to incur risk in return for greater income, although growth may still be an important objective for some mutual insurers. On the other hand, mutual insurers have greater difficulty in raising capital to fund growth and, hence, must rely to a greater extent on accumulated surplus and income from new members to support growth. Scholars also believe that the managers of mutual insurers tend to exercise more discretion, which tends to favor long-term stability over greater risk.[12]

The difficulty for mutual insurers to raise capital for growth, which in some markets impacts the insurers' financial strength and even its solvency, has lead to greatly increased activity in insurer demutualizations. One study of demutualization of property-casualty insurers found little conclusive evidence of efficiency or profitability benefits:

> Demutualization is associated with greater concentration in property and liability coverages, an increase in the expense ratio, and

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[11] *Hill v. State Farm Mutual Automobile Ins. Co.*, slip op. at 10 (Los Angeles Super. Ct. Aug. 3, 2006).

[12] R. KLINE, A REGULATOR'S INTRODUCTION TO THE INSURANCE INDUSTRY 60-61 (2d ed. 2005) (references omitted).

> an increase in turnover of management. The change in business mix affects the organization's underwriting expense and creates a need for managerial expertise in the emphasized lines of insurance. ... However, the change in business mix is not associated with improved profitability as captured by financial statements for the four years following conversion.[13]

Demutualization and other types of conversions undertaken by mutual insurance companies are only one costly risk associated with the type of second-guessing urged by Appellants. This is not to say demutualization or other types of conversions are necessarily disfavored in every situation. Rather, the NAIC believes the decision to demutualize should not be driven by fear of litigation over surplus but by policyholder benefit and financial solvency, matters better left with the companies and the regulators.

IV. PLAINTIFFS SEEK A JUDICIAL REMEDY THAT FAILS TO CONSIDER, AND MAY PREEMPT, APPLICABLE SOLVENCY AND RISK ASSESSMENT STANDARDS APPLIED BY STATE INSURANCE REGULATORS

To the extent that the plaintiff asked the Superior Court to substitute its judgment for that of the company's board of directors, as overseen by the domestic regulator, the NAIC respectfully suggests that such a decision could engender the type of conflict that the national system of state-based insurance regulation was designed to avoid. As this court previously held, determining the adequacy of an insurer's surplus is presumed to be within

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[13] Julie A.B. Cagle, Robert L. Lippert and William T. Moore, *Demutualization in the Property-Liability Insurance Industry*, 14 J. INS. REGULATION 343, 367 (1996).

the business judgment of the insurer's board of directors,[14] with the regulatory oversight of state regulators, who possess the expertise to interpret and apply solvency laws and regulations.

The laws of most jurisdictions establish specific and certain minimum capital and surplus requirements for domestic companies and there is no contention that the surplus of State Farm's does not exceed the minimum capital and surplus requirements in every jurisdiction in which it does business.

It is critically important to note that statutory requirements establish merely the minimum level of surplus to be maintained. In the case of a large insurer such as State Farm, it is prudent and practically essential to maintain surplus in excess of the statutory minimum. In fact, insurance regulators are required by law to look beyond the statutory minimum in assessing an insurer's overall financial condition.[15]

Beyond the statutory minimum surplus level, it is the insurer, with the oversight of the domestic regulator, for State Farm, the Director of the Division of Insurance of the Illinois Department of Financial and Professional Responsibility, who is responsible for determining and maintaining reserves sufficient to ensure financial stability. Each company

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[14] *Hill v. State Farm Mutual Automobile Ins. Co.*, 114 Cal. App. 4th 434, 450 (2003).

[15] In California, the regulator is authorized to order corrective action based on reasonable belief the company is conducting its business and affairs in a manner which is hazardous to its policyholders, creditors or the public. CAL. INS. CODE § 1065.1 (West 2005). In Illinois, the regulator may order corrective action based on the company's failure "to maintain a relationship of policyholder surplus to premium writings or policyholder surplus to claim and unearned premium reserves." 215 ILL. COMP. STAT. 5/186.1 (West, Westlaw through 2007 Reg. Sess.).

has a unique mix of underwriting risks, premium volume and investment value. Balancing and weighing these complicated factors is the responsibility of the entity most familiar with these factors—the insurance company at the direction of its duly appointed officers and directors.

The fact that the several states rely on the insurer's domiciliary state to determine reasonable surplus is a direct result of the inherent variability of each company's needs. The statutory framework illustrates the fluidity that enables state insurance regulators to tailor solvency regulation to an individual insurer's needs.

A judicial determination of what should be a maximum surplus level for an insurer presents a substantial insurance risk. A distribution of "excess" surplus today would only increase the risk of inadequate surplus in the future, leaving insurers vulnerable to unforeseeable and unknowable circumstances in every jurisdiction in which it does business. The consideration of the dollar amount of the surplus, of known and unknown exposures, investment risk, risk from catastrophic losses and risks from potential failure of reinsurers are technically complex, particularly for a multi-jurisdictional, multi-line company—which is why federal law assigns this role to the states severally.

If the Superior Court's judgment were overturned in the present case and the business judgment rule found inapplicable, it is entirely conceivable the remedy may consist of an accounting whereby the unassigned surplus or "excess surplus" of an ongoing mutual insurer is determined as a means of arriving at a judicial remedy under contract law. In reaching this remedy, a court may develop or create principles which are not consistent with the well-recognized statutory accounting and risk assessment principles utilized by state insurance regulators. Thus, the possibility exists

that a remedy may be applied that has significant implications for state insurance regulators.

The remedy sought in the pending proceeding may, if granted, be viewed as a de facto preemption of the Illinois Insurance Director's authority to require surplus in excess of the statutory minimum. In other words, a financial award of sufficient magnitude could develop or create principles that are not consistent with the well-recognized statutory accounting and risk assessment principles utilized and enforced by state insurance regulators. The NAIC is alarmed by this potential for judicial determinations of adequate capital and surplus to conflict with corporate determinations subject to statutory oversight.

V. CONCLUSION

In the present case, there is the potential for a judicial determination of solvency standards, which are historically and statutorily within the province of state insurance regulators. The NAIC believes such a determination would have significant negative implications for consumer interests that have traditionally been protected by state insurance regulators as part of the executive branch of government. Solvency regulation has historically relied upon the considerable expertise of the domiciliary insurance regulator to regulate the financial affairs of its insurers no matter where such companies may do business. In its role as the facilitator of national insurance policy and regulation, the NAIC therefore respectfully offers this court the foregoing public policy background information in support of State Farm and its prayer that the Superior Court's judgment be affirmed.

CERTIFICATE OF INTERESTED ENTITIES OR PERSONS

California Rules of Court, Rule 8.208

Case Caption:

Jerry Hill, Josephine Hill, Wilson Mallory and Norene Mallory,

v.

State Farm Mutual Automobile Insurance Company, et al.

Case No. B194463

Name of Interested Entity or Person	**Nature of Interest**
Jerry Hill	Plaintiff
Josephine Hill	Plaintiff
Wilson Mallory	Plaintiff
Norene Mallory	Plaintiff
State Farm Mutual Automobile Insurance Company	Defendant
National Association of Insurance Commissioners	Amicus Curiae
American Insurance Association	Amicus Curiae
Association of California Insurance Companies	Amicus Curiae
Pacific Association of Domestic Insurance Companies	Amicus Curiae
Freedom Works	Amicus Curiae
Personal Insurance Federation of California	Amicus Curiae
National Association of Mutual Insurance Companies	Amicus Curiae
National Conference of Insurance Legislators	Amicus Curiae

Please check here if applicable:

_____ There are no interested entities or parties to list in this Certificate per California Rules of Court, Rule 8.208(d)(3).

Date: October 23, 2007

Signature of Attorney for Amicus Curiae

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Los Angeles, CA 90017-5704

Party Represented: National Association of Insurance Commissioners

CERTIFICATE OF COMPLIANCE WITH CALIFORNIA RULE OF COURT 14(C)

Pursuant to California Rule of Court 14(C), I certify that the attached Brief of Amicus Curiae is proportionately spaced, has a typeface of 13 points and contains 3,542 words.

Dated: October 23, 2007

Respectfully submitted,

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CERTIFICATE OF SERVICE

The undersigned hereby certifies that a copy of the Brief Amicus Curiae was served overnight courier to each of said addresses on October 23, 2007

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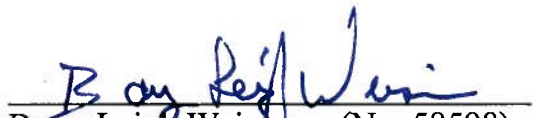
and that the original was filed with the Clerk of the Court in which said cause is pending.

Dated: October 23, 2007

Respectfully submitted,



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